2007

AICPA audit and accounting manual as of July 1, 2007 : nonauthoritative technical practice aid

Kenneth R. Biser

Christopher Cole

Kristy L. Illuzzi

Lori L. Pombo

American Institute of Certified Public Accountants. Accounting and Auditing Publications

AICPA Audit and Accounting Manual

Nonauthoritative Practice Aids

As of July 1, 2007

AICPA

American Institute of Certified Public Accountants

AICPA Audit and Accounting Manual
As of July 1, 2007

AICPA

AICPA Member and Public Information:
www.aicpa.org

AICPA Online Store:
www.cpa2biz.com

ISO Certified

005137

AICPA Audit and Accounting Manual

Nonauthoritative Practice Aids

Edited by:
Kenneth R. Biser
Christopher Cole
Kristy L. Illuzzi
Lori L. Pombo
Technical Managers
Accounting and Auditing Publications

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

As of July 1, 2007

AICPA®

0573-344

TABLE OF CONTENTS

[*The next page is 1*.]

HOW *AUDIT AND ACCOUNTING MANUAL* IS ORGANIZED

This edition contains the following significant additions:

- Updated illustrative inquiries for a review of financial statements to reflect the issuance of Statement on Standards for Accounting and Review Services No. 13, *Compilation of Specified Elements, Accounts, or Items of a Financial Statement* (AICPA, *Professional Standards*, vol. 2, AR sec. 110), and Statement on Standards for Accounting and Review Services No. 14, *Compilation of Pro Forma Information* (AICPA, *Professional Standards*, vol. 2, AR sec. 120) [AAM section 2000]
- Added changes due to issuance of the new Statements on Auditing Standards (SAS) Nos. 104–111 (the risk assessment standards) [AAM sections 3000, 4000, and 5000]
- Updated communication with those charged with governance to reflect issuance of SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380) [AAM section 7000]
- 2006/2007 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 & Representations
Alerts
Accountants' Reports
Quality Control

Description of Content . . .

The major divisions are subdivided into sections, each with its own section number. Each paragraph within a section is decimally numbered. For example, AAM section 7100.01 refers to the first paragraph of section 7100, *Control of Confirmations and Correspondence*.

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

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

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.

TABLE OF CONTENTS

[*The next page is 1101*.]

AAM Section 1100
Introduction

.01 This manual has been prepared by the staff of the American Institute of Certified Public Accountants (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 must be applied by practitioners. The manual, where practicable, offers choices and alternatives rather than particular positions. The manual is not a substitute for the authoritative technical literature and users are urged to refer directly to applicable authoritative pronouncements for the text of technical standards.

.02 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 (PCAOB).

.03 Some sections of the manual include quotations from Statements on Auditing Standards (SAS) 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:

APB =	AICPA Accounting Principles Board Opinion
AR =	Reference to section number in AICPA *Professional Standards*
ARB =	AICPA Accounting Research Bulletin
AT =	Reference to section number in AICPA *Professional Standards*
AU =	Reference to section number in AICPA *Professional 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 =	FASB Interpretation
FSP =	FASB Staff Positions
PB =	AcSEC Practice Bulletin
QC =	Reference to section number in AICPA *Professional Standards*
SAS =	AICPA Statement on Auditing Standards
SFAS =	FASB Statement of Financial Accounting Standards

SOP =	AICPA Statement of Position
SQCS =	Statement on Quality Control Standards
SSAE =	Statement on Standards for Attestation Engagements
SSARS =	Statement on Standards for Accounting and Review Services

.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
AICPA
220 Leigh Farm Road
Durham, NC 27707-8110

AICPA TECHNICAL HOTLINE

The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services.

Call Toll Free

(888) 777-7077

This service is free to AICPA members.

[*The next page is 1201.*]

AAM Section 1200

How to Use the Audit and Accounting Manual

Overview

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

Section No.	*Section Name*
2000	Compilation and Review
3000	Engagement Planning & Administration
4000	Internal Control
5000	Designing and Performing Further Audit Procedures
6000	Audit Documentation
7000	Correspondence, Confirmations & 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. The Quality Control section [AAM section 10,000] includes sample forms which can be used by a firm to document its adherence to the AICPA requirement for a System of Quality Control for a CPA Firm. Included in this section are forms that relate to the five elements of Quality Control:

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

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

c. The Internal Control section [AAM section 4000] conforms to the *Internal Control—Integrated Framework,* published by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO report) and 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. The Designing and Performing Further Audit Procedures section [AAM section 5000] explains how the auditor should design and perform tests of controls or substantive procedures or both that are responsive to the assessed risks of material misstatement.

e. The Audit Documentation section [AAM section 6000] provides the auditor with a general discussion of the purpose of audit documentation.

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

g. The Accountants' Reports section [AAM section 9000] addresses the format of the accountants' report and numerous examples of the auditor's report.

Compilation and Review Services

.07 To perform either a review or compilation engagement in accordance with Statements on Standards for Accounting and Review Services (SSARS), an accountant must comply with the standards promulgated by the Accounting and Review Services Committee. There have been 14 statements issued.

.08 SSARS No. 1, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR sec. 100), provides guidance to accountants concerning the standards and procedures applicable to compilation and review services for a nonpublic entity. The statement also provides examples of standard single year reports and departures from those reports.

.09 SSARS No. 2, *Reporting on Comparative Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR sec. 200), establishes standards for reporting on comparative financial statements of a nonpublic entity when one or more prior periods have been compiled or reviewed in accordance with SSARS No. 1.

.10 SSARS No. 3, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms* (AICPA, *Professional Standards*, vol. 2, AR sec. 300), provides an alternative form of standard compilation report when reporting on a prescribed form calls for a departure from generally accepted accounting principles (GAAP).

.11 SSARS No. 4, *Communications Between Predecessor and Successor Accountants* (AICPA, *Professional Standards* vol. 2, AR sec. 400), provides guidance to a successor accountant who communicates with a predecessor accountant regarding acceptance of an engagement to compile or review financial statements of a nonpublic entity.

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

.13 SSARS No. 6, *Reporting on Personal Financial Statements Included in Written Personal Financial Plans* (AICPA, *Professional Standards*, vol. 2, AR sec. 600), provides an exemption from SSARS No. 1 for personal financial plans.

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

.15 SSARS No. 8, *Amendment to Statements on Standards for Accounting and Review Services No. 1,* Compilation and Review of Financial Statements (AICPA, *Professional Standards*, vol. 2, AR sec. 100), provides communication and performance requirements for unaudited financial statements submitted to a client that are not expected to be used by a third party.

.16 SSARS No. 9, *Omnibus Statement on Standards for Accounting and Review Services—2002* (AICPA, *Professional Standards*, vol. 2, AR secs. 100 and 400).

.17 SSARS No. 10, *Performance of Review Engagements* (AICPA, *Professional Standards*, vol. 2, AR sec. 100), expands on previous guidance on analytical procedures, inquiries, and other review procedures.

.18 SSARS No. 11, *Standards for Accounting and Review Services* (AICPA, *Professional Standards*, vol. 2, AR sec. 50), clarifies the standards by which the SSARS are issued and defines terms that are used to describe certain publications. SSARS No. 11 also amends SSARS No. 2, paragraph 17, footnote 9.

.19 SSARS No. 12, *Omnibus Statement on Standards for Accounting and Review Services—2005* (AICPA, *Professional Standards*, vol. 2, AR secs. 100 and 200).

.20 SSARS No. 13, *Compilation of Specified Elements, Accounts, or Items of a Financial Statement* (AICPA, *Professional Standards*, vol. 2, AR sec. 110), 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.

.21 SSARS No. 14, *Compilation of Pro Forma Financial Information* (AICPA, *Professional Standards*, vol. 2, AR sec. 120), expands SSARS to apply when an accountant is engaged to compile or issues a compilation report on pro forma financial information.

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

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

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

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

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

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

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

Correspondence, Confirmations & Representations [AAM section 7000]

Quality Control [AAM section 10,000]

Audit Risk Alerts

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

[*The next page is 2001.*]

AAM Section 2000
Compilation and Review

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

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

TABLE OF CONTENTS

[*The next page is 2101.*]

AAM Section 2100
Introduction

.01 Statements on Standards for Accounting and Review Services (SSARS) are issued by the American Institute of Certified Public Accountants (AICPA) Accounting and Review Services Committee (ARSC), the senior technical committee of the AICPA designated by its Council to issue pronouncements in connection with unaudited financial statements and other unaudited financial information of nonpublic entities. (A complete listing of SSARS and the full text can be found in AICPA *Professional Standards,* vol. 2.) A nonpublic entity is defined as any entity other than (*a*) one whose securities trade in a public market either on a stock exchange or over the counter, (*b*) one that files with a regulatory agency in preparation for the sale of any class of its securities in a public market, or (*c*) subsidiary, corporate joint venture, or other entity controlled by an entity covered by (*a*) or (*b*). Thus, if an entity does not fall into either category (*a*), (*b*), or (*c*) in the above definition, it is a nonpublic entity.

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

Standards for Accounting and Review Services

.03 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.

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

.05 Rule 202, *Compliance With Standards*, of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET section 202.01), requires an AICPA member who performs compilations or reviews to 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.

.06 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

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

.08 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

.09 *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.

.10 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

.11 ARSC has issued 14 Statements on Standards for Accounting and Review Services. They are

- SSARS No. 1, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR sec. 100) (December 1978)

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

- SSARS No. 2, *Reporting on Comparative Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR sec. 200) (October 1979)

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

- SSARS No. 3, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms* (AICPA, *Professional Standards*, vol. 2, AR sec. 300) (December 1981)

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

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

- SSARS No. 4, *Communications Between Predecessor and Successor Accountants* (AICPA, *Professional Standards*, vol. 2, AR sec. 400) (December 1981)

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

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

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

- SSARS No. 6, *Reporting on Personal Financial Statements Included in Written Personal Financial Plans* (AICPA, *Professional Standards*, vol. 2, AR sec. 600) (September 1986)

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

  — Will be used solely to assist the client and the client's advisors to develop the client's personal financial goals and objectives

  — Will not be used to obtain credit or for any other purpose

  — Indicate that nothing comes to the CPA's attention during the engagement that causes him to believe that the financial statements will be used to obtain credit or for other purposes

- SSARS No. 7, *Omnibus Statement on Standards for Accounting and Review Services—1992* (November 1992)

  Contains a number of technical amendments to various standards.

- SSARS No. 8, *Amendment to Statement on Standards for Accounting and Review Services No. 1*, Compilation and Review of Financial Statements (October 2000)

  Amends SSARS No. 1 to create a management-use-only compilation (and make other changes).

- SSARS No. 9, *Omnibus Statement on Standards for Accounting and Review Services—2002* (November 2002)

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

- SSARS No. 10, *Performance of Review Engagements* (May 2004)

  Amends SSARS No. 1, *Compilation and Review of Financial Statements*, by:

  — Expanding on previously provided guidance on analytical procedures, inquiries, and other review procedures

  — Providing inquiries regarding fraud that the accountant should consider making in a review engagement

  — Requiring representations regarding fraud in the management representation letter

  — Clarifying and providing guidance regarding documentation in a review engagement

- SSARS No. 11, *Standards for Accounting and Review Services* (AICPA, *Professional Standards*, vol. 2, AR sec. 50) (May 2004)

  — Establishes a SSARS hierarchy

  — Makes practitioners aware of the appropriate literature and the standing of various publications in the SSARS hierarchy

  — In addition, it amends footnote 9 of SSARS No. 2, *Reporting on Comparative Financial Statements*, so that it conforms with the guidance in footnote 29 of AU section 508, *Reports on Audited Financial*

Statements (AICPA, *Professional Standards*, vol. 1), which states that a successor auditor may name the predecessor auditor if the predecessor auditor's practice was acquired by, or merged with, that of the successor auditor

- SSARS No. 12, *Omnibus Statement on Standards for Accounting and Review Services—2005* (AICPA, *Professional Standards*, vol. 2, AR sec. 200) (July 2005)

  Amends SSARS No. 1, *Compilation and Review of Financial Statements*, by:

  — Requiring the accountant to establish an understanding with the client, 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

  — Requiring the accountant to 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

  — Providing guidance as to when an accountant should obtain an updating representation letter from management

  — Providing guidance to accountants on restricting the use of reports issued pursuant to SSARS

  Amends SSARS No. 2 to allow a successor accountant to report on a restatement adjustment while indicating that a predecessor accountant reported on the financial statements of the prior period before restatement.

- SSARS No. 13, *Compilation of Specified Elements, Accounts, or Items of a Financial Statement* (AICPA, *Professional Standards*, vol. 2, AR sec. 110) (July 2005)

  Provides guidance on performance and reporting requirements for an accountant who is engaged to compile or issues a compilation report of one or more specified elements, accounts, or items of a financial statement. 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.

- SSARS No. 14, *Compilation of Pro Forma Financial Information* (AICPA, *Professional Standards*, vol. 2, AR sec. 120) (July 2005)

  Provides guidance on performance and reporting requirements for an accountant who is engaged to compile or issues a compilation report on pro forma financial information

.12 SSARS No. 1 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).

.13 Paragraph 4 of SSARS No. 1 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 a comprehensive basis of accounting other than generally accepted accounting principles. Financial forecasts, projections, and similar presentations, and financial presentations included in tax returns are not financial statements for purposes of this statement. SSARS No. 1 also gives the following specific examples of financial statements:

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

.14 Paragraphs 20–23 of SSARS No. 1, as amended by SSARS No. 8, include guidelines regarding an accountant's communications with the client when the compiled financial statements are not expected to be used by a third party. Paragraph 4 of SSARS No. 1, as amended, defines *third parties* as all parties except for members of management who are knowledgeable about the nature of the procedures applied and the basis of accounting and assumptions used in the preparation of the financial statements. This definition by exception indicates that all parties are third parties except for certain members of management who are knowledgeable enough about the business to put the information in the proper context.

.15 SSARS No. 2, as amended by SSARS No. 11 (See AR section 200.17), and SSARS No. 12 (See AR section 200.25–.27) establishes the standards for reporting on comparative financial statements of a nonpublic entity when the statements of one or more periods have been compiled or reviewed under SSARS No. 1.

Practice Tip

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

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

.17 The requirements of AR section 100 are applicable when the unaudited financial statements of a nonpublic entity are included in a prescribed form. If the compiled or reviewed financial statements included in the prescribed form contain departures from GAAP, the accountant should follow the guidance in AR section 100.46–.48. Additionally, AR section 300 provides an alternative form of the standard compilation report when the prescribed form or related instructions call for a departure from GAAP by specifying a measurement principle not in conformity with GAAP or by failing to request the disclosures required by GAAP.

.18 SSARS No. 4, as amended by SSARS Nos. 7 and 9, provides guidance on required, as well as, optional communications between predecessor and successor accountants. SSARS No. 7 amended SSARS No. 4 to require the successor accountant to request the client to communicate with the predecessor accountant, if the successor accountant becomes aware of information that may require revision of financial statements reported on by the predecessor accountant. SSARS No. 9 amends SSARS No. 4 by providing guidance on communications between accountants when the successor accountant decides to communicate with the predecessor regarding acceptance of an engagement. The amendment defines predecessor and successor accountants, provides guidance regarding acceptance of an engagement, suggests inquiries the successor accountant may decide to ask the predecessor accountant, and includes an example successor accountant acknowledgement letter, which the predecessor may want to use in connection with granting access to working papers.

.19 Under SSARS No. 6, an accountant may submit a written personal financial plan containing unaudited personal financial statements to a client without issuing a report under SSARS No. 1, as amended, when all of the following conditions exist:

- The accountant establishes an understanding with the client that the financial statements (i) will be used solely to assist the client and the client's advisors to develop the client's personal financial goals and objectives and (ii) will not be used to obtain credit or for any purpose other than developing the aforementioned goals and objectives.
- Nothing comes to the accountant's attention during the engagement that would cause him or her to believe that the financial statements will be used to obtain credit or for any purpose other than developing the client's financial goals and objectives.

.20 Examples of implementation of a personal financial plan by a client's advisors include use of the plan by the following:

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

.21 An accountant following the exemption under SSARS No. 6 should issue a written report stating that the unaudited financial statements are as follows:

- Are designed solely to help develop the financial plan
- May be incomplete or contain departures from GAAP and should not be used to obtain credit or for any purpose other than developing the plan
- Have not been audited, reviewed, or compiled

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

- Clarified the applicability of SSARS No. 1 by indicating that, in certain circumstances, an accountant may perform a review of a public company under the provisions of SSARS.
- Eliminated the prohibition against merely typing or reproducing financial statements without modification and defined the term *submission of financial statements*.[2]
- Made explicit that the accountant is not required to communicate to a client errors that are not material and fraud or illegal acts that are clearly inconsequential.

[2] The term *submission of financial statements* has since been redefined by SSARS No. 8, *Amendment to Statement on Standards for Accounting and Review Services No. 1* (AICPA, *Professional Standards*, vol. 2, AR sec. 100).

- Modified the SSARS review report to differentiate it from the review report presented in AU section 722, *Interim Financial Information* (AICPA, *Professional Standards*, vol. 1) as well as the review and compilation report to clarify that the standards referred to in the reports are Statements on Standards for Accounting and Review Services.
- Required a client representation letter when performing a review engagement under SSARS.
- Clarified the accountant's reporting responsibilities in a compilation or review engagement when he or she decides there is an uncertainty about an entity's ability to continue as a going concern.

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

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

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

- The auditing literature permits an accountant who may be associated with financial statements of a public company, but has not audited or reviewed such statements to state that he or she has not audited the unaudited information and includes illustrative report wording. This guidance is also appropriate for compilation and review engagements. This amendment revises SSARS No. 1 to include wording that may be appropriate under the circumstances.
- SSARS No. 9 includes two footnotes to SSARS No. 1 (See AR section 100.14 and 100.42), stating that the disclosure of a change in capital is required. 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 and (1) if a separate statement of retained earnings is not presented as a separate statement, reference in the compilation and review report is not needed and (2) if the statement of retained earnings is presented, reference should be made in the appropriate paragraphs of the report.
- SSARSs did not specifically require a signature of the accounting firm or the accountant on a review or compilation report. This amendment revises SSARS No. 1 (See AR section 100.11 and 100.39) to require a signature (this signature could be manual, stamped, or typed).
- SSARS No. 9 (See AR section 100) requires the accountant to obtain specific representations from management when performing a review engagement, provides guidance on the dating of the letter, and provides guidance regarding obtaining representations from current management when they were not present during all periods covered by the accountant's report. In addition, Appendix F of AR section 100 gives an illustrative sample representation letter for a review of financial statements.
- SSARS No. 9 (See AR section 100.60) explicitly permits the accountant to issue a separate report on supplementary information in a compilation engagement, consistent with guidance on supplemental information in a review report.
- SSARS No. 9 (See AR section 100.72) clarifies that although an effective quality control system is conducive to compliance with SSARSs, deficiencies in or noncompliance with a firm's quality control system do not, in and of themselves, indicate that an engagement was not performed in accordance with the applicable professional standards.

- SSARS No. 9 (See AR section 400) defines predecessor and successor accountants, provides guidance regarding acceptance of an engagement, suggests inquiries the successor accountant may decide to ask the predecessor accountant, and includes an illustrative successor-accountant acknowledgment letter that the predecessor may want to use in connection with granting access to the working papers.

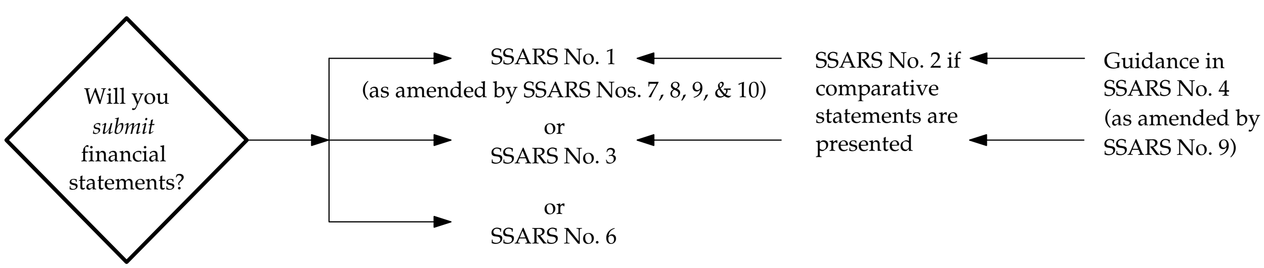
.26 Every standard does not apply to every engagement. SSARS No. 1, as amended by SSARS Nos. 7, 8, 9, 10, and 12, generally applies to any engagement in which the accountant submits financial statements to a client or third parties (compilation or review engagement). SSARS No. 2 applies to any engagement to report on comparative financial statements.

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

.28 SSARS No. 4 contains recommended communication guidance for any compilation or review engagement where a change of accountants has occurred.

.29 Exhibit 2100-1 illustrates the interactions between the standards:

Exhibit 2100-1—Interaction of SSARS



.30 Illustrative reports to be issued under the provisions of SSARS Nos. 1 through 14 can be found in AAM sections 2610, 2620, and 2710.

.31 In addition to SSARS Nos. 1 through 14, interpretations issued by the staff of ARSC provide timely guidance on applying SSARS. An interpretation is not as authoritative as a SSARS, but accountants may have to justify departure from an interpretation's guidance if the quality of their work is questioned. The following interpretations have been issued by the staff.

Interpretations of SSARS No. 1

.32 No. 1—"Omission of Disclosures in Reviewed Financial Statements" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.01–.02, December 1979; revised November 2002; revised May 2004; revised July 2005). This interpretation states that typically the accountant would not accept an engagement to review financial statements that omit substantially all the disclosures required by GAAP. This interpretation gives guidance on the reporting implications if an accountant who has undertaken a review of financial statements subsequently finds that the client declines to include substantially all required disclosures.

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

.34 No. 3—"Reporting on the Highest Level of Service" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.06–.12, December 1979; revised October 2000). This interpretation requires that if an accountant provides more than one level of service on the same financial statements, the financial statements should be accompanied by the accountant's report that is appropriate for the highest level of service provided. This interpretation does not preclude the accountant from using procedures that go beyond those required for the level of assurance expressed. Nor does this interpretation require that the accountant "step up" the level of his or her report if the accountant uses procedures that go beyond those required for the level of assurance expressed.

.35 No. 4—"Discovery of Information After the Date of the Accountant's Report" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.13–.15, November 1980; revised November 2002; revised May 2004, revised July 2005). The interpretation emphasizes the need for professional judgment in determining an appropriate course of action when information becomes available after the date of the accountant's report and that information causes the accountant to believe that the compiled or reviewed financial statements may be incorrect, incomplete, or otherwise unsatisfactory. This interpretation instructs the accountant to consider the reliability of the information and the existence of persons known to be relying on or likely to rely on the financial statements when making a decision about an appropriate course of action, as well as the existence of persons known to be relying or likely to rely on the financial statements. The accountant should also consider consulting with an attorney.

.36 No. 5—"Planning and Supervision" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.16–.17, August 1981; revised November 2002). The interpretation clarifies that the audit guidance in "Planning and Supervision," does not apply to compilation or review engagements. However, this interpretation suggests that the accountant may wish to consider AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1) and other references when planning and supervising a compilation or review engagement.

.37 No. 6—"Withdrawal From Compilation or Review Engagement" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.18–.22, August 1981; revised November 2002; revised May 2004; revised July 2005). The interpretation identifies circumstances in which it is appropriate for an accountant to withdraw from an engagement. Circumstances suggested include those in which the nature, extent, and probable effect of GAAP departures or departures from an OCBOA might cause the accountant to question whether the departures are a result of the preparer's intention to mislead those who might reasonably be expected to use the financial statements. The accountant would also withdraw from a compilation or review engagement if the financial statements are not revised after the accountant requests that revisions be made, and the client refuses to accept the modified standard report that the accountant believes is appropriate.

.38 No. 7—"Reporting When There Are Significant Departures From Generally Accepted Accounting Principles" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.23–.26, August 1981; revised November 2002; revised May 2004; revised July 2005). The interpretation indicates that a statement in a compilation or review report that the financial statements are not in conformity with GAAP or an "other comprehensive basis of accounting" would be tantamount to expressing an adverse opinion on the financial statements taken as a whole; therefore, an accountant is precluded from making such a statement. Such an opinion can be expressed only in the context of an audit engagement. This interpretation does not preclude the accountant from emphasizing the limitation of the financial statements in a separate paragraph of the report. This separate paragraph is not, however, a substitute for disclosure of the specific GAAP or OCBOA departures or the effects of the departures.

.39 No. 8—"Reports on Specified Elements, Accounts, or Items of a Financial Statement" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.27–.28, November 1981; revised January 2001; revised November 2002; revised

September 2003; revised May 2004). The interpretation has been rescinded by the issuance of SSARS No. 13, July 2005.

.40 No. 9—"Reporting When Management Has Elected to Omit Substantially All Disclosures" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.29–.30, May 1982). The interpretation allows the accountant to modify the language in the sample report in AR section 100.18 from "Management has elected to omit substantially all disclosures." However, this interpretation stresses that the language used should clearly indicate that the omission of substantially all disclosures is the entity's decision, not the accountant's. The interpretation encourages the use of the language in the sample report in AR section 100.18.

.41 No. 10—"Reporting on Tax Returns" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.31–.32, November 1982). SSARSs do not apply to tax returns. The interpretation exempts the accountant from compiling the financial information contained in a tax return, although the accountant may accept an engagement to compile or review such a presentation.

.42 No. 11—"Reporting on Uncertainties" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.33–.40, December 1982; revised November 2002; revised May 2004). The interpretation has been rescinded by the issuance of Interpretation No. 29 in February 2007.

.43 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, December 1982; revised November 1992 and October 2000). The interpretation illustrates how the standard compilation and review reports should be modified if financial statements are prepared on another comprehensive basis of accounting. Footnotes to the financial statements should state the basis of presentation and describe how that basis differs from GAAP. If footnotes present this information, the standard compilation and review reports should be appropriately modified to identify the financial statement title (for example, Balance Sheet—Income Tax Basis). When an accountant compiles OCBOA financial statements that omit substantially all disclosures, either a footnote or a note to those statements should disclose the basis of accounting. If that disclosure is not made, the following sentence should be added to the first paragraph of the accountant's report:

> The financial statements have been prepared on the accounting basis used by the Company for federal income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles.

.44 No. 13—"Additional Procedures" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.46–.49, March 1983; revised October 2000; revised November 2002; revised May 2004). The interpretation permits the accountant to perform additional procedures in a compilation or review engagement without requiring the accountant to change the engagement level.

.45 No. 14—"Reporting on Financial Statements When the Scope of the Accountant's Procedures Has Been Restricted" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.50–.53, Withdrawn—April 1990).

.46 No. 15—"Differentiating a Financial Statement Presentation From a Trial Balance" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.54-.57, September 1990; revised October 2000). The interpretation identifies the attributes of a financial statement and those of a trial balance. It assists an accountant in determining whether a financial statement presentation is a financial statement, requiring compliance with the provisions of AR section 100, or a trial balance, which does not require compliance with the provisions of AR section 100.

.47 No. 16—"Determining if the Accountant Has "Submitted" Financial Statements Even When Not Engaged to Compile or Review Financial Statements" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.58–.60, Withdrawn by the issuance of SSARS No. 7—November 1992).

.48 No. 17—"Submitting Draft Financial Statements" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.61–.62, September 1990; revised October 2000). The interpretation prohibits an accountant from submitting draft financial statements without intending to submit those financial statements in final form accompanied by an appropriate compilation or review report. This interpretation requires that draft financial statements be so marked and suggests that an accountant document the reasons why he or she intended to submit, but never submitted final financial statements, should that situation occur.

.49 No. 18—"Special-Purpose Financial Presentations to Comply With Contractual Agreements or Regulatory Provisions" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.63–.72, September 1990; revised January 2004; revised May 2004). This interpretation was rescinded in September 2005.

.50 No. 19—"Reporting When Financial Statements Contain a Departure From Promulgated Accounting Principles That Prevents the Financial Statements From Being Misleading" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.73-.75, February 1991; revised October 2000; revised November 2002; revised May 2004; revised July 2005). The interpretation addresses Ethics Rule 203, *Accounting Principles* of AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 203.01), which prohibits a member from expressing an opinion that financial statements are presented in conformity with GAAP if the member is aware that the statements contain a GAAP departure. If the statements contain a GAAP departure, and the member can demonstrate that due to unusual circumstances compliance with GAAP would render the financial statements misleading, the member can comply with ET section 203 by describing in the report the departure; its approximate effects, if practicable; and the reasons why compliance with GAAP would result in misleading statements. The interpretation indicates that if the circumstances contemplated by ET section 203 exist in a review engagement, the accountant's review opinion should be unmodified, but the accountant's review report should be modified to contain a separate paragraph, including the information required by ET section 203. The interpretation clarifies that ET section 203 does not apply to compilation engagements. If the circumstances contemplated by ET section 203 exist in a compilation engagement, an accountant should follow the guidance in AR sections 100.46–48 for reporting on a compilation engagement with a GAAP departure.

.51 No. 20—"Applicability of SSARS to Litigation Services" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.76-.79, May 1991; revised October 2000). SSARSs do not apply to financial statements submitted in litigation services that involve pending or potential proceedings before a court, regulatory body, or governmental authority (or the agent of any of these) such as a grand jury or an arbitrator (mediator) when the

- Accountant is an expert witness or a "trier of fact" (or an agent for one).
- Accountant's work is subject to detailed analysis and challenge by each party to the dispute.
- Accountant is engaged by the attorney and protected by the attorney's work product privilege and such work is not intended to be used for other purposes.

.52 No. 21—"Applicability of SSARS No. 1 When Performing Controllership or Other Management Services" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.80-.84, July 2002). The interpretation clarifies that if the accountant is in the practice of public accounting as defined by the AICPA's Code of Conduct, *Definitions* (AICPA, *Professional Standards*, vol. 2, ET sec. 92.25) and is not a stockholder, partner, director, officer, or employee of the entity, the accountant is required to follow the performance and communication requirements of AR section 100, including any requirement to disclose a lack of independence. The interpretation further states that if the accountant is in the practice of public accounting and is also a stockholder, partner, director, officer, or employee of the entity, the accountant may either (1) comply with the requirements of AR section 100, or (2) communicate, preferably in writing, the accountant's relationship to the entity (for example, stockholder, partner, director, officer, or employee). In addition, if an accountant is not in the practice of public accounting, the issuance of a report under SSARS would be inappropriate.

.53 No. 22—"Use of *Selected Information—Substantially All Disclosures Required by Generally Accepted Accounting Principles Are Not Included*" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.85–.88, December 2002). The interpretation clarifies that an accountant cannot label notes to the financial statements "Selected

Information—Substantially All Disclosures Required by Generally Accepted Accounting Principles Are Not Included" in situations where substantially all disclosures are included. It further states that the omission of one or more notes, when substantially all other disclosures are presented, should be treated in a compilation or review report like any other departure from GAAP, and the nature of the departure and its effects, if known, should be disclosed. The label "Selected Information—Substantially All Disclosures Required by Generally Accepted Accounting Principles Are Not Included" is not intended to be used for the omission of (intentionally or unintentionally) one or more disclosures and the accountant should use his or her judgment in determining the appropriateness of the label.

.54 No. 23—"Applicability of Statements on Standards for Accounting and Review Services When an Accountant Engaged to Perform a Business Valuation Derives Information From an Entity's Tax Return" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.89–.92, August 2003). This interpretation clarifies whether or not SSARS applies if an accountant derives financial information from an entity's tax return, and such information is presented as part of the business valuation report. The interpretation states that as discussed in paragraph 4 of AR section 100, under the definition of a financial statement, "Financial forecasts, projections and similar presentations, and financial presentations included in tax returns are not financial statements for purposes of this Statement." Therefore, even if the accountant has prepared the tax return, he or she has not prepared financial statements in accordance with SSARS and the financial information derived from the tax return and presented as part of a business valuation is not deemed to be submission of financial statements as contemplated by AR section 100. It further states that when an accountant, in the course of performing a business valuation engagement, derives financial information from the client's tax return, or another accountant's audited, reviewed, or compiled financial statements, or client-prepared financial statements, the accountant should refer to the source of the financial information and include an indication in the business valuation report that the accountant has not audited, reviewed, or compiled the financial information and that the accountant assumes no responsibility for the information. However, if the accountant submits financial statements in the course of performing a business valuation as defined in paragraph 4 of AR section 100, then, at a minimum, the accountant should comply with the provisions of SSARS applicable to a compilation engagement.

.55 No. 24—"Reference to the Country of Origin in a Review or Compilation Report" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.93–.94, September 2003). The interpretation states that SSARS does not require the reference to the country of origin as review and compilation reports refer to the American Institute of Certified Public Accountants. However, there is no prohibition of the reference if the accountant believes it is appropriate under the circumstances to include it in the report.

.56 No. 25—"Omission of the Display of Comprehensive Income in a Compilation" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.95–.99, September 2003; revised May 2004; revised July 2005). The interpretation clarifies that when an element of comprehensive income is present, the display of comprehensive income can be omitted when issuing a compilation report with substantially all disclosures omitted. FASB Statement No. 130, Reporting Comprehensive Income, requires the display of comprehensive income when a full set of financial statements is presented in conformity with generally accepted accounting principles. However, the display of comprehensive income may be omitted by identifying the omission in the compilation report or engagement letter. In addition, the interpretation also suggests wording if the accountant issues a compilation report on financial statements that omit substantially all disclosures and the display of comprehensive income but include the statement of cash flows. If the accountant compiles financial statements that include all disclosures but omit the display of comprehensive income, the omission should be treated as a departure from generally accepted accounting principles. It further states if an element of comprehensive income has not been computed, for example, unrealized gains and losses arising from investments in marketable securities classified as "available for sale" then the accountant should consider a departure from generally accepted accounting principles and follow the guidance in AR sections 100.46–.48.

.57 No. 26—"Communicating Possible Fraud and Illegal Acts to Management and Others" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.100–.103, May 2004). This interpretation has been rescinded by the issuance of SSARS No. 12, July 2005.

.58 No. 27—"Applicability of Statements on Standards for Accounting and Review Services to Reviews of Nonissuers Who Are Owned by or Controlled by an Issuer" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.104–.108, August 2005). This interpretation clarifies whether accountants should perform reviews in accordance with the Public Company Accounting Oversight Board or in accordance with SSARSs when engaged to review the separate financial statements of a subsidiary, which itself is not an issuer.

.59 No. 28—"Special Purpose Financial Statements to Comply With Contractual Agreements or Regulatory Provisions" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.109-.119, December 2006). This interpretation describes the wording special purpose financial statements that are prepared to comply with contractual agreements or regulatory provisions that specify a special basis of presentation in accordance with AR section 100. This interpretation describes reporting on (1) Special-purpose financial statements prepared in compliance with a contractual agreement or regulatory provision that does not constitute a complete presentation of the entity's assets, liabilities, revenues and expenses, but is otherwise prepared in conformity with generally accepted accounting principles or an other comprehensive basis of accounting or (2) A special-purpose financial presentation (may be a complete set of financial statements or a single financial statement) prepared on a basis of accounting prescribed in an agreement that does not result in a presentation in conformity with GAAP or OCBOA. Illustrative report examples are also given for each type of report.

.60 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, February 2007). This interpretation provides guidance on how an accountant should modify the standard compilation report when, during the performance of a compilation or review, 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. In such circumstances, the accountant should consider the adequacy of management's disclosure of the uncertainty. 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 AR section 100.46–.48 with respect to departures from generally accepted accounting principles. The same guidance applies if the accountant becomes aware of a material uncertainty other than a going concern uncertainty (for example, an uncertainty regarding pending or threatened litigation). This interpretation also includes sample language if the accountant determines that disclosure of the uncertainty is in compliance with generally accepted accounting principles, but would like to emphasize the matter in the compilation or review report.

Interpretation of SSARS No. 2

.61 No. 1—"Reporting on Financial Statements That Previously Did Not Omit Substantially All Disclosures" (AICPA, *Professional Standards*, vol. 2, AR sec. 9200.01–.04, November 1980; revised November 2002; revised May 2004; revised July 2005). If the financial statements are compiled (disclosures omitted) from financial statements that previously did not omit disclosures, the accountant's reference to the previous reports should include a description or quotation of any report modification or emphasis matter.

Interpretation of SSARS No. 3

.62 No. 1—"Omission of Disclosures in Financial Statements Included in Certain Prescribed Forms" (AICPA, *Professional Standards*, vol. 2, AR sec. 9300.01–.03, May 1982). This interpretation permits an accountant who has reviewed financial statements of a nonpublic entity to issue a compilation report on financial statements for the same period in a prescribed form that calls for a departure from GAAP.

Interpretation of SSARS No. 4

.63 No. 1—"Reports on the Application of Accounting Principles" (AICPA, *Professional Standards*, vol. 2, AR sec. 9400.01–.05, August 1987; revised November 2002). An accountant who has been asked to provide written or oral advice on the application of accounting principles to a client whose financial statements are compiled or reviewed by another accountant is obligated to follow AU section 625, *Reports on the Application of Accounting Principles* (AICPA, *Professional Standards*, vol. 1).

Interpretation of SSARS No. 6

.64 No. 1—"Submitting a Personal Financial Plan to Client's Advisers" (AICPA, *Professional Standards*, vol. 2, AR sec. 9600.01–.03, May 1991). The interpretation allows the accountant to submit a written personal financial plan, to be implemented by the client or his or her advisers, without complying with SSARS No. 1. Examples of implementation include an:

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

Determining Applicability of SSARS No. 1

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

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

.66 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

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

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

Practice Tip

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

.69 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 exmple, via e-mail) should be carefully considered.

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

[*The next page is 2201.*]

AAM Section 2200

Engagement Planning and Administration

.01 It is important to remember that when engaged to provide compilation or review services, the accountant must comply with Rules 201, *General Standards*, and 202, *Compliance With Standards*, respectively, of the AICPA's Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 201.01 and 202.01). Rule 201 requires that an AICPA member comply with the following standards and any interpretations thereof by bodies designated by its Council:

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

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

Client and Engagement Selection

.03 Prior to accepting an engagement to perform a compilation or review for all prospective clients, the accountant should 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, client integrity, etc., 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 must be aware 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, you might consider them in determining whether or not to accept a client. Certain of these elements may not be applicable to every engagement. Practitioners should exercise professional judgment in determining the applicability of each of the following to the acceptance or continuance of a specific engagement.

- 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.
- 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 anti-fraud 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 should 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 firm should 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 The client acceptance procedures also should require the firm 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, Moodys, or other publications.* Many localities provide a local or regional "S&P" in conjunction with the *Daily Journal of Commerce* or similar business publication. There is a plethora of available information on the Web. In addition, many firms offer database searches of financial, legal, and operational information, as well as personal information about key executives. Check the court dockets (including the U.S. Bankruptcy and Tax Court dockets) in the area where the client is domiciled.
- *Meet with financial persons of the company.* Ask for a brief overview of their internal practices and procedures, the business plan, bylaws, staff turnover, and so on. Representatives from other departments may provide information as well.
- *Discuss the prospective client with former accountants* (after the client provides written authorization).

.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 AAM section 2200.67.

Documentation

.09 Whether or not an engagement is accepted or a professional relationship continued, the firm should appropriately 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 should comply with its document retention policies regarding the client acceptance and/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 Generally, the cost of a review will be more than a compilation, and the cost of a compilation with full disclosure will be more than a compilation that omits substantially all disclosures. These cost considerations should be carefully explained and evaluated with the client. In addition, special consideration should be given to the issues of independence and the demands of bankers and other creditors.

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

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

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

- A review (if the accountant is independent and the client needs a moderate level of assurance on the financial statements)
- A traditional 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 AR section 100.04, *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 AR section 100.01, as amended, now provides for two types of compilations:

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

---

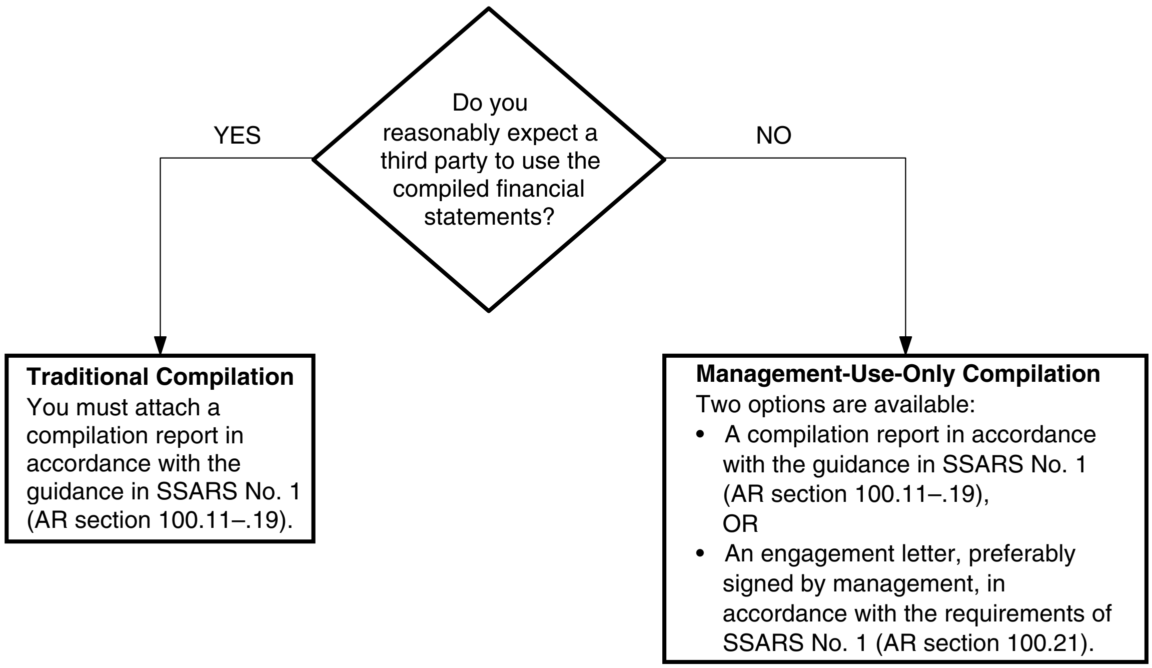
[1] See paragraph .15 for more information about types of compilations.

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

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

.16 In either case, the engagement is a compilation requiring that the accountant comply with the performance requirements of Statement on Standards for Accounting and Review Services (SSARS) No. 1, *Compilation and Review of Financial Statements* (AICPA, Professional Standards, vol. 2, AR sec. 100). 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, you might consider making the decision about the best type of engagement for the client early in engagement planning and base that decision on a combination of (1) the needs of the client and other users, (2) knowledge of the client, and (3) the nature of the procedures that will be performed.

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

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

.19 Although not an authoritative requirement in a traditional compilation engagement, a written engagement letter for a bookkeeping services engagement could be important because there are no specific standards to follow for these types of engagements. Other professional engagements, such as audits, reviews, and compilations, include the added benefit of authoritative standards that define the engagement objectives, limitations, communication, and so on. An illustrative engagement letter for a bookkeeping service engagement can be found in AAM section 2200.71, *Engagement Planning and Administration*.

Independence Issues

.20 If an accountant is not independent, he or she can only issue a compilation report (with report modification). If the client needs reviewed or audited financial statements, the nonindependent CPA should refer the client to another CPA. The primary rules governing independence are found in the *Independence* section of the AICPA Code of Professional Conduct. The independence standards are contained in Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101), 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. 101.05), 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 5 of SSARS No. 1, as amended by SSARS No. 12, *Omnibus Statement on Standards for Accounting and Review Services—2005* (See AR section 100.05), states that the accountant should establish an understanding with the entity, preferably in writing, regarding the services to be performed. If the engagement is to compile financial statements not expected to be used by a third party, a written communication is required. (See AR section 100.20–.21.)

Establishing an Understanding With the Client

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

a. A description of the nature and limitations of the services.

b. A description of the report the accountant expects to render.

c. A statement that the engagement cannot be relied upon to detect errors, fraud, or illegal acts.

d. A statement that the accountant will inform the appropriate level of management of any material errors, 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 21 of SSARS No. 1, as amended by SSARS No. 8, *Amendment to Statement on Standards for Accounting and Review Services No. 1* (AIPCA, *Professional Standards*, vol. 2, AR sec. 100.21):

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

---

[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. This guidance is effective for compilations and reviews of financial statements for periods ending after December 15, 2005, by Statement on Standards for Accounting and Review Services (SSARS) No. 12.

.31 According to paragraph 21 of SSARS No. 1, as amended by SSARS No. 8 (See AR section 100.21), 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.
- 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 several reasons:

- They help to avoid client misunderstandings.
- They help to avoid staff misunderstandings.
- They reduce potential legal liability.
- They improve practice management.
- They clarify contractual 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 non-payment
- Timing of the work
- Alternative dispute resolution
- Consequences of extending completion deadlines
- Withdrawal and termination

- Requests for additional services
- Client signature
- Client communications required by the AICPA
- Provisions to resolve potential ethical conflicts
- Any matter or terms unique to an engagement that are agreed upon in advance of rendering services

Overcoming Client Resistance to an Engagement Letter

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

.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 should 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 should be 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 (compilation, review, consulting, bookkeeping, tax services, etc.). However, care should be taken when addressing multiple levels of service (for example, compilation and review) in one engagement letter, as 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. Before adding such language, the accountant should consult with legal counsel.

.40 Illustrative engagement letters for compilation engagements are presented in AAM section 2200.68.

Practice Tip

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

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

Change in Engagement Level of Service

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

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

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

Practice Tip

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

Step-Downs and Changes in Service

Step-Down From Audit to Review or Compilation

.44 SSARS No. 1 (See AR section 100.63) lists three reasons that might cause a client to request a change from an audit engagement to another type of engagement after an audit has begun:

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

Step-Down From Review to Compilation

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

- A change in circumstances affecting the entity's requirement for a review
  - For example, a bank may no longer require a review because a line-of-credit is reduced to a level that does not require audited financial statements.
  - Generally, a step-down in this case is acceptable.
- A misunderstanding as to the nature of an audit, review, or compilation services originally available
  - Generally, a step-down in this case is acceptable.
  - The CPA should, however, explain all of the options available to the client.
- A restriction on the scope of the inquiries or analytical procedures, whether imposed by the client or caused by circumstances.
  - The implications of a scope restriction need to be considered carefully.
  - The management's or owner's has 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 400, *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 400 does not require a successor accountant to communicate with a predecessor accountant in connection with acceptance of a compilation or review engagement, but he or she may believe it is beneficial to obtain information that will assist in determining whether to accept the engagement. The successor accountant may consider making inquiries of the predecessor accountant when circumstances such as the following exist:

- Information about the prospective client is limited or requires special attention.
- The change in accountants occurs substantially after the end of the accounting period for which financial statements are to be compiled or reviewed.
- The client has frequently changed accountants.

.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 AR section 400.04).

Inquiries Regarding Acceptance of the Engagement

.52 According to AR section 400.05, if a successor accountant decides to communicate with the predecessor accountant, either orally or in writing, the inquiries should be specific and reasonable regarding matters that will assist the successor accountant in determining whether to accept the engagement. Matters subject to inquiry would include:

- Information that might bear on the honesty or integrity of management.
- Disagreements with management about accounting matters or performance of compilation or review procedures or similarly significant matters.

- Cooperation from management when additional or revised information is needed.
- Predecessor's knowledge of any fraud or illegal acts perpetrated within the client.
- Predecessor's understanding of the reason for the change of accountants.

.53 AR section 400.06 does require the predecessor accountant, when authorized by the client, to respond promptly and fully to the inquiries on the basis of known facts. If the predecessor accountant decides, due to unusual circumstances such as impending, threatened, or potential litigation; disciplinary proceedings; or other unusual circumstances, not to respond fully to the inquiries, the predecessor accountant should indicate that the response is limited. (Note that unpaid fees are not considered to be an unusual circumstance for purposes of this paragraph; however, see the paragraph below.) The successor accountant should consider the reasons and consider the implications of such a response in connection with acceptance of the engagement.

.54 If authorized by the client, AR section 400.08 states that the predecessor accountant should ordinarily make available certain work papers relating to matters of continuing significance and those relating to contingencies, for example. However, valid business reasons may lead the predecessor accountant to decide not to allow access to the work papers. Unpaid fees constitute a valid business reason to deny access to the predecessor accountant's workpapers. The predecessor accountant may decide to reach an understanding with the successor accountant about the use of the working papers. Before permitting access to the working papers, the predecessor accountant may wish to obtain a written communication from the successor accountant regarding the use of the working papers. The Appendix of AR section 400 contains an illustrative successor accountant acknowledgement letter presented for illustrative purposes only and is not required by professional standards. In addition, a predecessor accountant is not obligated to make himself or herself or the work papers available to more than one prospective successor accountant.

Materially Misleading Financial Statements

.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. AR section 100.59, as amended, 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. In this case, the accountant may wish to consider the guidance in AU section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (AICPA, *Professional Standards*, vol. 1).

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

- *The reliability of the information*. If the accountant believes that the information is reliable and that it existed at the date of the report, and if the information indicates that the financial statements, the report, or both need revision, the accountant would ordinarily conclude that persons known to be relying on or likely to rely on the financial statements should be notified in an appropriate manner.

- *The existence of persons known to be relying on or likely to rely on the financial statements.* In evaluating the likelihood that users are currently relying on or likely to rely on the financial statements, the accountant should consider the time elapsed since the financial statements were issued.

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

Management-Use-Only Financial Statements Distributed to Third Parties

.59 AR section 100.23 states the following:

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

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

.61 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.

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

Practice Tip

Notification of third parties would involve legal matters beyond the scope of this Manual, therefore, you should consult with an attorney before taking any action. In order to minimize the risk of a client distributing management-use-only financial statements to third parties, the accountant may want to include language in the engagement letter alerting the client to the fact that if he or she needs financial statements for third-party use that service can be provided separately (see illustrative engagement letter in AAM section 2200.68).

When to Withdraw From an Engagement

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

- He or she determines that he does not have and cannot obtain sufficient knowledge of the client's business or industry.
- The client refuses, or is unable, to provide additional or revised information when the accountant has become aware that information supplied is incorrect, incomplete, or otherwise unsatisfactory.

- Disclosures were omitted with an intent to mislead.
- The CPA determines that he or she is not independent with respect to the entity and reviewed financial statements are required.
- The compiled or reviewed financial statements contain departures from GAAP that the client will not correct and the CPA believes the departures were undertaken with the intention of misleading statement users.
- There have been substantial limitations in the scope of the engagement, particularly in a review engagement when management does not provide a client representation letter.
- Information comes to the accountant's attention that contradicts management's representation that financial statements compiled for management's use only will not be used by third parties.

Key Question and Answer Guidance

.64 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.

.65 Answering specific questions about compilations and reviews, this Practice Aid covers many topics including:

- 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

.66 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.

.67

Client Acceptance and Continuance Form—Part I

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

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

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

CLIENT'S LEGAL NAME:

ADDRESS:

PHONE:	FISCAL YEAR END:

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

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

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

Client Acceptance and Continuance Form—Part I (continued)

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

Name	Percentage Owned	Position	Family Relationship

4. Identify any related businesses or individuals:

Name	Nature of Relationship

5. Identify the client's predecessor accountants:

Name:
Address:
Contact Person:

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

a. Reasons for change of accountant: ____
____
____

b. Integrity of management: ____
____
____

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

d. Fee disputes: ____
____
____

(continued)

Client Acceptance and Continuance Form—Part I (continued)

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

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

8. Describe the services our firm is to provide: ______________________
____
____

	How Often?			Report Deadlines
Service	Monthly	Quarterly	Annually	

Other Services:

Consulting services: ______________________

Federal tax returns: ______________________

State tax returns: ______________________

Payroll tax returns: ______________________

Tax returns for principal owners: ______________________

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

Describe the use of the financial statements:

Client Acceptance and Continuance Form—Part I (continued)

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

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

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

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

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

(continued)

Client Acceptance and Continuance Form—Part I (continued)

15. Identify the client's legal counsel:

Name:
Address:
Contact Person:

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

17. Describe the billing arrangements:

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

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

	20 ______	20 ______	20 ______	20 ______	20 ______
Prepared or updated by: In-Charge	________	________	________	________	________
Reviewed by: Engagement Partner	________	________	________	________	________

Client Acceptance and Continuance Form—Part II

Client: ______________________________

Financial Statement Date: ______________________________

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

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

Acceptance Decision:

Yes ____ No ____

Engagement Partner: ______________________________ Date: ____________

Concurring Partner: ______________________________ Date: ____________

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

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

Dear Mr. Gowers:

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

I (We) will perform the following services:

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

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

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

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

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

My (Our) engagement cannot be relied upon to disclose errors, fraud, or illegal acts that may exist. However, I (we) will inform the appropriate level of management* of any material errors, of any evidence or information that comes to my (our) attention during the performance of compilation procedures, that fraud or an illegal act may have occurred, unless clearly inconsequential.

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

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

In view of the limitations described above, you agree not to take or assist in any action seeking to hold me (us) liable for damages due to any deficiency in the financial statements I (we) prepare and you agree to hold

* When fraud or an illegal act involves senior management, the accountant should report the matter to an individual or group at a higher level within the entity, such as the board of directors. Refer to SSARS No. 12, *Omnibus Statement on Standards for Accounting and Review Services—2005*, for guidance as to the steps the accountant should take to perform the required communication when, during the performance of a compilation or a review engagement, the accountant suspects that fraud or an illegal act may have occurred.

me (us) harmless from any liability and related legal costs arising from any third-party use of the financial statements in contravention of the terms of this agreement.—[*optional*]

Our fees for these services [*fill in*]

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

If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.[5]

Sincerely yours,

____

[Signature of accountant]

Accepted and agreed to:

Gowers Drug Stores

____

Title

____

Date

[5] 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 . . ."

.69 Illustrative Engagement Letter for a Compilation of Financial Statements

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

Dear Mr. Gowers:

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

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

   I (We) have compiled the accompanying balance sheet of Gowers Drug Stores as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statement on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

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

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

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

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

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

* See footnote * in paragraph .68, Illustrative Engagement Letter for a Compilation of Financial Statements Not Intended for Third Party Use.

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

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

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

Sincerely yours,

____

[Signature of accountant]

Accepted and agreed to:

Gowers Drug Stores

____

Title

____

Date

.70 Illustrative Engagement Letter for a Review of Financial Statements

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

Dear Mr. Gowers:

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

I (We) will perform the following services:

1. I (We) will review the balance sheet of Gowers Drug Stores as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. My (Our) review will consist primarily of inquiries of company personnel and analytical procedures applied to financial data, and I (we) will require a representation letter from management. A review does not contemplate obtaining an understanding of internal control or assessing control risk, tests of accounting records and responses to inquiries by obtaining corroborating evidential matter, and certain other procedures ordinarily performed during an audit.

   Thus, a review does not provide assurance that I (we) will become aware of all significant matters that would be disclosed in an audit. My (Our) engagement cannot be relied upon to disclose errors, fraud, or illegal acts that may exist. However, I (we) will inform the appropriate level of management* of any material errors, of any evidence or information that comes to my (our) attention during the performance of review procedures, that fraud or an illegal act may have occurred, unless they are clearly inconsequential. I (We) will not perform an audit of such financial statements, the objective of which is the expression of an opinion regarding the financial statements taken as a whole, and, accordingly, I (we) will not express such an opinion on them.

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

   I (We) have reviewed the accompanying balance sheet of Gowers Drug Stores as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management of Gowers Drug Stores.

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

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

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

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

---

* See footnote * in paragraph .68, Illustrative Engagement Letter for a Compilation of Financial Statements Not Intended for Third Party Use.

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

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

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

Sincerely yours,

____
[Signature of accountant]

Accepted and agreed to:

Gowers Drug Stores

____
Title

____
Date

.71 Illustrative Engagement Letter for a Bookkeeping Engagement

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

Dear Mr. Gowers:

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

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

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

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

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

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

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

My (Our) engagement cannot be relied upon to disclose errors, fraud, or illegal acts that may exist. However, I (we) will inform the appropriate level of management[*] of any material errors, of any evidence or information that comes to my (our) attention during the engagement, that fraud or an illegal act may have occurred, unless they are clearly inconsequential.

---

[*] See footnote * in paragraph .68, Illustrative Engagement Letter for a Compilation of Financial Statements Not Intended for Third Party Use.

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 AR section 100.04, *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 100, as amended, now provides for two types of compilations:

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

.03 In either case, the engagement is a compilation requiring that the accountant comply with the performance requirements in AR section 100. The difference between the two options lies in the form of communication used in the engagement (see Exhibit 2200-1 in the previous section of this manual for additional details).

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

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

- *What the engagement is*—in both cases the CPA tells the user that the financial statements are compiled and explains what a compilation is (presenting in the form of financial statements information that is the representation of management).
- *What the engagement is not*—in both cases the CPA tells the user that the financial statements are not audited or reviewed and that no opinion or any other form of assurance is expressed.
- *Limitations in the financial statements*—in both cases the CPA tells the user about any limitations in the financial statements. In this area, however, the way in which limitations are communicated is very different:
  - — *Traditional Compilation (Report)*—AR section 100.46–.47 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)*—AR section 100.21 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 must be communicated in such a way as to be understood by anyone, including those not familiar with the financial matters of the entity. In the case of a management-use-only compilation, the financial statements are intended for a limited group of management ("non third parties"). By definition, these members of management have a certain level of knowledge about the business and about the engagement that the accountant is performing. For that reason, the issue of limitations can be handled in a more broad way ("departures may exist") rather than specifically identifying each and every known departure.

.06 In an engagement to compile financial statements for management's use only, a written engagement letter is required. (Note that in all compilation and review engagements an understanding with the client is required.) This engagement letter might address certain matters, as described in AAM section 2200.33, *Engagement Planning and Administration.* It is permissible to issue one engagement letter to cover multiple periods and/or multiple services. However, it is recommended that this engagement letter be updated at least annually. Because client relationships change over time, it is especially important in this type of engagement to ensure that there is a good understanding between the CPA and the client (restricted nature of the statements, limitations of the financial statements).

Performance Requirements for a Compilation Engagement

.07 AR section 100, as amended, states that in all compilation engagements, the performance standards in AR section 100.05 and .07–.10 should be followed.

.08 These performance standards consist of:

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

The accountant should have a sufficient understanding of his or her client's industry to know what the financial statements for an entity in that industry should look like and to be aware of any accounting principles or practices that are unique to that industry. The accountant does not have to be an industry expert, and he or she can obtain this general understanding if he or she does not already possess it (for example, through AICPA guides, 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, since they have the requisite knowledge of the business to put the information in the proper context.

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

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

Traditional Compilation

Performance Requirements

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

- Establish an understanding with the client (See AAM section 2200.29–.40).
- Have or obtain a general understanding of the accounting principles and practices of the industry in which the client operates.
- Have or obtain a general understanding of the client's business.
- Obtain additional or revised information if the information supplied by the client appears to be incorrect, incomplete, or otherwise unsatisfactory.
- Read the compiled financial statements and consider whether they appear to be appropriate in form and free of obvious material error.

Reporting Requirements

.10 If the accountant submits financial statements to a client that will be used by a third party (or if he or she reasonably expects that they might be used by a third party), the accountant must comply with the reporting requirements in AR section 100.11–.19.

.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 (See AAM section 2200.29–.40).
- 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. AR section 100.04 defines *third parties* as follows:

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

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

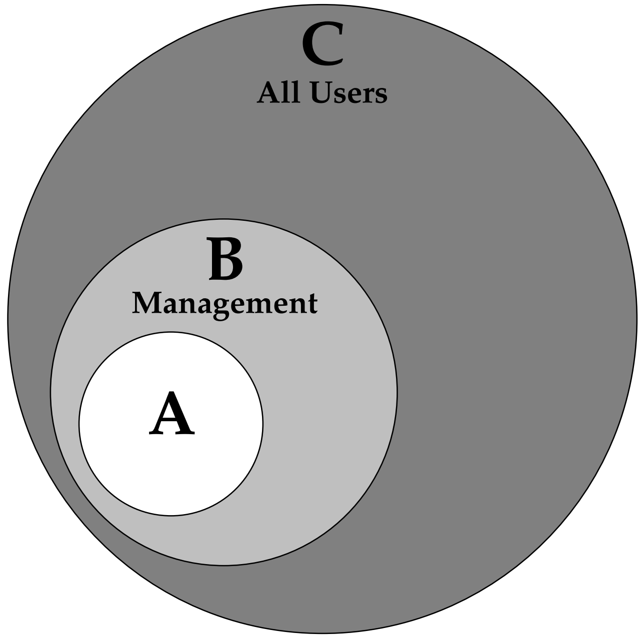
- He or she is a member of management.
- He or she is knowledgeable enough about the business to put the information in the proper context.

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

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

.16 In Exhibit 2300-1, "Third Parties," circle C represents all potential users of an entity's financial statements (banks, bonding companies, creditors, shareholders, vendors, customers, and so on), and circle B represents all members of management. All users in circle C would be considered third parties. In addition, members of management in circle B—those without the requisite knowledge of the client's business that would allow them to place the information contained in the financial statements in the proper context—also would be considered third parties. Compiled financial statements which do not include a report should be restricted to those parties in circle A—those members of management who have the requisite knowledge of the business.

Exhibit 2300-1—Third Parties



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

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

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

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

Transmittal Letter for Management-Use-Only Compilation

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

Documentation Requirement

.21 AR section 100 does not discuss work paper documentation for a compilation engagement except in the case of the engagement letter in a management-use-only compilation.[1] Although not required, including the type of documentation noted below may be helpful from a risk management and quality control perspective:

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

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

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

Practice Tip

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

[1] AR section 100, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2), as amended by SSARS No. 8, *Amendment to Statement on Standards for Accounting and Review Services No. 1* (AICPA, *Professional Standards*, vol. 2, AR sec. 100), does require documentation of the understanding with the client in the form of a written engagement letter for a management-use-only compilation (if a compilation report is not to be issued).

.24 Compilation Engagement Program

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

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

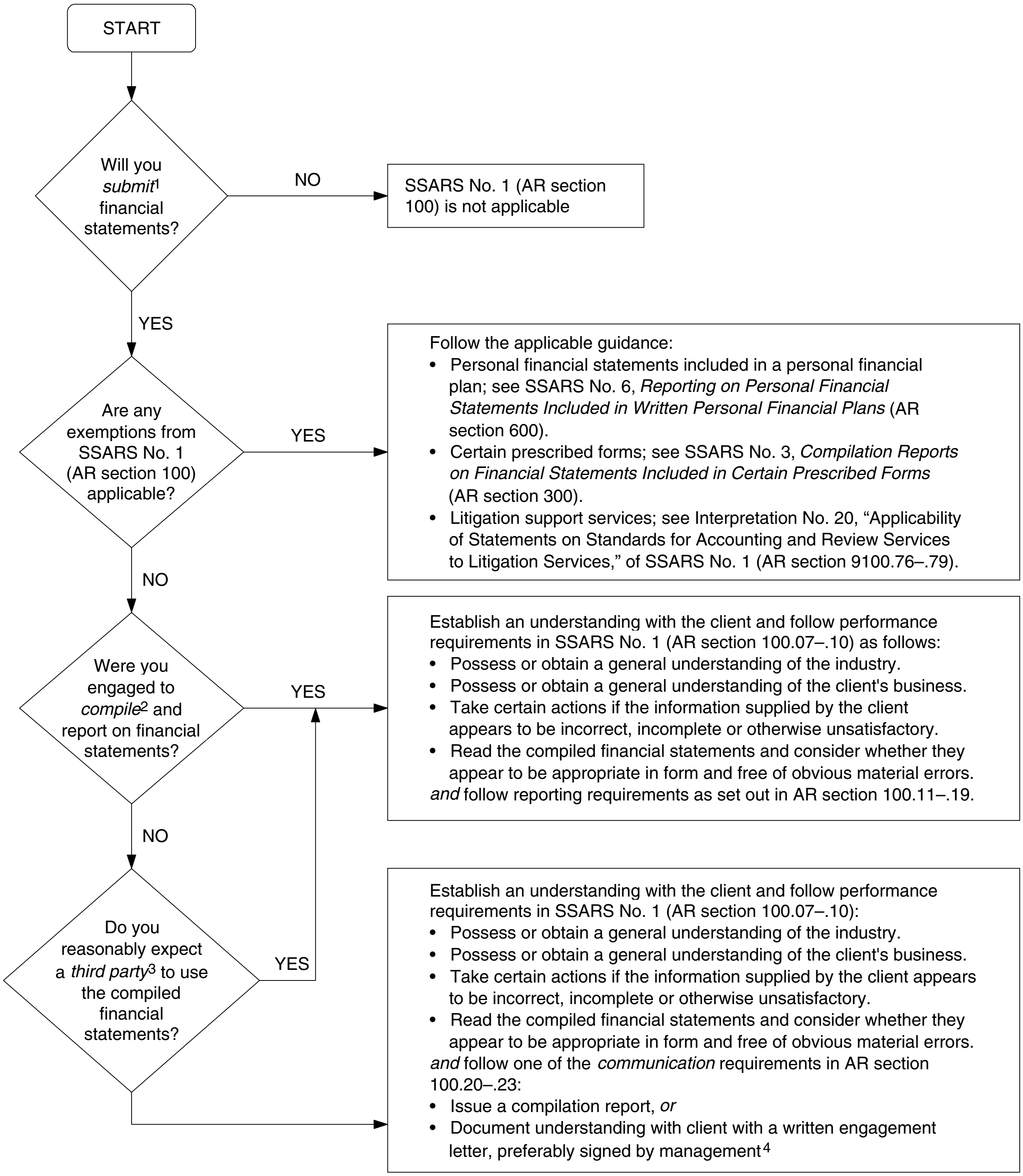
(continued)

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

Compilation of Financial Statements Flowchart

.25 During the initial development of Statement on Standards for Accounting and Review Service (SSARS) No. 8, *Amendment to Statement on Standards for Accounting and Review Services No. 1* (AICPA, *Professional Standards*, vol. 2, AR sec. 100), the members of Accounting and Review Services Committee designed a flowchart to help guide their discussion about the proposed changes in SSARS No. 1. That flowchart, which appeared in SSARS No. 8, is also useful in explaining how compilation engagements may change due to the issuance of SSARS No. 8. We are including it here with the addition of explanatory notes following.

Exhibit 2300-2—Flowchart of Changes in SSARS No. 1 Resulting From Issuance of SSARS No. 8



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

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

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

[4] The engagement letter should include the following matters:

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

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

- A statement that material departures from 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.

.26 Management-Use-Only Compilation Engagement Checklist

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

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

(continued)

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

[*The next page is 2401*.]

AAM Section 2400
Review Engagements

Overview

.01 Statement on Standards for Accounting and Review Services (SSARS) No. 1 (AICPA, *Professional Standards*, vol. 2, AR sec. 100.04) defines a *review* of financial statements as follows:

> Performing inquiry and analytical procedures that provide the accountant with a reasonable basis for expressing limited assurance that there are no material modifications necessary that should be made to the statements in order for them to be in conformity with generally accepted accounting principles (GAAP) or 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 standards are applicable to a review engagement:

- Establish an understanding with the entity regarding the services to be performed and the report the accountant expects to render (See AAM section 2200.29–.40 for a discussion of engagement letters).
- Have, or obtain, knowledge of the accounting principles and practices of the entity's industry and a general understanding of certain matters related to the entity itself.
- Consider whether it will be necessary to perform other accounting services such as assistance in adjusting the books of account, consultation on accounting matters, or compilation of the financial statements.
- Perform sufficient inquiry and analytical procedures to provide a reasonable basis for expressing limited assurance.
- Take certain actions when the accountant becomes aware that information supplied by the entity is incorrect, incomplete, or otherwise unsatisfactory.
- Obtain a representation letter from management.
- Document certain items in work papers, as required by SSARS No. 1, as amended by SSARS No. 10 (AR section 100.36–.38).

Knowledge of Accounting Principles and Practices of the Industry

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

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

.06 AR section 100 states that the accountant must possess or obtain certain knowledge about the entity whose financial statements are under review. Since its basic purpose in a review is to enable the accountant to construct appropriate inquiries and analytical procedures, this level of understanding is more extensive than that required for a compilation engagement.

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

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

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

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

Necessity to Perform Other Accounting Services

.09 AR section 100.04 states that "The accountant might consider it necessary to compile the financial statements or to perform other accounting services to enable him to perform a review."

.10 Since the definition of a review assumes the existence of financial statements as a basis for a review, if the statements do not already exist, the accountant may have to prepare books of original entry, post the ledger, prepare a trial balance, and/or compile the financial statements. However, one must 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 should be guided by the AICPA Code of Professional Conduct.

.11 In many cases the financial statements may have to be adjusted (for example, accruals, deferrals, 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 must be performed in a given engagement to achieve its reporting objective. That is a matter of professional judgment. The extent of the total knowledge the accountant possesses about an entity and the industry in which it operates is the basis for planning the extent of procedures to be performed.

Analytical Procedures

.13 AR section 100.29 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:

- 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 100 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 AAM section 2400.48.

.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 100 does not require a formal process of developing and documenting expectations.
- Consider how close the existing account balance or class of transaction comes to the expectation developed in the previous step.
- If the differences are small, no additional evidence may be needed. If the differences are large, material errors could exist. Inquire about valid business reasons for the difference. If the results of inquiry are plausible and agree with other evidence, no additional evidence may be needed.
- If additional evidence is needed, apply other analytical procedures or obtain other suitable evidence.

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 100):

(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 100 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.

.22 A list of illustrative inquiries for a review engagement is included in AAM section 2400.53.

---

[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.

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

.24 AR section 100.35 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, AR section 100.35 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 100 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), AR section 100.25 requires the accountant to apply additional procedures. The accountant must achieve limited assurance that no material modifications are necessary to conform the financial statements to GAAP. Sometimes inquiries and analytical procedures will be sufficient. However, in many cases, the accountant will combine additional inquiry or analytical procedures with preparing other accounting schedules or analyses to explain fluctuations.

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

.30 An illustrative ratio analysis worksheet is included in AAM section 2400.54, and an illustrative analytical procedures comparative report is included in AAM section 2400.55.

Awareness Concerning Information Supplied

.31 AR section 100.25 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 AR section 100.43 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 generally accepted accounting principles.
- 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 should be tailored to the client based on the accountant's knowledge of the client's business and the

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

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 associations, and not-for-profit organizations). These additional representations may be found in AICPA *Industry Audit and Accounting Guides* you can obtain by contacting AICPA 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 since the accountant is concerned with events occurring through the date of the report that may require adjustments to or disclosure in the financial statements. The letter should be signed by those members of management whom the accountant believes are responsible for and knowledgeable, directly or through others in the organization, about the matters covered in the representation letter. Normally the chief executive officer and chief financial officer or others with equivalent positions in the entity should sign the representation letter. If the current management was not present during all the periods covered by the accountant's report, the accountant should nevertheless obtain written representations from current management on all such periods.

.37 An illustrative management representation letter is provided in Appendix F of AR section 100 and is included in AAM section 2400.51.

.38 There are circumstances in which an accountant should consider obtaining an updating representation 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 100 and is included in AAM section 2400.50.

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 AR section 100.37 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 AR section 100.38 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 AR section 100.29, 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 practitioners include some or all of the following in their work papers:

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

Additional Guidance

.44 For additional guidance practitioners should 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 should be documented in those engagements.

.45 Practitioners may also refer to the new 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 SSARS, suggests ways of implementing existing and new standards in special circumstances, and provides practical guidance to help implement the changes to AR section 100.

.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 AAM section 2400.48.	
8. Inquire of members of management having responsibility for financial and accounting matters concerning:	
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 AR section 100.60.	
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.	
b. The analytical procedures performed.	

(continued)

Procedure	Completed by or N/A
c. The expectations as discussed in AR section 100.29, 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 work 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:

- 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), as amended, 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 [*No earlier than the date of the Accountant's Report*])

(To the Accountant)

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

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

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.[4]

We confirm, to the best of our knowledge and belief, (as of [*a date no earlier than the date of review report, see section 100.79]*), 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 for the design and implementation of programs and controls to prevent and detect fraud.
5. 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 that could have a material effect on the financial statements.
6. We have no knowledge of any allegations of fraud or suspected fraud affecting the entity received in communications from employees, former employees, or others.

---

[4] 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. We have no plans or intentions that may materially affect the carrying amounts or classification of assets and liabilities.
8. 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.
9. There are no:
   a. Violations or possible violations of laws or regulations, whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
   b. Unasserted claims or assessments that our lawyer has advised us are probable of assertion that must be disclosed in accordance with Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies.*[5]
   c. Other material liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5.
10. The company has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets, nor has any asset been pledged as collateral.
11. We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.
12. 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.*]

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.

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

- The financial statements disclose all of the matters of which we are aware that are relevant to the entity's ability to continue as a going concern, including significant conditions and events, and our plans.
- We have reviewed long-lived assets and certain identifiable intangibles to be held and used for impairment whenever events or changes in circumstances have indicated that the carrying amount of those assets might not be recoverable and have appropriately recorded the adjustment.

---

[5] 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.

- Debt securities that have been classified as held-to-maturity have been so classified due to our intent to hold such securities to maturity and our ability to do so. All other debt securities have been classified as available-for-sale or trading.
- We consider the decline in value of debt or equity securities classified as either available-for-sale or held-to-maturity to be temporary.
- Receivables reported in the financial statements represent valid claims against debtors for sales or other charges arising on or before the balance-sheet date and have been appropriately reduced to their estimated net realizable value.
- We believe that the carrying amounts of all material assets will be recoverable.
- All agreements to repurchase assets previously sold have been properly disclosed.
- We have made provisions for losses to be sustained in the fulfillment of, or from the inability to fulfill sales commitments.

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)

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

See AU section 333.17, *Management Representations*, Appendix B, “Additional Illustrative Representations” (AICPA, *Professional Standards*, vol. 1), for other representations that may be appropriate from management relating to matters specific to the entity’s business or industry.

.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 . . ."[6]

[*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)

See AU section 333.17 for other representations that may be appropriate from management relating to matters specific to the entity's business or industry.

[6] 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 100. 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 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[7] 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, 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?

---

[7] 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 Financial Accounting Standards Board Statement No. 95, *Statement of Cash Flows*.

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 measurements 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/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

Below you will find 24 financial ratios. These financial ratios include liquidity, activity, and efficiency ratios. Accountants should use the ratios deemed necessary and use additional ones as needed.

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

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

For private companies (four variable):

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

For private companies (five variable):

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

For public companies:

$\dfrac{\text{Working Capital}}{\text{Total Assets}}$	×	.012	=	
$\dfrac{\text{Retained Earnings}}{\text{Total Assets}}$	×	.014	=	
$\dfrac{\text{Income before Interest and Taxes}}{\text{Total Assets}}$	×	.033	=	
$\dfrac{\text{Market Value Equity}}{\text{Book Value of Total Liabilities}}$	×	.006	=	
$\dfrac{\text{Sales}}{\text{Total Assets}}$	×	.999	=	
		Altman Z Score		

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

.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 must be presented in a format that has eye appeal, is understandable, conveys the company's financial picture, and can be produced economically. Preparing financial statements is a science in that it requires mastery of a complex array of authoritative standards for measurement, presentation, and disclosure.

Title Page

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

Name of the Entity

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

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

Title of Financial Statements

.04 If the presentation includes more than one type of financial statement (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 should include the words "consolidated" or "combined." When financial statements include supplementary information, the title should be modified. Some practitioners add a description of the service performed to the title of the financial statements on the title page.

Date or Period Covered

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

Presentation of the Accountant's Report

.06 This section discusses presentation and format of the accountant's report. AAM section 2600, *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 should be addressed to the Board of Directors, stockholders, or both. Reports are not intended as letters. Accordingly, addresses that include street names or zip codes are not appropriate. Examples of appropriate addresses are as follows:

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

Salutations

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

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* or Changes in Stockholders' Equity
- Statement of Cash Flows

Heading

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

Reference on Financial Statements

.15 The type of reference/legend on the financial statements depends upon the type of engagement:

- If the financial statements are reviewed, each page of the financial statements should contain a reference, such as: *See Accountant's Review Report*.
- If the financial statements are compiled for general-use (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:
  - — *Restricted for Management's Use Only*, or
  - — *Solely for the information of and use by the management of XYZ Company and not intended to be and should not be used by any other party*.
- If the financial statements are compiled and included in certain prescribed forms (according to SSARS No. 3, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms* [AICPA, *Professional Standards*, vol. 2, AR sec. 300]), each page of the form should include a reference, such as: *See Accountant's Compilation Report*.
- If the financial statements are personal financial statements prepared for inclusion in a personal financial plan (SSARS No. 6, *Reporting on Personal Financial Statements Included in Written Personal Financial Plans* [AICPA, *Professional Standards*, vol. 2, AR sec. 600]), each of the personal financial statements should contain a reference to the report, such as: *See Accountant's Report*.

---

* The accounting literature does not require the statement of retained earnings to be presented as a 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 (since the footnotes are part of the financial statements). However, there is diversity in practice as to how to meet this requirement for footnotes. Some practitioners place the reference on each page of the footnotes, and others place the reference only on the first page of the footnotes. Still others place a statement on each page of the financial statements that "the notes are an integral part of the financial statements" and, therefore, do not place the reference on the footnote pages. Any of these approaches is acceptable.

.17 Also, the references above are examples given in SSARS, and the accountant may modify the wording of the reference. SSARS No. 1, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR sec. 100), requires only that the accountant refer to the report—not that he or she state the type of report (level of service) in the reference. Therefore, the reference "See Accountant's Report" would be sufficient in all engagements that contain a report. However, most practitioners follow the wording given in the examples. Accountants may place the reference on the financial statements by installing footers in the financial statement software, by using a rubber stamp, by manually writing the reference or by any other method that is practical to use.

Use of the Term "Unaudited"

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

Supplementary Information

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

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

Presentation

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

Reporting

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

Headings

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

Reference to Report

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

Disclosures

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

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

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

.26 Note that if the financial statements are presented on a basis of accounting other than GAAP (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 should not be labeled as "Notes to the Financial Statements" (this title implies full disclosure). Instead, an appropriate title would be "Selected Information—Substantially All Disclosures Required by GAAP Are Not Included."

Referencing Notes

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

[*The next page is 2551.*]

AAM Section 2600
Reporting

Reporting Obligation

.01 AR section 100, *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:

- A compilation is the minimum level of service that an accountant can provide before submitting unaudited financial statements of a nonpublic entity to a client or others (AR section 100.01)
- The accountant should not consent to the use of his or her name in a document or written communication containing unaudited financial statements of a nonpublic entity unless (*a*) the accountant has compiled or reviewed the financial statements in compliance with the provisions of AR section 100, or (*b*) the financial statements are accompanied by an indication that the accountant has not compiled or reviewed the financial statements and that the accountant assumes no responsibility for them. For example, the indication may be worded as follows:
- The accountant should issue a report prepared in accordance with Statement 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 SSARS No. 1, as amended by SSARS No. 9)
- The accountant should issue a report prepared in accordance with SSARS whenever he or she is engaged to review financial statements of a nonpublic entity (paragraph 34 of SSARS No. 1, as amended by SSARS No. 9)

  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 3 of SSARS No. 1, as amended by SSARS No. 9)

- The accountant should issue a report prepared in accordance with SSARS whenever he or she is engaged to compile financial statements of a nonpublic entity, or submits financial statements that are reasonably expected to be used by a third party (paragraph 11 of SSARS No. 11, as amended by SSARS No. 9)
- The accountant should issue a report prepared in accordance with SSARS whenever he or she is engaged to review financial statements of a nonpublic entity (paragraph 39 of SSARS No. 1, as amended by SSARS No. 9)

.02 The first item in the bulleted list above is addressed in AR section 100.01. Whenever the accountant prepares financial statements (manually or using a computer) and presents them to a client or third parties, he or she has submitted financial statements. When this occurs, the accountant must at least perform a compilation.

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

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

Basic Compilation Reports

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

- A statement that a compilation has been performed in accordance with SSARS, issued by the AICPA
- A statement that a compilation is limited to presenting in the form of financial statements information that is the representation of management (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 Financial statements reviewed by an accountant should be accompanied by a report which includes the following basic elements:

- A statement that a review has been performed in accordance with SSARS, issued by the AICPA
- A statement that all information included in the financial statements is the representation of management (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 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.

.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 generally accepted accounting principles (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 should not be labeled as "Notes to the Financial Statements" (this title implies full disclosure). Instead, an appropriate title would be "Selected Information—Substantially All Disclosures Required by GAAP Are Not Included."

.15 Interpretation No. 1 of SSARS No. 1, "Omission of Disclosures in Reviewed Financial Statements" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.01), indicates that the above modification for compiled

[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, ET sec. 100).

financial statements is not appropriate for reviewed financial statements. Since the omission of substantially all disclosures is a departure from GAAP, the review report should include the omitted disclosures.

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

Reporting on Financial Statements With Departures From GAAP

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

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

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

Reporting When There Are Significant Departures From GAAP

.19 According to Interpretation No. 7 of SSARS No. 1, "Reporting When There Are Significant Departures From Generally Accepted Accounting Principles" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.23–.26), an accountant cannot modify a compilation or review report to indicate that the financial statements are not fairly presented in accordance with GAAP. Thus, an adverse opinion is not appropriate in a compilation or review engagement. An adverse opinion can only be expressed in an audit engagement.

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

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

Date of Reports

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

Highest Level of Service

.22 If the accountant provides more than one level of service on the same financial statements (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 of SSARS No. 1, "Reporting on the Highest Level of Service" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.06–.12) provides guidance on the type of report to be issued when the accountant performs procedures that go beyond those required. It states that simply performing procedures (for example, analytical procedures in a compilation engagement) do not require the issuance of the higher report.

.24 Interpretation No. 13 of SSARS No. 1, "Additional Procedures" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.46–.49) addresses whether an accountant can perform audit procedures in a compilation or review engagement and still issue a compilation or review report. It states that this is acceptable, but the report should not reference the additional procedures performed.

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

.26 An exception to the highest level of service rule is indicated in AR section 100.45. 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 300, *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:

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

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

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

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

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

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

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

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

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

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

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

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

Reporting When Supplementary Information Is Included

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

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

.37 The term "supplementary information" is not defined in SSARS. 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:

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

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

.40 SSARS No. 1, as amended by SSARS No. 9 (AR section 100.60), requires that the accountant indicate the degree of responsibility, if any, he or she is taking with respect to the supplementary information that accompanies the basic financial statements.

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

> We have compiled the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings and cash flows for the year then ended, and the accompanying supplementary information contained in Schedules A and B, which are presented only for supplementary analysis purposes, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.
>
> A compilation is limited to presenting in the form of financial statements and supplementary schedules information that is the representation of management. We have not audited or reviewed the accompanying financial statements and supplementary schedules and, accordingly, do not express an opinion or any other form of assurance on them.

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

- The other data accompanying the financial statements are presented only for supplementary analysis purposes and have been subjected to the inquiry and analytical procedures applied in the review of the financial statements, and the accountant did not become aware of any material modifications that should be made to such data (in other words the accountant is stating that he or she also *reviewed* the supplementary information), or
- The other data accompanying the financial statements are presented only for supplementary analysis purposes and have not been subjected to the inquiry and analytical procedures applied in the review of the financial statements, but were compiled from information that is the representation of management, without audit or review, and the accountant does not express an opinion or any other form of assurance on such data (in other words, the accountant is stating that he or she reviewed the financial statements but only *compiled* the supplementary information).

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

Client-Prepared Supplementary Information

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

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

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

.45 When the client-prepared supplementary information is bound in the accountant's report cover, a third party would normally conclude that the accountant has some responsibility for the information. Thus, in such a situation, being silent about the accountant's responsibility for the client-prepared supplementary information is not a valid alternative. SSARS No. 1 (AR section 100.60) 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 SSARS No. 1 and SSARS No. 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 should be accompanied by a statement that they were not prepared by the accounting firm and the accounting firm assumes no responsibility for them. Absent such a statement, the accountant is advised to consult with his attorney to consider what other actions are appropriate. In such situations, the accountant should ask the client to disclose (preferably on a page immediately preceding the data) a statement such as the following:

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

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

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

Percentages

.48 Percentages presented in the financial statements (as is commonly the case with computer-generated statements) do not constitute supplementary information for purposes of the reporting requirements of AR section 100. Accordingly, the accountant should not mention the percentages in the report. A related question is whether the inclusion of such percentages implies the accountant has performed analytical procedures and, thus, must report on the financial statements as if it were a SSARS review engagement. Most would argue that this is not the case.

Forecast or Projection Included With Historical Financial Statements

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

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

Pro Forma Information

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

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

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

.53 In situations where the pro forma information is treated as supplementary information, the reporting guidance in AR section 100 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 AR section 120.05, 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 AR section 100.16, as amended.

.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.

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 generally accepted accounting principles.

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.)

---

[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 AR section 100.16–.18, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2).

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

Reporting on Charts and Graphs

General

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

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

Charts and Graphs That Accompany Financial Statements

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

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

Stand-Alone Charts and Graphs

.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 Footnote 29 of AR section 100 states, "Nothing in this statement . . . is intended to preclude an accountant from emphasizing in a separate paragraph of his or her report a matter regarding the financial statements." In other words, footnote 29 permits, but never requires, an emphasis paragraph (as long as the matter is appropriately disclosed in the financial statements). If the financial statements are deficient or do not contain a needed disclosure and the client does not correct the statements, the accountant is *required* to state, in a separate paragraph of the report, that the financial statements contain a departure from GAAP.

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

- Emphasis paragraphs should not introduce new information about the financial statements; they should only emphasize a matter that is disclosed in the financial statements.
- If the financial statements are deficient or do not contain a needed disclosure and the client does not correct the statements, the accountant is *required* to state, in a separate paragraph of the report, that the financial statements contain a departure from GAAP. This required paragraph differs from a voluntary emphasis paragraph.
- Emphasis paragraphs should not contain information about the procedures the accountant has or has not performed.
- Emphasis paragraphs should not contain any conclusions or opinions.
- If the accountant decides to add an emphasis paragraph to highlight a going-concern disclosure in the client's financial statements, he or she should not use the term "substantial doubt" in that paragraph (Substantial doubt is an audit-evidence-based concept that should only be used in audit reports.)

Going Concern Issues

.67 According to Interpretation No. 11 of SSARS No. 1, "Reporting on Uncertainties" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.33–.40) and footnote 29 of SSARS No. 1, the accountant should consult AU section 341.10–.11, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1), to evaluate the adequacy of disclosure of uncertainties caused by concern about the entity's ability to continue as a going concern. If, based on AU section 341, the accountant believes that the financial statement disclosure of the uncertainty is inadequate, he or she should consider modifying the report. See the preceding "Emphasis Paragraphs" section above for further information.

Full Disclosure Financial Statements

.68 As discussed earlier, footnote 29 of SSARS No. 1 permits, but never requires, an emphasis paragraph (as long as the matter is appropriately disclosed in the financial statements). If the accountant decides to add a paragraph to emphasize a going concern matter, Interpretation No. 29 of SSARS No. 1, "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. 9100.123) contains illustrative language that he or she may use:

> As discussed in Note X, certain conditions indicate that the Company may be unable to continue as a going concern. The accompanying financial statements do not include any adjustments 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 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 Since the user is alerted that substantially all disclosures have been omitted from the financial statements (by adding a paragraph to the compilation report to explain the omission), going concern disclosures would not be required.

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

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

Reporting on Computer-Prepared Financial Statements

.72 Computer-prepared financial statements for interim or annual periods that contain disclosure omissions or measurement departures must be reported on in accordance with AR section 100. The accountant cannot place a legend on computer-prepared financial statements saying that the statements were not compiled, reviewed, or audited by an accountant and thereby avoid the reporting requirements of AR section 100.

Reporting When There Is a Scope Limitation

.73 Scope limitations occur in audit engagements when the auditor is prevented from applying GAAS because of limitations imposed by the client or caused by circumstances. When an auditor encounters a scope limitation, he or she issues an "except for" opinion or disclaimer of opinion. However, AR section 100 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. AR section 100.43 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.

.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 should consider the following:

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

.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. AR section 100.09 requires the accountant to withdraw from the engagement if the client refuses to provide additional or revised information. A scope restriction resulting from inadequate accounting records should normally be considered a client-imposed restriction. Although the restriction may be unintentional, the maintenance of adequate accounting records is within the client's control. Situations where the client is unable to provide additional or revised information should be rare. One such situation may be when accounting records have been destroyed.

.77 When there has been a scope restriction that precludes a review report and the accountant decides to issue a compilation report, AR section 100.68 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 should try to provide other accounting information to the client, short of submitting financial statements. For example, a working trial balance may satisfy the client's needs.

Reporting on Financial Statements Included in MCS Reports

General

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

Financial Statements Compiled or Reviewed by Another Accountant

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

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

.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 since they are included in a document (MCS report) that bears their name and because a compilation is the lowest level of service with which they would want to be associated. If the accountant decides not to compile the statements, he or she should add a statement to the MCS report to clarify his or her responsibility for the financial statements. Such a statement might be worded as follows:

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

Reporting When Only One Financial Statement Is Presented

.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 SSARS No. 2, *Reporting on Comparative Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR sec. 200), sets forth the authoritative requirements that obligate the accountant to report on each period when financial statements of two or more periods are presented in columnar form. Reporting is simple unless a change of accountants has occurred, the level of service (compilation or review) differs from period to period, or a change in the nonpublic status of the entity has occurred. In these situations, the accountant may face some rather complex reporting decisions. Because the accountant may not face these complexities often, applying SSARS No. 2 can be daunting.

.87 The following definitions from SSARS No. 2 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

- 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]

[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. [SSARS No. 2, *Reporting on Comparative Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR sec. 200), as amended, effective May 2004, by SSARS No. 11, *Standards for Accounting and Review Services* (AICPA, *Professional Standards*, vol. 2, AR sec. 50).]

- 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 AR section 200.20, 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.

Changed Prior Period Financial Statements

.102 When the financial statements have been changed, either the predecessor (as discussed above) or the successor should report on the restated financial statements. If the successor reports on them, he or she should audit, review, or compile the financial statements and report accordingly. The successor accountant is not precluded from issuing a compilation or review report on the financial statements for both years. Additionally, the predecessor is not precluded from updating his or her compilation or review report. If the predecessor accountant does not reissue his or her report and the successor auditor does not report on the restated 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.

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 SSARS No. 2. Basically, it permits the successor to (*a*) make reference to the old or acquired firm's report or (*b*) assume compilation, review, or audit responsibility for the prior period financial statements. The new firm or purchaser may also indicate in the report that a merger or purchase took place if reference is made to the predecessor's report. However, the predecessor firm should not be named.

Change of Accountants—Predecessor Accountant Has Ceased Operations

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

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

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

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

- That the prior period financial statements were audited by another firm who has ceased operations
- The date of the predecessor's report
- The type of opinion issued by the predecessor

- If the opinion was other than unqualified, the substantive reasons therefore
- That no auditing procedures were performed after the date of the predecessor's report

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

Change of Status—Public/Nonpublic Entity

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

SSARS No. 2 Summary

.111 SSARS No. 2 is rather complex. The following summary decision aid helps simplify the report decision process in SSARS No. 2. The comparative statements are for years 20X5 and 20X6.

1. If 20X6 is audited, SASs apply.
2. If the entity's current status for 20X6 is a public company, SASs apply.
3. For continuing accountant:
   a. If 20X6 level of service is equal to or higher than 20X5, update report.
   b. If 20X6 is lower level of service, either refer to or reissue prior report.
4. For successor accountant:
   a. If predecessor does not reissue, refer to report of predecessor or perform audit, review, or compilation of 20X5.
   b. If financial statements are restated because of an error and predecessor doesn't report on restated financials, perform audit, review, or compilation of 20X5.

Split-Level Reporting

.112 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

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

Preliminary Financial Statement Drafts

.114 Interpretation No. 17 of SSARS No. 1, "Submitting Draft Financial Statements" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.62) 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."

.115 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[1] of Financial Statements of a Nonpublic Entity

.01 Accountants' Standard Report

Stockholders and Board of Directors
[*Company*]

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

January 28, 20X7

[*Signature of CPA*]

---

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

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

.02 Omission of Substantially All Disclosures

Stockholders and Board of Directors
[*Company*]

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

.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*]

.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*]

.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*]

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

Stockholders and Board of Directors
[*Company*]

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

.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*]

.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*]

.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*]

.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*]

.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*]

.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*]

.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*]

.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*]

.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*]

.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).[2]

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.*][3]

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*]

---

[2] 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.

[3] 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*]

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

January 28, 20X7

[*Signature of Successor CPA*]

.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 who have ceased operations, and they expressed an unqualified opinion on them in their report dated [*Date*], but they have not performed any audit procedures since that date.

January 28, 20X7

[*Signature of Successor CPA*]

[*The next page is 2641.*]

AAM Section 2620

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

.01 Accountants' Standard Report

Stockholders and Board of Directors
[*Company*]

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

January 28, 20X7

[*Signature of CPA*]

---

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

.02 Departure From GAAP—Accounting Principle Not Generally Accepted

Stockholders and Board of Directors
[*Company*]

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

.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*]

.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*]

.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*]

.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*]

.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*]

.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*]

.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*]

.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*]

.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*]

.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*]

.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 who have ceased operations and 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*]

.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 who have ceased operations, 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*]

[*The next page is 2661.*]

AAM Section 2700
Special Areas

Other Comprehensive Bases of Accounting

.01 Bases of accounting other than generally accepted accounting principles (GAAP) (referred to as other comprehensive bases of accounting, or OCBOA) have become a widely used alternative to the numerous and sometimes complex accounting requirements prescribed by GAAP. Unfortunately, there is very little authoritative guidance related to applying OCBOA.

.02 The only authoritative guidance for OCBOA is found in the auditing standards. AU section 623.03, *Special Reports* (AICPA, *Professional Standards*, vol. 1), and states that "an independent auditor's judgment concerning the overall presentation of financial statements should be applied within an identifiable framework." Ordinarily, that framework is provided by GAAP, but AU section 623 allows the use of a comprehensive basis of accounting other than GAAP (AR section 100, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2), also recognizes OCBOA for compiled and reviewed financial statements). AU section 623 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 receipts and disbursements basis of accounting, and modifications of the cash basis having substantial support, such as recording depreciation on fixed assets or accruing income taxes
- A definite set of criteria having substantial support that is applied to all material items appearing in financial statements, such as the price-level basis of accounting

.03 AU section 623.04 prohibits auditors from issuing the special report described in the Statement on Auditing Standards (SAS) unless one of the foregoing descriptions applies to the financial statements.

Deciding When To Use an OCBOA

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

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

- 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
- 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

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

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

Basic Financial Statements

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

Statement Titles

.08 AU section 623.07 and Interpretation No. 12 of Statement on Standards for Accounting and Review Services (SSARS) No. 1, "Reporting on a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.41–.45) indicate that titles of OCBOA financial statements should differ from titles of similar statements prepared in accordance with GAAP. AU section 623 and Interpretation No. 12 do not require specific titles, although they do list examples.

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
Statement of Income & Retained Earnings	Statement of Revenues, Expenses, and Retained Earnings—Cash Basis	Statement of Revenues, Expenses, and Retained Earnings—Income Tax Basis
Statement of Changes in Equity	Statement of Changes in Equity—Cash Basis	Statement of Changes in Equity—Income Tax Basis
Statement of Cash Flows	Statement of Cash Flows—Cash Basis	Statement of Cash Flows—Income Tax Basis

Notes:

- These titles are only suggestions. Other titles may be derived from the suggestions in AU section 623.07–.08.
- The pure cash basis has a single asset and no liabilities. Accordingly, only a single statement titled "Statement of Cash Receipts and Disbursements" is normally presented.
- Although Financial Accounting Standards Board (FASB) Statement No. 95, *Statement of Cash Flows,* does not require a statement of cash flows for OCBOA financial statements, if a cash flow statement is presented, it is suggested that the basis of accounting used be added to the statement title.

Disclosures

.09 Authoritative accounting literature does not address OCBOA or the disclosures necessary in such presentations. Limited guidance on disclosures can be found in the auditing literature (which is also applicable to compilation and review engagements). AU section 623 establishes the overriding criterion that cash, modified cash, and income tax basis financial statements should be "informative of matters that may affect their use, understanding, and interpretation." It goes on by stating that:

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

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

.11 A survey completed by the AICPA Private Companies Practice Section in the mid-1990's found that there was a great deal of diversity in the interpretation of AU section 623 regarding the issue of disclosures. Guidance for practitioners was needed.

.12 To help clarify the issue of the disclosures related to AU section 623, the Audit Issues Task Force (AITF) of the Auditing Standards Board issued Interpretation No. 14 of AU section 623, *Evaluating the Adequacy of Disclosure in Financial Statements Prepared on the Cash, Modified Cash, or Income Tax Basis of Accounting* (AICPA, *Professional Standards* vol. 1, AU sec. 9623.90–.95). The interpretation provides the following guidance:

- The discussion of the basis of accounting required by AU section 623 may be brief and only needs to describe the primary differences from GAAP. Quantifying differences is not required.
- If the financial statements contain amounts for which GAAP would require disclosure, the statements should either provide the relevant disclosure or provide information that communicates the substance of that disclosure.
- If GAAP sets forth requirements that apply to the presentation of financial statements, cash, modified cash, and income tax basis statements should either comply with those requirements or provide information that communicates the substance of those requirements.
- A statement of cash flows is not required in presentations on the cash, modified cash, or income tax basis of accounting. However, if a presentation of cash receipts and disbursements is presented in a format similar to a statement of cash flows or if the entity chooses to present such a statement, the statement should conform to the requirements for a GAAP presentation or communicate the substance of the GAAP requirements.
- If GAAP would require disclosure of other matters, the need for that same disclosure or disclosure that communicates the substance of those requirements should be considered.

Cash Basis of Accounting

Pure Cash Basis

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

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

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

Modified Cash Basis

.15 AU section 623 describes the modified cash basis of accounting as the pure cash basis incorporating modifications having substantial support. These modifications generally include the recognition of certain transactions on an accrual basis, as entities would recognize them under GAAP. The appropriate modifications and the extent of those modifications are not clearly defined in the literature, however.

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

- They are profit oriented
- They distribute profits as collected (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

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

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

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

Nontaxed Entities

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

Other Bases of Accounting

.20 Although less common, entities may present their financial statements on a basis of accounting other than cash, tax, or GAAP. For example, insurance companies present financial statements on a regulatory basis. In addition, AU section 623 allows entities to use other comprehensive bases if they have substantial support and are applied consistently to all items in the financial statements. At the present time, however, only the price-level basis of accounting meets that criteria, and its use is very rare.

Disclosure of Basis of Accounting

.21 AR section 100 states that when the accountant reports on compiled financial statements that omit substantially all disclosures, he or she must disclose the basis of accounting in the compilation report if it is not disclosed in the financial statements. This paragraph has been interpreted by some accountants to mean that compiled or reviewed OCBOA financial statements must disclose the OCBOA is some manner, but that such statements are not required to describe the basis of accounting or to state that it is a comprehensive basis of accounting other than GAAP. AU section 623 requires these latter two disclosures for audited OCBOA financial statements.

.22 Interpretation No. 12 of SSARS No. 1 clarifies the disclosure requirements of OCBOA financial statements. The interpretation states that, ordinarily, OCBOA statements would contain a note stating the basis of presentation and describing how the basis differs from GAAP. Thus, the interpretation implies that the OCBOA disclosures for a SSARS engagement and an audit engagement should be similar. However, the location of this disclosure does differ. In a SSARS engagement, the disclosure is made in the notes. In an audit engagement, AU section 623 requires that the disclosure of the basis of presentation and a statement that it is a basis other than GAAP be made in a separate paragraph in the auditor's report, with a description of how the basis of presentation differs from GAAP in the notes. However, the difference between GAAP and the basis need not be quantified. Interpretation No. 14 of AU section 623 makes an exception to this disclosure requirement for compiled OCBOA financial statements that omit substantially all disclosures. In such an engagement, the report is modified by adding a sentence such as the following to the first paragraph of the report:

> The financial statements have been prepared on the accounting basis used by the Company for federal income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles.

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

Other Disclosures

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

Reporting

.25 In general, the only report modification necessary when financial statements are prepared using a comprehensive basis of accounting other than GAAP is the identification of the financial statements. Since financial statements prepared using an OCBOA must contain modified titles (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, AR section 100 requires that he or she disclose the basis of accounting. This disclosure may be in an attached footnote or in a note on the face of the financial statements. If disclosure is not made as part of the financial statements, modification of the compilation report would be required.

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

> Management has elected to omit substantially all disclosures ordinarily included in financial statements prepared on the income tax basis of accounting. If the omitted disclosures were

> included in the financial statements, they might influence the user's conclusions about the Company's assets, liabilities, equity, revenue, and expenses. Accordingly, these financial statements are not designed for those who are not informed about such matters.

Prescribed Forms

Background

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

Provisions of SSARS No. 3

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

.29 According to AR section 300.03, *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.

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

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

Departures From GAAP or From the Prescribed Form

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

- Departures from GAAP required by the prescribed form. This type of departure does not require disclosure in the AR section 300 report.
- Departures from GAAP not required by the prescribed form. Such departures must be disclosed following the guidance in AR section 100.
- Departures from the requirements of the prescribed form. These departures also require disclosure following the guidance in AR section 100.

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

Signing a Preprinted Report Form

.33 AR section 300.05 states that the accountant should not sign a preprinted report form unless the language in it conforms to the guidance in AR section 300 or AR section 100. If the preprinted report is not suitable, the accountant should attach an appropriate report to the prescribed form. It is advisable to type, "See accountant's report" in the prescribed form signature block.

Determining When AR Section 300 Is Applicable

.34 Questions involving the applicability of AR section 300 might pertain to the definition of a prescribed form, the type of service involved or clarification of how a form calls for a departure from GAAP. These issues are discussed in the following questions.

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

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

.37 Is a tax return a prescribed form? No. AR section 300 refers to financial statements, and thus excludes financial presentations included in tax returns. Interpretation No. 10, "Reporting on Tax Returns" of AR section 100 (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.31–.32) points out that an accountant may attach a report to tax or information returns. This report should follow the guidance in AR section 100, since the tax return will be submitted to a user that did not design the form.

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

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

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

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

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

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

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

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

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

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

Personal Financial Statements

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

.47 AICPA Statement of Position (SOP) 82-1, *Accounting and Financial Reporting for Personal Financial Statements* (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

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

Acceptance of Clients

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

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

Engagement Letters

.51 Both AR section 100 and the *Personal Financial Statements Guide* recommend, but do not require, written engagement letters. Engagement letters are especially important in personal financial statement engagements to:

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

Client Representation Letters

.52 Although AR section 100 only requires that a representation letter be obtained from the client in engagements to review personal financial statements, the *Personal Financial Statements Guide* recommends obtaining written representations on all personal financial statement engagements, because:

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

Compilation of Personal Financial Statements

.53 Standards for compilation of financial statements prescribed by AR section 100 are applicable to the compilation of personal financial statements in the same manner as to the compilation of other financial statements. There is an exception for personal financial statements contained in written financial plans, if certain criteria are met (see the subsequent section in this Manual, "Exception for Personal Financial Statements Included in Written Financial Plans"). Thus, in compiling personal financial statements, the accountant must meet the same general requirements.

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

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

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

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

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

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

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

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

Review of Personal Financial Statements

.61 Standards for the review of financial statements prescribed by AR section 100 are applicable to the review of personal financial statements in the same manner as the review of other financial statements. Accordingly, to review personal financial statements, the accountant must meet the following general requirements.

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

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

Reporting

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

> I (we) have compiled the accompanying statement of financial condition of James and Jane Person as of December 31, 20XX, and the related statement of changes in net worth for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.
>
> A compilation is limited to presenting in the form of financial statements information that is the representation of the individuals whose financial statements are presented. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

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

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

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

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

Exception for Personal Financial Statements Included in Written Financial Plans

.67 AR section 600.03, *Reporting on Personal Financial Statements Included in Written Personal Financial Plans* (AICPA, *Professional Standards*, vol. 2), provides an exemption from AR section 100 for personal financial statements included in written personal financial plans when the following conditions exist:

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

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

.69 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. 9600.01) clarifies that the same exception applies when an accountant submits a written personal financial plan containing the financial statements for use by a client's advisers to help the client implement the personal financial plan. Implementing the plan includes, for example, use of the plan by an insurance broker who will recommend specific insurance products to the client, an investment adviser who will provide specific recommendations about the investment portfolio, and an attorney who will draft a will or trust document.

The Accountant's Report

.70 AR section 600 prescribes the following language when the conditions of the AR section 100 exemption are met:

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

.71 AR section 600 does not require the accountant to identify specific measurement or disclosure departures in the report. As with any SSARS engagement, the accountant is required to place a notation such as "See accountant's report" on each financial statement page.

Specified Elements, Accounts, or Items of a Financial Statement

.72 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.)

.73 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.

.74 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 should refer to AR section 100.60, as amended. 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.

.75 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.

.76 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.

.77 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 AAM section 2600.05, *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.

.78 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."

.79 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

.80 SSARS No. 1, as amended by SSARS No. 9, *Omnibus Statement on Standards for Accounting and Review Services—2002* (See AR section 100.70–.72), 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. 202.01) of the Code of Professional Conduct of the American Institute of Certified Public Accountants requires members to comply with such standards when associated with reviewed or compiled financial statements.

.81 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.

.82 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. This amendment is effective for review reports dated January 1, 2003, or after, by SSARS No. 9.

[*The next page is 2701.*]

AAM Section 2710

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

.01 Compilation Report—Cash Basis Statements; Full Disclosure

Stockholders and Board of Directors
[*Company*]

We have compiled the accompanying statement of assets, liabilities, and equity—modified cash basis of [*Company*] as of 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*]

.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*]

.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*]

.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*]

.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*]

.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*]

.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*]

.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*]

.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*]

.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*]

[*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. Readers are urged to 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.

TABLE OF CONTENTS

Section *Paragraph*

[*The next page is 3101*.]

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. 201.01), AICPA Code of Professional Conduct, which states: "A member shall adequately plan and supervise an engagement."

.03 The first standard of fieldwork of generally accepted auditing standards states: "The auditor must adequately plan the work and must properly supervise any assistants." Statement on Auditing Standards (SAS) No. 108, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), establishes standards and provides guidance to the independent auditor conducting an audit in accordance with generally accepted auditing standards on the considerations and activities applicable to planning and supervision.

.04 Proper planning also enhances the productivity of engagement personnel and should 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

---

[1] Paragraph 3 of SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314), 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.

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.

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 SAS No. 108 requires the auditor to 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 should describe in detail the services to be rendered, the fee, and other terms and conditions of the engagement. Oral agreements may result in differences of recollection or understanding between the accountant and the client.
- *Avoid misunderstandings by the staff*. The members of the staff working on the engagement must have a complete understanding of what is required of them. A copy of the engagement letter in the working papers provides them with an authoritative reference to supplement their oral instructions.

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

.12 The understanding with the client should be obtained and the letter should be prepared before any significant work takes place on the engagement. The partner should personally present the letter to the client to ensure that a complete understanding has been achieved. The understanding or a signed copy of the engagement letter should be filed with the engagement's current working papers and permanent file.

Practice Tip

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

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

Special Considerations

.14 The following matters should 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 508.42, *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 generally accepted auditing standards. Those standards require that the auditor obtain reasonable rather than absolute assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Accordingly, a material misstatement may remain undetected. Also, an audit is not designed to detect error or fraud that is immaterial to the financial statements. If, for any reason, the auditor is unable to complete the audit or is unable to form or has not formed an opinion, he or she may decline to express an opinion or decline to issue a report as a result of the engagement.

- An audit includes obtaining an understanding of 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 should be addressed to those charged with governance, chief executive, or to whomever retained the firm. The engagement partner should sign the letter on behalf of the firm. The client representative responsible for the engagement should sign the letter denoting agreement with the contract. The original letter should be maintained in the engagement documentation. A copy of the letter should be given to the client.

.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 should be based on conservative, carefully prepared estimates. The expected billing methods and payment periods should be described.

- Any limitation of or other arrangements regarding the liability of the auditor or the client, such as indemnification to the auditor for liability arising from knowing misrepresentations to the auditor by management (regulators, including the Securities and Exchange Commission, may restrict or prohibit such liability limitation arrangements).

- Conditions under which access to the auditor's documentation may be granted to others.

- Additional services to be provided relating to regulatory requirements.
- 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. 101.05).

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

- The general ledger.
- A reconciliation for each bank account.
- A trade accounts receivable aging.
- Accounts receivable confirmation letters, using drafts to be provided by the accountant.
- A schedule of accounts receivable from officers and employees.
- A schedule of bad debts written off during the year.
- A schedule of notes receivable. The notes should be available for inspection.
- A schedule of transactions with affiliated enterprises.
- An inventory listing.
- An analysis of transactions affecting marketable securities.
- An insurance schedule. The policies should be available for inspection.
- A schedule of property and equipment additions and retirements.
- A depreciation schedule.
- A schedule of life insurance for officers.
- A schedule of accounts payable. The creditor's regular monthly statements for [*date*] should be retained and made available.
- A schedule of notes payable.
- The corporate stock book and minutes should be up to date and available for inspection.
- A schedule of all transactions to partners' capital and drawing accounts.
- A copy of the partnership agreement or corporate charter should be available for inspection.
- Copies of all leases, including equipment rental contracts, should be available for inspection.
- Copies of employment contracts with salesmen or executives should be available for inspection.
- Copies of pension, profit-sharing, deferred compensation, and stock option agreements, and letters of acceptance from the Treasury Department, should be available for inspection.
- A schedule of repairs in excess of $________.
- A schedule of each officer's salary and expense account payments.
- A schedule of contributions.
- A schedule of tax expense.
- A schedule of professional fees.

.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 of 1971.

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

Sample Engagement Letters

.22 See AAM section 3165 for sample engagement letters.

Preliminary Engagement Activities

.23 In addition to the procedures mentioned above, 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 SAS No. 108 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:

- A description of the nature, timing, and extent of planned risk assessment procedures sufficient to assess the risks of material misstatement, as determined under SAS No. 109, *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 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). 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 generally accepted auditing standards (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 The auditor may discuss elements of planning with those charged with governance and the entity's management. These discussions may be a part of the overall communications made to those charged with governance of the entity or may be made to improve the effectiveness and efficiency of the audit. Discussions with those charged with governance ordinarily include the overall audit strategy and timing of the audit, including any limitations thereon, or any additional requirements. Discussions with management often occur to facilitate the conduct and management of the audit engagement (for example, to coordinate some of the planned audit procedures with the work of the entity's personnel). Although these discussions often occur, the overall audit strategy and the audit plan remain the auditor's responsibility. When discussions with those charged with governance or with the entity's management of matters included in the overall audit strategy or audit plan occur, the auditor should be careful to not compromise the effectiveness of the audit. For example, discussing the nature and timing of detailed audit procedures with management might compromise the effectiveness of the audit by making the audit procedures too predictable.

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 ordinarily have the previous experience with the entity that is considered when planning recurring engagements. See paragraph 27 of SAS No. 108 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 should (*a*) meet with the client to understand the type, scope, and timing of the engagement; (*b*) understand if reports on compliance, internal control, or segments of the entity are required; (*c*) understand the client's expectations, both stated and implied; and (*d*) review the expectations of both the owners and managers.

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

.03 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. Statement on Standards for Accounting and Review Services (SSARS) No. 7, *Omnibus Statement on Standards for Accounting and Review Services—1992* (AICPA, *Professional Standards*, vol. 2), indicates that the GAAP hierarchy set forth in AU section 411 also applies to compilation and review engagements.

.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 table below in paragraph .06 summarizes the pronouncements that are included in each of the five categories of GAAP for nongovernmental entities, state and local governments, and federal governmental entities. This Manual does not take into account federal governmental entities.

---

[*] In April 2005, the FASB issued an exposure draft of a proposed statement, *The Hierarchy of Generally Accepted Accounting Principles*, objectives of which include moving responsibility for the 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. Additionally, the proposed FASB Statement expands the sources of category (a) 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 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 SAS, *Amendment to Statement on Auditing Standards No. 69 for Nongovernmental Entities*, which deletes the GAAP hierarchy for nongovernmental entities from AU section 411. The final FASB Statement and SAS on GAAP hierarchy will be issued concurrently and will have a uniform effective date. For more information please visit the FASB Web site at www.fasb.org and the AICPA Web site at www.aicpa.org.

.06 GAAP Hierarchy Summary*

Nongovernmental Entities	*State and Local Governments*	*Federal Governmental Entities*
	Established Accounting Principles	
.10*a* FASB Statements and Interpretations, APB Opinions, and AICPA Accounting Research Bulletins	.12*a* 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* 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 AcSEC Practice Bulletins if specifically made applicable to federal governmental entities and cleared by the FASAB and Technical Releases of the Accounting and Auditing Policy Committee of the FASAB
.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

* Paragraph references correspond to the paragraphs of AU section 411 that describe the categories of the GAAP hierarchy.

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

Nongovernmental Entities	*State and Local Governments*	*Federal Governmental Entities*
	Other Accounting Literature[‡]	
.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*) through (*d*) of the hierarchy for nongovernmental entities when not specifically made applicable to state and local governments; FASB Concepts Statements; FASAB Statements, Interpretations, Technical Bulletins, and Concepts Statements; AICPA Issues Papers; International Accounting Standards Committee Statements; pronouncements of other professional associations or regulatory agencies; AICPA *Technical Practice Aids*; and accounting textbooks, handbooks, and articles	.15 Other accounting literature, including FASAB Concepts Statements; pronouncements in categories (*a*) through (*d*) of the hierarchy in paragraph .10 when not specifically made applicable to federal governmental entities; FASB Concepts Statements; GASB Statements, Interpretations, Technical Bulletins, and Concepts Statements; AICPA Issues Papers; International Accounting Standards of the International Accounting Standards Committee; pronouncements of other professional associations or regulatory agencies; AICPA *Technical Practice Aids*; and accounting textbooks, handbooks, and articles

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

Generally Accepted Auditing Standards

.07 An independent auditor plans, conducts and reports the results of an audit in accordance with generally accepted auditing standards (GAAS). Auditing standards provide a measure of audit quality and the objectives to be achieved in an audit. Auditing procedures differ from auditing standards. Auditing procedures are acts that the auditor performs during the course of an audit to comply with auditing standards.

.08 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) approved and adopted by the membership of the AICPA, as amended by the AICPA Auditing Standards Board (ASB), are as follows:

General Standards

1. The 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

1. The auditor must state in the auditor's report whether the financial statements are presented in accordance with generally accepted accounting principles (GAAP).[2]
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.

---

[1] See paragraph 6 of SAS No. 106, *Audit Evidence* (AICPA, *Professional Standards*, AU sec. 326.06), for the definition of the term *appropriate*.

[2] 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.

.10 Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, vol. 2, ET sec. 202.01) of the AICPA Code of Professional Conduct, requires an AICPA member who performs an audit (the auditor) to comply with standards promulgated by the ASB. The ASB develops and issues standards in the form of SASs through a due process that includes deliberation in meetings open to the public, public exposure of proposed SASs, and a formal vote. The SASs are codified within the framework of the 10 standards.

.11 The auditor should have sufficient knowledge of the SASs to identify those that are applicable to his audit. The nature of the 10 standards and the SASs requires the auditor to exercise professional judgment in applying them. Materiality and audit risk also underlie the application of the 10 standards and the SASs, particularly those related to field work and reporting. The auditor should be prepared to justify departures from the SASs.

.12 *Interpretive Publications* consist of auditing interpretations of the SASs, appendixes to the SASs,[3] 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. The specific terms used to define professional requirements in the SASs are not intended to apply to interpretive publications since interpretive publications are not auditing standards. It is the ASB'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 where none exists.[†]

.14 *Other Auditing Publications* include:

- AICPA auditing publications not referred to above
- Auditing articles in the *Journal of Accountancy* and other professional journals
- Auditing articles in the AICPA *CPA Letter*
- Continuing professional education programs and other instructional materials, textbooks, guide books, audit programs and checklists; and other auditing publications from state CPA societies, other organizations and individuals

---

[3] Appendixes to the SASs referred to in paragraph 5 of SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150.05), do not include previously issued appendixes to original pronouncements that when adopted modified other SASs.

[†] 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, AU sec. 120), and the companion Statement for Attestation Engagements (SSAE) No. 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 20). Those statements, which were effective upon issuance, define the terminology that the ASB will use going forward to describe the degree of responsibility that the requirements impose on the auditor or the practitioner in engagements performed for nonissuers.

SASs and SSAEs will use the words *must* or *is required* to indicate an unconditional requirement, with which the auditor or practitioner is required to comply. SASs and SSAEs will use the word *should* to indicate a presumptively mandatory requirement. The auditor or practitioner is 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 auditor or practitioner may depart from a presumptively mandatory requirement provided the auditor or 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. If a SAS or SSAE provides that a procedure or action is one that the auditor *should consider*, the consideration of the procedure or action is presumptively required, whereas carrying out the procedure or action is not.

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

.02 Some procedures regarding assignment of personnel to the engagement are discussed in this section. The specific procedures adopted by a firm would not necessarily include all the procedures or be limited to those discussed. Overall firm requirements for assigning personnel to engagements are addressed in the *Guide for Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice* at AAM section 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 should be prepared to determine manpower requirements and to schedule field work. The engagement partner should approve the time budget prior to the beginning of field work. A time budget should have columns for budgeted time (in hours) for preliminary and final field work. Time budget forms differ depending upon firm preference and needs. Some firms use separate forms for the time budget report and the job progress report or analysis (see AAM section 3160.01 for "Audit Time Budget—Sample A"), whereas others combine these reports into one form (see AAM section 3160.02 for "Audit Time Budget—Sample B").

.04 Other alternatives include longer, more detailed sets of forms. These forms combine the features of a time budget, a source document for staff scheduling, and a job progress report that compares each assigned person's actual daily hours against the budget. Some firms use a shorter, less detailed form for jobs of less than a predetermined number of staff hours (for example, one hundred hours; see AAM section 3160.03 for "Audit Time Analysis—Short Form") and a longer form for jobs requiring more time (see AAM section 3160.04 for "Audit Time Analysis—Long Form"). Some firms use a weekly (or daily) progress report (see AAM section 3160.05, for example). This report, submitted by the accountant in charge, shows the time actually spent in relation to the estimate, the estimated additional time required, and the estimated variance from the original estimate.

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

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

a. Engagement size and complexity

b. Personnel availability

c. Special expertise

d. Timing of the work to be performed

e. Continuity and periodic rotation of personnel

f. Opportunities for on-the-job training

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

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

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 AICPA professional standards require independence, in accordance with Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.01), of the AICPA Code of Professional Conduct, for all attest engagements.[1] Attest engagements are those in which your firm attests—or affirms—that a client's financial or other information is reasonably stated. Examples of attest services are—

- Financial statement audits.
- Financial statement reviews.
- Other attest services as defined in the Statements on Standards for Attestation Engagements.

.02 Third parties—investors, creditors, and others—rely on your firm's attestations about a client's financial information when making various business decisions. Therefore, attest services have value for third parties only if an *independent firm* renders the services. Accordingly, AICPA professional standards require independence when your firm provides attest services; your firm may perform attest services for a client *only* when it is independent of that client. Independence is not required to perform the following services, if these are the *only* services your firm provides to a client:

1. Tax preparation and advice.
2. Consulting services (such as tax consulting or personal financial planning).

.03 One other service—a compilation of a client's historical financial statements—does not require independence. If a nonindependent firm issues a compilation report, the report must state, "I am (we are) not independent with respect to XYZ Company."[2]

.04 Engagement planning should include 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 below, audit firms that perform audits of or perform other attest services for public companies or other SEC registrants must comply with the independence rules of the SEC and the Public Company Accounting Oversight Board.

.06 Other organizations that have established other independence requirements that may be applicable to you and your firm include:

---

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

[2] Statements on Standards for Accounting and Review Services (SSARS) No. 1, *Compilation and Review of Financial Statements*, paragraph 19 (AICPA, *Professional Standards*, vol. 2, AR sec. 100.19).

- State boards of Accountancy
- State CPA Societies
- Federal and State Agencies, such as the Governmental Accountability Office (GAO)

.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 Aid, *Independence Compliance—Checklists and Tools for Complying With AICPA and GAO Independence Requirements* (product no. 006627), is a valuable resource for helping practitioners observe applicable independence rules. The Practice Aid 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 required to address independence matters; however, ultimately it is up to you to follow firm policies and the independence rules. Many firms require you to certify your independence on a regular basis. The following are some suggestions that will help you to complete and sign that certification in good faith.

.09 *Gain an understanding of the independence rules and firm policies.* As a prerequisite to establishing and maintaining the independence of you and your firm, you must have a good, working understanding of the basic independence rules. At a minimum, you should be aware of the circumstances in which you and your immediate family meet the definition of a covered member (discussed below 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 should 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 familiarize yourself with rules promulgated by the SEC and the Public Company Accounting Oversight Board (PCAOB), too.

Covered Member

.10 Know when you meet the definition of a covered member. Whenever you are a *covered member* with respect to a particular attest client, you become subject to the highest possible level of independence restrictions (for example, restrictions on financial and business interests, and your family's employment). You are a covered member with respect to a client if you are:

1. An individual on the attest engagement team;
2. An individual in a position to influence the attest engagement;
3. A partner or manager who provides more than ten hours of nonattest services to the attest client;
4. A partner in the office in which the lead attest engagement partner primarily practices in connection with the attest engagement;
5. The firm, including the firm's employee benefit plans; or
6. An entity whose operating, financial, or accounting policies can be controlled (as defined by generally accepted accounting principles (GAAP) for consolidation purposes) by any of the individuals or entities described in (1)–(5) or by two or more such individuals or entities if they act together.

.11 However, there are two relationships that— due to their magnitude—impair independence even when you are *not* considered to be a covered member.

The following rules apply to all partners and professional employees of a firm:

- No partner or professional employee may be simultaneously employed by an attest client in any position or serve a client as a:
  — Director, officer (or any management capacity), or employee.
  — Promoter, underwriter, or voting trustee.
  — Trustee of any of the client's employee benefit plans.
- No partner or professional employee may own greater than 5 percent of an attest client's outstanding equity securities (or other ownership interests).

Family Members

.12 The investments and employment of certain family members may impair your independence. Know which of your family members meet the definition of "immediate family" and which ones meet the definition of "close relative."

.13 If you are a covered member with respect to a client, members of your immediate family (your spouse—or equivalent—and your dependents) generally must follow the same rules as you. So, for example, your spouse's investments must be investments that you could own under the rules. This would be the case even if your spouse keeps the investments in his or her own name or with a different broker.

.14 There are two exceptions to this general rule.

1. Your immediate family member's employment with a client would not impair your firm's independence provided he or she is not in a "key position." A key position is one in which your family member
   - Has primary responsibility for significant accounting functions that support material components of the financial statements or the preparation of the financial statements;
   - Has primary responsibility for preparing the financial statements; or
   - Is able to influence the contents of the financial statements (for example, a chief executive officer, treasurer, or a member of the board of directors).
2. Immediate family members of *certain* covered members may have a financial interest in a client through an employee benefit plan (for example, retirement or savings account) provided the plan is offered equitably to all similar employees. The covered members whose families may have such interests are:
   - Partners and managers who provide only nonattest services to the client; and
   - Partners who are covered members *only* because they practice in the same office where the client's lead attest partner practices in connection with the engagement.

.15 Also note that immediate family of individuals on the attest engagement team *or* of those who can influence the attest engagement team may not apply this exception.

.16 Your immediate family is also prohibited from owning more than 5 percent of the client's outstanding equity securities.

.17 The close relatives of *certain* covered members will be subject to some employment and financial restrictions. These covered members are:

- Persons on the attest engagement team.
- Persons who can influence the attest engagement.

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

.18 Close relatives are your:

- Nondependent children
- Siblings
- Parents

.19 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.

.20 Rules pertaining to your close relatives' financial interests differ depending on whether you participate on the client's attest engagement as follows:

- If you participate on the client's attest engagement team, your independence would be considered to be impaired if you are aware that your close relative has a financial interest in the client that either:
  - — Was material to your relative's net worth, **or**
  - — Enables the relative to exercise significant influence over the client.
- If you are able to influence the client's attest engagement or are a partner in the office in which the lead attest engagement partner practices in connection with the engagement, your independence will be impaired if you are aware that your close relative has a financial interest in the client that:
  - — Is material to your relative's net worth, **and**
  - — Enables your relative to exercise significant influence over the client.

Financial Relationships

.21 There are various types of financial interests and some of those interests affect independence. Although your firm 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.

.22 As a covered member with respect to a particular client, you (and your spouse and dependents) may not have a:

- Direct financial interest in that client, regardless of how immaterial it would be to you.
- Material indirect financial interest in that client.

.23 In addition, if you commit to acquire a financial interest in a client with respect to which you are a covered member, your independence would be impaired.

.24 Examples of financial interests include shares of stock; mutual fund shares; partnership units; stock rights; options or warrants to acquire an interest in a client; or rights of participation, such as puts, calls, or straddles.

.25 Direct financial interests 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.

.26 You also have a direct financial interest in a client when you have a financial interest in a client through a:

- Partnership if you are a general partner.
- 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.

.27 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

.28 As a partner or professional employee of your firm, independence would be considered to be impaired if you entered into certain business relationships with an attest client of the firm. Accordingly, you may not simultaneously serve a client as a:

- Director, officer, employee, or act in any management capacity
- Promoter, underwriter, or voting trustee
- Stock transfer or escrow agent
- General counsel (or equivalent)
- Trustee for a client's pension or profit-sharing trust

.29 In essence, any time you are able to make management decisions on behalf of a client or exercise authority over a client's operations or business affairs, independence is considered impaired.

.30 Your independence is considered impaired even if you were a volunteer board member because you would be part of the client's governing body and therefore would be able to participate in the client's management decisions.

.31 There are two possible exceptions to this rule, as follows:

1. If you are an honorary director or trustee for a client that is a nonprofit charitable, civic, or religious organization, you may serve that client and not impair your firm's independence if:
   - Your position is purely honorary.
   - You do not vote or participate in managing the organization.
   - Your position is clearly identified as honorary in any internal or external correspondence.
2. In addition, you are also permitted to serve on a client's advisory board provided all the following criteria are met:
   - The advisory board's function is purely advisory.
   - The advisory board does not appear to make decisions for the client.
   - The advisory board and any decision-making boards are separate and distinct bodies.
   - Common membership between the advisory board and any decision-making groups is minimal.

Fee Issues

.32 Two types of fee arrangements, contingent fees and commissions, are prohibited when the arrangement involves certain attest clients (see paragraph .37 for details), even though the fee is not related to an attest service.

.33 A contingent fee is an arrangement where (1) no fee is charged unless a specified result is attained or (2) the amount of the fee otherwise depends on the results of your firm's services. Some examples of contingent fees are:

- Your firm receives a "finder's fee" for helping a client locate a buyer for one of the client's assets.
- Your firm performs a consulting engagement to decrease a client's operating costs. The fee is based on a percentage of the cost reduction that the client achieves as a result of your service.

Exceptions are:

- Fees fixed by a court or other public authority.
- In tax matters, fees based on the results of judicial proceedings or the findings of governmental agencies.

.34 A commission is any compensation paid to you or your firm for (1) recommending or referring a third party's product or service to a client or (2) recommending or referring a client's product or service to a third party. Permitted commissions must be disclosed to the person or entity you recommend or refer a product or service to.

.35 For example, you or your firm:

- Refers a client to a financial planning firm that pays you a commission for the referral.
- Sells accounting software to a client and receives a percentage of the sales price (a commission) from a software company.
- Refers a nonclient to an insurance company client, which pays you a percentage of any premiums subsequently received (a commission) from the nonclient.

.36 The rule provides an exception for *referral fees* that are related to recommending or referring the services of a CPA. That is, you may (1) receive a fee for referring the services of a CPA to any person or entity or (2) if you are a CPA, pay a fee to obtain a client provided you disclose such receipt or payment to the client. Referral fees are not considered commissions under these specific circumstances.

.37 You and your firm may not have commission or contingent fee arrangements with a client when your firm also provides one of the following services to a client:

- An audit of financial statements.
- A review of financial statements.
- Compiled financial statements when a third party (for example, a bank or investor) will rely on the financial statements and the report does not disclose a lack of independence.
- An examination of prospective financial statements.

.38 You and your firm may have commission and contingent fee arrangements with persons associated with a client—such as officers, directors, and principal shareholders—or with a benefit plan that is sponsored by a client (that is, the plan itself is not a client).[3] For example, you or your firm may receive a commission from an officer of a client without violating the AICPA rule. Even when permitted, the existence of a commission arrangement must be disclosed to the person (or entity) to whom the commission relates.

Restricted Entities

.39 Be familiar with the firm's restricted entities. Restricted entities are those entities for whom the firm provides attest services. You should be aware of who these entities are. Many firms maintain a formal list or database of these clients. If yours is one of these firms, you should know how to access the list.

.40 Maintain the integrity of the restricted entity list. If you perform attest services, then you need to make sure that those clients are identified as restricted entities of the firm. Certain entities that are related to your clients (for example, subsidiaries) also will be considered restricted entities, even if they are not clients of the firm.

.41 Consult the restricted entities list regularly. Get into the habit of referring to the firm's restricted entity list whenever you are considering changes in circumstances that could affect your independence. For example, you should consult the restricted entity list prior to—

- Making an investment or acquiring a financial interest in an entity
- Entering into a business relationship
- Obtaining a loan or refinancing an existing loan
- Having an immediate family member change employers or assume new responsibilities at an existing job

Nonattest Services

.42 Be aware of the rules relating to the performance of nonattest services. If you provide nonattest services to restricted entities, you should be familiar with Interpretation 101-3, "Performance of nonattest services" (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05) regarding the performance of nonattest services. You should be aware of the services that are permitted and prohibited under the ruling, as well as your responsibilities for establishing an understanding of the engagement with your client and documenting various aspects of the engagement. If your clients are SEC registrants, you should be aware of the more restrictive SEC rules in this area. Certain other regulators (for example, the Government Accounting Office or GAO) may have more restrictive rules concerning nonattest services, which should be reviewed depending upon the circumstances of the engagement.

.43 The term, *nonattest services*, includes accounting and consulting services that are not part of an attest engagement.[4] Nonattest services specifically addressed in the rules are:

- Bookkeeping services
- Payroll and other disbursement services
- Internal audit assistance
- Benefit plan administration

---

[3] Also see AICPA Ethics Ruling No. 25 under section 391 of the Code of Professional Conduct, "Commission and Contingent Fee Arrangements With Nonattest Client" (AICPA, *Professional Standards*, vol. 2, ET sec. 391.049–.050).

[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.

- Investment advisory or management services
- Tax compliance services
- 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

.44 Interpretation 101-3 requires the adherence to three general requirements in order to maintain independence when performing permitted nonattest services.

.45 The first of the three general requirements of Interpretation 101-3 states that you 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.)

.46 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, and/or 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

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.

.47 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 documentation requirement does not apply to certain routine activities performed by the member such as providing advice and responding to the client's technical questions as part of the normal client-member relationship. The understanding might be documented in a separate engagement letter, in the workpapers, or in an internal memo, or it might be included in an engagement letter obtained in conjunction with an attest engagement.

.48 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.
- 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.

.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 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. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*,* paragraphs 7–10, as amended by SQCS No. 4, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (AICPA, *Professional Standards*, vol. 2, QC sec. 20.07–.10).

Independence Quality Controls

.53 The AICPA SQCSs include the following requirement.

* SQCS No. 6, *Amendment to Statement on Quality Control Standards No. 2*, System of Quality Control for a CPA Firm's Accounting and Auditing Practice, amends SQCS No. 2 (AICPA, *Professional Standards*, vol. 2, QC sec. 20), to clarify that deficiencies in individual audit, attest, review, and compilation engagements do not, in and of themselves, indicate that the firm's system of quality control is insufficient to provide it with reasonable assurance that its personnel comply with applicable professional standards.

> Policies and procedures should be established to provide the firm with reasonable assurance that personnel maintain independence (in fact and in appearance) in all required circumstances. (See QC section 20.13.)

The professional standards do not describe how a firm should establish compliance with these requirements. However, in regards to independence matters, a CPA firm should consider the following.

.54 *Establish "plain English" independence policies and procedures.* Written policies and procedures are an important first step toward ensuring compliance with the independence rules. These policies should be written in a manner that is easy to read and understand.

.55 *Designate a partner-in-charge.* There are two reasons why a firm might wish to designate a partner-in-charge of independence matters. First, firm members who have questions about independence matters need to have someone to turn to for answers. It helps if they know there is one person in charge. Additionally, the independence rules are complicated and subject to change. A firm is more likely to have a good understanding of the independence rules when one person is specifically assigned the responsibility.

.56 *Communication and training.* The firm's independence policies and procedures must be communicated throughout the firm. Periodic training on these matters will help ensure understanding and compliance.

.57 *Maintain a list of restricted entities.* Firm personnel must be independent with respect to the firm's restricted entities. It is important for the firm to maintain a database or list of all clients (and certain related entities) for whom the firm performs services requiring independence. Policies and procedures should exist for keeping the list current.

.58 *Obtain written representations from firm personnel.* Many firms require their personnel to execute and return to the firm an independence representation in which the firm member affirms that he or she is independent with respect to the firm's restricted entities. Typically, these representations are completed annually.

.59 *Resolution of apparent independence violations.* The firm should have procedures for resolving apparent independence violations that are reported by firm personnel.

Additional Guidance

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

.61 For additional guidance practitioners should 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. Call 888-777-7077 of visit www.cpa2biz.com to obtain the Alert.

[*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.
- 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 inquires 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 table below provides examples of other individuals within the entity who might be able to help the auditor identify and assess the risk of material misstatement.

.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), directs the auditor to 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 AU section 329.06–.08 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.
- 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:

- 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 above for each aspect of the understanding described below. 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 should be included.

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 above 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 SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314).

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 above definition reflects certain fundamental concepts:

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

.03 Auditors are required to obtain an understanding of their client's internal control during the planning phase of every audit. SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314), 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 above requirement raises the following questions.

- What constitutes a "sufficient understanding"? That is, what should an auditor know about the client's internal control?
- How should an auditor obtain this understanding?

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

What Auditors Should Understand About Internal Control

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

- 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 should be distinguished 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 SAS No. 109 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 should be assessed. However, as stated in paragraph 115 of SAS No. 109, 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 since these controls are not relevant to the audit, he or she is not required to do so.*

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

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

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

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

.17 Controls designed to prevent or detect misappropriations of assets may include controls relating to financial reporting and operations objectives. For example, use of a lockbox system for collecting cash or access controls, such as passwords that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit. Conversely, controls to prevent the excess use of materials in production generally are not relevant to a financial statement audit. An auditor's responsibility to understand internal control is generally limited to those controls relevant to the reliability of financial reporting.

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

.19 SAS No. 109 provides a framework that separates each financial reporting objective into five components. These components represent what is needed to achieve the entity's objectives. The components of internal control are briefly described as follows:

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

- *Monitoring*. The entire process must be monitored, and modifications made as necessary. In this way, the system can react dynamically, changing as conditions warrant.

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

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

.22 The internal control framework described here and in AAM section 4200 is only a means to help auditors consider the impact of an entity's internal control in an audit. An auditor's primary concern is *not* the classification of a specific control into any particular component and related objective. Rather, an auditor's primary concern is whether, 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 is required to 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 should consider the types of misstatements that occurred in prior audits (for example, whether they were associated with accounting estimates, whether they were routine errors that resulted from a lack of control consciousness, or whether they resulted from lack of sufficient personnel). This knowledge of prior misstatements can help an auditor focus his or her inquiries on those areas and whether changes have been made to internal control to prevent those misstatements in the future.

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

.28 *Jones Grocery purchased a commercially available software package for independent grocers. During 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's documentation should be.

[*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:

- 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 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).

.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 SAS No. 106, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1, AU sec. 326), discuss the use of assertions in obtaining audit evidence. In representing that the financial statements are fairly presented in accordance with GAAP, 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 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.

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. SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314), 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 SAS No. 110 (AICPA, *Professional Standards*, vol. 1, AU sec. 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 SAS No. 110.

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 SAS No. 110 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. 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 generally accepted accounting principles;

c. The omission of a financial statement element, account, or item;

d. A financial statement disclosure that is not presented in conformity with generally accepted accounting principles;

---

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

e. The omission of information required to be disclosed in conformity with generally accepted accounting principles;

f. An incorrect accounting estimate arising, for example, from an oversight or misinterpretation of facts; and

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:

a. *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.

b. *Likely misstatements*. These are misstatements that:

   i. 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).

   ii. 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 generally accepted accounting principles

.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 section below entitled, "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 (AR) 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 percentages, 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* (IR) 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* (CR) 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. SAS No. 107, *Audit Risk and Materiality in Conducting an Audit* (AICPA *Professional Standards*, vol. 1, AU sec. 312), and other SASs describe the risk of material misstatement (RMM) 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* (DR) 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 (TD) and substantive analytical procedures risk (AP).

.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 elements of the financial statements (for example, assets, liabilities, equity, income, and expenses) and the financial statement measures defined in generally accepted accounting principles (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 above, 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 SAS No. 107 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 should be relative rather than absolute. In other words, materiality is usually set as a percentage rather than as an absolute amount. For example, an absolute amount such as

$100,000 may be immaterial to a large, multinational corporation but very material to a small, closely held company. To apply percentage guidelines, auditors must determine what base to use. Generally, auditors select a base that is relatively stable and predictable. Bases commonly used include income before taxes, revenues, and total assets. Generally, misstatements become material to income before they become material to the balance sheet. As a consequence, net income before taxes is often selected as the base.

.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 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 and 10 percent, judgment is applied. For example, when unusual factors exist (perhaps the company is about to be sold for a multiple of audited earnings) auditors would tend to classify items between 5 and 10 percent as material. Others use 1 or 1.5 percent of the larger of total assets or revenues. (See Exhibit 1 for a sample planning materiality worksheet.) 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 should include such factors as income variability and the nature of the client's business and industry. For a not-for-profit organization, for example, the auditor would probably use total assets or revenues as a base, since pretax income is not meaningful.

SEC Staff Bulletin on Materiality for SEC Registrants

.38 SEC 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 should not rely exclusively on quantitative benchmarks to determine whether an item is material to the financial statements. Equally important is a consideration of whether, in light of the surrounding circumstances, a reasonable investor would consider the item to be important. The SAB also states that management should not make intentional immaterial errors in a registrant's financial statements to "manage" earnings. It further reminds registrants of their legal responsibility to make and keep books, records, and accounts that, in reasonable detail, accurately and fairly reflect transactions and the disposition of assets. The SAB reminds auditors of their obligations to inform management and, in some cases, audit committees of illegal acts that come to the auditor's attention. The full text of the SAB can be viewed at the SEC Web site at: www.sec.gov/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 generally accepted accounting principles, 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.

---

[2] Matters that are "trivial" are amount 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.

.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 SAS No. 107 [AU section 312.59–.60]). 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."

.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, 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 should be set so that any such misstatements, either individually, or when aggregated with other such misstatements, would not be material to the financial statements, after the possibility of further undetected misstatements is considered.

.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 SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), SAS No. 107 states the auditor should document:

a. The levels of materiality, as discussed in AU section 312.27, 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 AU section 312.60)

[*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. AU section 316.03, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), describes the auditor's consideration of fraud as something that should be integrated into the overall audit process. AU section 316 describes a process in which the auditor:

- Exercises professional skepticism
- Discusses the risks of material misstatements due to fraud with engagement personnel
- Gathers information needed to identify risks of material misstatement due to fraud
- Identifies risks that may result in a material misstatement due to fraud
- Assesses the identified risks after taking into account an evaluation of the entity's programs and controls that address the risks
- Responds to the results of the assessment
- Evaluates audit evidence
- Communicates about fraud to management, the audit committee, and others
- Documents the auditor's consideration of fraud

.03 Even though some requirements and guidance set forth in 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. 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 AU section 316 requires that members of the audit team discuss the potential for material misstatement due to fraud prior to or in conjunction with his or her information-gathering procedures. The discussion should include:

- An exchange of ideas or "brainstorming" among the audit team members, including the auditor with final responsibility for the audit, about how and where they believe the entity's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated.
- An emphasis on the importance of maintaining the proper state of mind throughout the audit regarding the potential for material misstatement due to fraud.

.10 Communication among the audit team members about the risks of material misstatement due to fraud should continue throughout the audit. See paragraphs .14–.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:

- 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:

- 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/pressures, opportunities, and attitudes/rationalizations. However, the auditor should not assume that all three conditions must be observed or evident before concluding that there are identified risks.

.15 The identification of a risk of material misstatement due to fraud involves the application of professional judgment and includes the consideration of the attributes of the risk, including:

---

[1] Statement on Auditing Standards (SAS) No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA *Professional Standards*, vol. 1, AU sec. 314), requires the auditor to 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 (see AU section 314.102).

- The type of risk that may exist, that is, whether it involves fraudulent financial reporting or misappropriation of assets.
- The significance of the risk, that is, whether it is of a magnitude that could lead to result in a possible material misstatement of the financial statements.
- The likelihood of the risk, that it, 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 AU section 316 identifies two new requirements for identifying risks that may result in a material misstatement due to fraud. The auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition. In addition, the risk of management override of controls should be considered a fraud risk on every audit.

Assessing the Identified Risks After Taking Into Account an Evaluation of the Entity's Programs and Controls That Address the Risks

.17 As part of the understanding of internal control sufficient to plan the audit required by 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 Judgements about the risk of material misstatement due to fraud have an overall effect on how the audit is conducted in the following ways:

- *Assignment of personnel and supervision*. The knowledge, skill, and ability of personnel assigned significant engagement responsibility should be commensurate with the auditor's assessment of the risks of material misstatement due to fraud for the engagement. In addition, the extent of supervision should reflect the risks of material misstatement due to fraud.

[2] 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), requires the auditor to determine overall responses and design and perform further audit procedures to respond to the assessed risks of material misstatement at the financial statement and relevant assertion levels in a financial statement audit. See AU section 318.04 and .07.

- *Accounting principles*. The auditor should consider management's selection and application of significant accounting principles, particularly those related to subjective measurements and complex transactions.
- *Predictability of auditing procedures*. The auditor should incorporate an element of unpredictability in the selection from year to year of auditing procedures to be performed.

Responses Involving the Nature, Timing, and Extent of Procedures to Be Performed to Address the Identified Risks

.21 The auditing procedures performed in response to identified risks of material misstatement due to fraud will vary depending on upon the types of risks identified and the account balances, classes of transactions, and related assertions that may be affected. These procedures may involve both substantive tests and tests of the operating effectiveness of the entity's programs and controls. The auditor's responses to address specifically identified risks of material misstatement due to fraud may include changing the nature, timing, and extent of auditing procedures. See AU section 316.52–.56 for more guidance.

Responses to Further Address the Risk of Management Override of Controls

.22 Management is in a unique position to perpetrate fraud because of its ability to directly or indirectly manipulate accounting records and prepare fraudulent financial statements by overriding established controls that otherwise appear to be operating effectively. Accordingly, in addition to overall responses and responses that address specifically identified risks of material misstatement due to fraud, certain procedures should be performed to further address the risk of management override of controls, as discussed in AU section 316.58–.67.

Evaluating Audit Evidence

.23 The auditor's assessment of the risks of material misstatement due to fraud should be ongoing throughout the audit. The auditor should consider whether analytical procedures performed in planning the audit result in identifying any unusual or unexpected relationships that should be considered in assessing the risks of material misstatements due to fraud. The auditor also should evaluate whether analytical procedure that were performed as substantive tests or in the overall review stage of the audit indicate a previously unrecognized risk of material misstatement due to fraud.

.24 At or near the completion of fieldwork, the auditor should evaluate whether the accumulated results of audit procedures and other observations affect the assessment of the risk of material misstatement due to fraud made earlier in the audit. Such an evaluation may provide further insight into the risk of material misstatement due to fraud and whether there is a need for additional or different audit procedures to be performed.

.25 If audit test results identify misstatements in the financial statements, the auditor should consider whether such misstatements may be indicative of fraud. If the auditor has determined that misstatements are or may be the result of fraud, but the effect of the misstatements is not material, the auditor nevertheless should evaluate the implications, especially those dealing with the organizational position of the person(s) involved. If the matter involves higher-level management, even though the amount itself is not material to the financial statements, it may be indicative of a more pervasive problem, for example, implications about the integrity of management. In such circumstances, the auditor should reevaluate the assessment of the risk of material misstatement due to fraud and its resulting impact on (*a*) the nature, timing, and extent of the tests of balances or transactions and (*b*) the assessment of the effectiveness of controls if control risk was assessed below the maximum.

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

- Attempt to obtain additional 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.
- If appropriate, suggest that the client consult with legal counsel.

.27 The auditor's consideration of the risks of material misstatement and the results of audit tests may indicate such a significant risk of material misstatement due to fraud that the auditor should consider withdrawing from the engagement and communicating the reasons for withdrawal to the audit committee or others with equivalent authority and responsibility. Whether the auditor concludes that withdrawal from the engagement is appropriate may depend on (*a*) the implications about the integrity of management and (*b*) the diligence and cooperation of management or the board of directors in investigating the circumstances and taking appropriate action. Because of the variety of circumstances that may arise, it is not always possible to definitely describe when withdrawal is appropriate. The auditor may wish to consult with legal counsel when considering withdrawal from an engagement.

Communicating About Possible Fraud to Management, the Audit Committee, and Others

.28 If the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. Fraud involving senior management and fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements should be reported directly to the audit committee. In addition, the auditor should reach an understanding with the audit committee regarding the nature and extent of communications with the committee about misappropriations perpetrated by lower-level employees.

.29 If the auditor, as a result of the assessment of the risks of material misstatement, has identified risks of material misstatement due to fraud that have continuing control implications (whether or not transactions or adjustments that could be the result of fraud have been detected) the auditor should consider whether these risks represent 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 SASs.

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 listing below contains example risk factors for small, privately-owned businesses. If used, this memory jogger should be tailored for the particular client being audited. Identified or possible risk factors should be added to the list. An auditor may also decide to remove the example factors from the list, based on the circumstances. In any event, be sure to consider fraud risk factors that relate to fraudulent financial reporting and misappropriation of assets in every related category presented below. An auditor should feel free to use this practice aid as he or she sees fit (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/Pressures				
a. Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):				
(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 (e.g., marital status) of the owner-manager. However, if you become aware of such information, you should consider it in your assessment of risk of material misstatement due to fraud.				
d. There is excessive pressure on management or operating personnel to meet financial targets set by the owner, including sales or profitability incentive goals.				
B. Opportunities				
a. The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:				
(1) Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.				
(2) Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate.				
(3) Significant, unusual, or highly complex transactions, especially those close to year end that pose difficult "substance over form" questions.				
b. There is a complex or unstable organizational structure as evidenced by the following:				
(1) Difficulty in determining the organization or individuals that have controlling interest in the entity.				
(2) Overly complex organizational structure involving unusual legal entities or managerial lines of authority.				
(3) High turnover of senior management or counsel.				
c. Internal control components are deficient as a result of the following:				
(1) Inadequate monitoring of controls, including automated controls.				
(2) High turnover rates or employment of ineffective accounting staff.				
(3) Ineffective accounting and information systems including situations involving reportable conditions.				

Fraud Risk Factors Considered	*Present at Client?*	*Audit Response Developed?*[3]	*Audit Response Documented? (W/P Ref.)*[4]	*Additional Information*
C. Attitudes/ Rationalizations				
1. A failure for management to display and communicate an appropriate attitude regarding internal control and the financial reporting process.				
2. Ineffective communication and support of the entity's values or ethical standards by management or the communication of inappropriate values or ethical standards.				
3. Nonfinancial management's excessive participation in or preoccupation with the selection of accounting principles or the determination of significant estimates.				
4. Known history of violations or claims against the entity, its owner or senior management alleging fraud or violations of laws and regulations.				
5. A practice by management of committing to, creditors, and other third parties to achieve aggressive or unrealistic forecasts.				
6. Management failing to correct known reportable conditions on a timely basis.				
7. An interest by management in employing inappropriate means to minimize reported earnings for tax motivated reasons.				
8. Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality.				
9. The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:				
a. Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.				
b. Unreasonable demands on the auditor, such as unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's report.				
c. Formal or informal restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with the board of directors or audit committee.				
d. Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of audit personnel assigned to the engagement.				

Part 2—Misappropriation of Assets

Fraud Risk Factors Considered	*Present at Client?*	*Audit Response Developed?*[3]	*Audit Response Documented? (W/P Ref.)*[4]	*Additional Information*
A. Incentives/Pressures				
a. Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.				
b. Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:				
(1) Known or anticipated future layoffs.				
(2) Promotions, compensation, or other rewards inconsistent with expectations.				
B. Opportunities				
a. Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:				
(1) Large amounts of cash on hand or processed.				
(2) Company issued credit cards.				
(3) Inventory items that are small in size, of high value, or in high demand.				
(4) Easily convertible assets.				
(5) Fixed assets, that, are small in size, marketable, or lacking observable identification of ownership.				
b. Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:				
(1) Inadequate segregation of duties or independent checks. Inadequate segregation of duties is quite often understandable in a small business environment in that it's a function of the entity's size. However, you should consider it in conjunction with other risk factors and with mitigating controls.				
(2) Inadequate management oversight of employees responsible for assets.				

Fraud Risk Factors Considered	*Present at Client?*	*Audit Response Developed?*[3]	*Audit Response Documented? (W/P Ref.)*[4]	*Additional Information*
(3) Inadequate job applicant screening of employees with access to assets.				
(4) Inadequate record keeping with respect to assets.				
(5) Inadequate system of authorization and approval of transactions (for example, in purchasing).				
(6) Inadequate physical safeguards over cash, investments, inventory, or fixed assets.				
(7) Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.				
(8) Lack of mandatory vacations for employees performing key control functions.				
(9) Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.				
(10) Inadequate access controls over automated records.				
C. Attitudes/Rationalizations				
1. Disregard for the need for monitoring or reducing risks related to misappropriations of assets.				
2. Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to correct known internal control deficiencies.				
3. Behavior indicating displeasure or dissatisfaction with the company or its treatment of the employee.				
4. Changes in behavior or lifestyle that may indicate assets have been misappropriated.				

[*The next page is 3311.*]

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

AAM Section 3150
Illegal Acts

General Comments

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

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

Direct and Material Effect Illegal Acts

.03 The auditor considers laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts (except disclosure of contingencies). For example, tax laws affect accruals and the amount recognized as expense in the accounting period; applicable laws and regulations may affect the amount of revenue accrued under government contracts.

.04 The auditor considers such laws or regulations from the perspective of their known relation to audit objectives derived from financial statement assertions rather than from the perspective of legality *per se*.

.05 The auditor's responsibility to detect and report misstatement resulting from illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for errors or fraud. (See SAS No. 107, *Audit Risk and Materiality in Conducting an Audit* [AICPA, *Professional Standards*, vol. 1, AU sec. 312].) That is, the auditor should design the audit to provide reasonable assurance that financial statement amounts are free from material misstatement resulting from these direct-effect illegal acts.

Other Illegal Acts

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

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

Engagement Planning Procedures

.08 The auditor should assess the risks that the entity has not complied with laws and regulations which have a direct and material effect on the determination of financial statement amounts (except disclosure of contingencies) in the planning phase of the audit.

.09 Matters that may influence the auditor's assessment include:

a. Management's understanding of the requirements of laws and regulations pertinent to audit objectives.

b. The nature and extent of noncompliance noted in prior audits.

c. Changes in requirements since the last audit.

d. Internal control components designed to give management reasonable assurance that the entity complies with those laws and regulations.

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

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

[*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 by AU section 329.02, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1), as amended, as "evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data.… A basic premise underlying the application of analytical procedures is that plausible relationships among data may reasonably be expected to exist and continue in the absence of conditions to the contrary." The definition implies several key concepts.

- The "evaluations of financial information" suggests that analytical procedures will be used to understand or test financial statement relationships or balances.

---

[1] In accordance with paragraph 6 of Statement on Auditing Standards (SAS) No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314), 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 SAS No. 109 for further guidance.

- 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.
- "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 9 of SAS No. 109, 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 are performed to obtain assurance that material misstatements are not likely to exist in financial statement account balances. To do this, the auditor focuses his or her analytical procedures on particular assertions about account balances and gives detailed attention to the underlying factors that affect those account balances through the development of an expectation independent of the recorded balance. Therefore, substantive analytical procedures generally are performed with more rigor and precision than those used for planning or overall review.

.07 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), provides guidance on the use of analytical procedures as substantive procedures. In designing substantive analytical procedures, the auditor should consider such matters as:

- 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 SAS No. 110.

.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, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1), requires the auditor to form an expectation whenever he or she applies analytical procedures.

.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 considers possible explanations for the difference. The greater the precision of the expectation (that is, the closer the expectation is to the correct amount) the greater the likelihood that the difference between the expected and recorded amounts is due to misstatement rather than nonmisstatement causes. The difference between an auditor's expectation and the recorded book value of an account (value of an account not subject to auditing procedures) can be due to any or all of the following three causes: (*a*) the difference is due to misstatements, (*b*) the difference is due to inherent factors that affect the account being audited (for example, the predictability of the account or account subjectivity), and (*c*) the difference is due to factors related to the reliability of data used to develop the expectation (for example, data that have been subject to auditing procedures versus data that have not been subject to auditing procedures). The greater the precision of the expectation, the more likely the difference between the auditor's expectation and the recorded value will be due to misstatements (cause *a*). Conversely, the less precise the expectation, the more likely the difference is due to factors related to the precision of the expectation (causes *b* and *c*).

Evaluation (Phase IV)

.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 SAS No. 107, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312.50), 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 would aggregate the misstatement, depending on materiality considerations, with other misstatements the entity has not corrected in the manner discussed in SAS No. 107.

Engagement Planning Procedures

.18 As stated above, the purpose of applying analytical procedures in planning the audit is to assist in planning the nature, timing, and extent of auditing procedures that will be used to obtain 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 non-financial information is considered as well. For example, number of employees, square footage of selling space, volume of goods produced, and similar information may contribute to accomplishing the purpose of the procedures.

Audit Documentation Requirements

.21 AU section 329.22 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 should refer to the AICPA Audit Guide *Analytical Procedures*. The guide provides practical guidance for auditors on the effective use of analytical procedures. Specifically, the audit guide includes a discussion of 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 number 012557.

[*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:
Start ______________ End ______________

Final work:
Start ______________ End ______________

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

(Excludes tax and report departments' time)

.02

Audit Time Budget — Sample B

Date	Total hours				General														Cash			Inventories																				Other (describe)		
	Accountant's initials color-coded																																										
	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											Actual Daily Hours																					Next Year's Budget
				Week Beginning																																
			Total																																Total	
Administration																																				
Client conferences																																				
Planning and scheduling																																				
Staff supervision																																				
Accounting systems review																																				
Internal control																																				
EDP installation																																				
General ledger																																				
Cash																																				
Sales																																				
Voucher register																																				
Payroll																																				
Journal entries																																				
Confirmations																																				
Permanent file																																				
Client advisory comments																																				
Report preparation																																				
Financial statements																																				
Footnotes																																				
Tax return preparation																																				
Review																																				
Initial review																																				
Overall review																																				
Detailed review																																				
Tax accrual review																																				
Subtotal to next page																																				

Audit Time Analysis (*Long Form*)—continued

Client Year Ended

	Prior Years		Budgeted Hours											Actual Daily Hours																					Next Year's Budget
			Total	Week Beginning																															Total	
Year end verification																																				
Trial balance																																				
Cash																																				
Notes receivable																																				
Accounts receivable																																				
Inventories																																				
Prepaid expenses																																				
Intercompany accounts																																				
Securities and investments																																				
Fixed assets																																				
Other assets																																				
Notes payable																																				
Accounts payable																																				
Tax grouping and accrual																																				
Accrued liabilities																																				
Deferred credits																																				
Contingencies and commitments																																				
Equity																																				
Audit of/with computer																																				
Operating accounts																																				
Subtotal from previous page																																				
Totals																																				
Accountants																																				
Manager																																				
In-charge																																				
Totals																																				

.05

Weekly Progress Report

Date ____________________

Supervisor ____ In-charge accountant ________________________________

Client ____ Case ____

	Staff days—seven hours				
	Original Estimate	Used to date	Unused	Est. to complete	Variance
In-charge accountant					
Assistants *(list)*:					
Total assistants					
Grand total					

[*The next page is 3401*.]

AAM Section 3165

Sample Engagement Letters

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

.02 Audit Engagement Leading to Opinion

LACKO, LYNCH, BROWN & COMPANY Certified Public Accountants

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

Dear Mr. Decker:

This will confirm our understanding of the services we will provide to Civil War Antiques, Inc. for the year ending December 31, 20XX.

We will audit the balance sheet of Civil War Antiques, Inc. as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended, for the purpose of expressing an opinion on them.

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

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

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

---

[1] Some practitioners prefer to include in an engagement letter a clause that would indemnify them against knowing management misrepresentations in jurisdictions where such clauses are permitted. Ethics Ruling No. 94 under AICPA Rule of Conduct 101, "Indemnification Clause in Engagement Letters" (AICPA, *Professional Standards*, vol. 1, ET sec. 191.188–.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 and is expected to issue guidance on the topic during the second half of 2006. Practitioners should be alert to any final guidance.

An audit includes obtaining an understanding 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. An audit is not designed to provide assurance on internal control or to identify significant deficiencies or material weaknesses. However, we are responsible for ensuring that you are aware of any significant deficiencies or material weaknesses which come to our attention.

An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Accordingly, the areas and number of transactions selected for testing will involve judgment. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. Our procedures will include tests of documentary evidence supporting the transactions recorded in the accounts, tests of the physical existence of inventory, and direct confirmation of receivables and certain other assets and liabilities by correspondence with selected customers, creditors, legal counsel, and banks. At the conclusion of our audit, we will request certain written representations (a "representation letter") from you about the financial statements and related matters.

The Company's management is responsible for adjusting the financial statements to correct material misstatements and for affirming to us in the representation letter that the effects of any uncorrected misstatements aggregated by us during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

As part of our engagement for the year ending December 31, 20XX, we will review the federal and state income tax returns for Civil War Antiques, Inc. Further, we will be available during the year to consult with you on the tax effects of any proposed transactions or contemplated changes in business policies.

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

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

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

The working papers for this engagement are the property of Lacko, Lynch, Brown & Company and constitute confidential information. However, we may be requested to make certain working papers available to ______________________ [*name of regulator*] pursuant to authority given to it by law or regulation. If requested, access to such working papers will be provided under the supervision of Lacko, Lynch, Brown & Company personnel. Furthermore, upon request, we may provide photocopies of selected working papers to ______________________________ [*name of regulator*]. The ____________________ [*name of regulator*] may intend, or decide, to distribute the photocopies or information contained therein to others, including governmental agencies.[2]

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

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

---

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

Sincerely,

LACKO, LYNCH, BROWN & COMPANY

____
[*Engagement Partner's Signature*]
Accepted and agreed to:

____
[*Client Representative's Signature*]

____
[*Title*]

____
[*Date*]

.03 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 Which Do Not Permit Expression of Opinion as Anticipated in Original Engagement Letter

GEROW, COLLINS & PATCH Certified Public Accountants

[*Date*]
Mrs. Helene Daestrom, President
Cohrane Manufacturing, Inc.
1234 West Street
Cedar Hill, Tennessee 10000

Dear Mrs. Daestrom:

Our March 15, 20XX letter described our present engagement as an audit for the purpose of expressing an opinion on the financial statements based on our audit. This letter is to inform you that because of the circumstances described below, we will be required to qualify our opinion on these statements.

As you know, the Internal Revenue Service has proposed total income tax assessments of approximately $XXX,XXX for the three fiscal years ended December 31, 20XX. Your tax counsel has advised us that although you have a defensible position and will protest the assessments, counsel cannot offer an opinion as to your ultimate liability. No provision for this assessment or any portion of it is included in your December 31, 20XX financial statements, nor do you feel any is necessary.

Due to an inability to obtain sufficient 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 Sample Engagement Memorandum (When No Formal Engagement Letter Is Sent)

Engagement Memorandum

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

[*Date*]	February 18, 20XX
Client	Kramden Bowling, Inc.
Address	1 Oak Street, Winchester, Virginia 00000
Phone	(555) 555-5555
Final arrangements made with	Ralph Marshall, President
Date final arrangements made	February 15, 20XX, at a meeting in the Kramden Bowling, Inc. offices
Client's personnel responsible for accounting matters	John Sandoval, Treasurer Bob Wesley, Controller
Objective of engagement	Audit engagement. Expression of an opinion on the financial statements. Also, review of federal and state income tax returns for year ended March 31, 20XX. If, for any reason, we are unable to complete the audit or are unable to form or have not formed an opinion, we may decline to express an opinion or decline to issue a report.
Management's responsibilities	Management is responsible for the entity's financial statements, establishing and maintaining effective internal control over financial reporting, identifying and ensuring that the entity complies with the laws and regulations applicable to its activities, and for making all financial records and related information available to us. At the conclusion of the engagement, management will provide us with a letter that confirms certain representations made during the audit. Management is responsible for adjusting the financial statements to correct material misstatements and for affirming to us in the representation letter that the effects of any uncorrected misstatements aggregated by us during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.
Auditor's responsibilities	We are responsible for conducting the audit in accordance with generally accepted auditing standards. Those standards require that we obtain reasonable rather than absolute assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Accordingly, a material misstatement may remain undetected. Also, an audit is not designed to detect error or fraud that is immaterial to the financial statements. We will inform management of all matters of fraud that come to our attention. We will also inform the client of illegal acts that come to our attention, unless they are clearly inconsequential.

Internal control	An audit includes obtaining an understanding of internal control sufficient to 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 significant deficiencies or material weaknesses. However, we are responsible for ensuring that management is aware of any reportable conditions which come to our attention.
Financial statements to be audited	Balance sheet at March 31, 20XX and statements of income, retained earnings, shareholders' equity, and cash flows for year ended March 31, 20XX
Responsibilities of client's personnel in preparation for engagement	Trial balance of G/L and completion of schedules, a list of which we will submit two weeks before beginning of engagement
Reports to be addressed to	Board of Directors (twelve copies)
Date audit to commence	Approximately April 24, 20XX (check with controller about April 10)
Estimated time required	Approximately three weeks
Staff requirements	Manager, supervisor, in-charge senior, and two staff assistants
Billing arrangements	Every two weeks, at standard plus out-of-pocket costs; invoices to attention of Bob Wesley; payable on presentation
Special accounting problems	Client was involved in a substantial sale and leaseback transaction during the year
	Imputed interest may be required on long-term liabilities resulting from purchase of business
Other comments	Client is presently negotiating with machinists' union

.06 Audit of Personal Financial Statements

[*Salutation*]

This will confirm our understanding of the arrangement for our audit of the financial statements of James and Jane Person for the [*period*] ended [*date*].

We will audit the statement of financial condition of James and Jane Person as of [*date*] and the related statement of changes in net worth for the [*period*] then ended, for the purpose of expressing an opinion on them. The financial statements are the responsibility of James and Jane Person. You are responsible for establishing and maintaining effective internal control over financial reporting, making all financial records and related information available for audit, and for identifying and ensuring compliance with the laws and regulations applicable to your activities.

You are responsible for adjusting the financial statements to correct material misstatements and for affirming to us in the representation letter that the effects of any uncorrected misstatements we have aggregated during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

We will conduct our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable rather than absolute assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Accordingly, a material misstatement may remain undetected.[3] Also, an audit is not designed to detect error or fraud that is immaterial to the financial statements. If, for any reason, we are unable to complete the audit or are unable to form or have not formed an opinion, we may decline to express an opinion or decline to issue a report as a result of the engagement.

The audit includes obtaining an understanding of internal control sufficient to 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 audit procedures to be performed. An audit is not designed to provide assurance on internal control or to identify significant deficiencies or material weaknesses. However, we are responsible for ensuring you are aware of any significant deficiencies or material weaknesses which come to our attention.

At the conclusion of our audit, you will provide us with a letter that confirms certain representations made during the audit.

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

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

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

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

Sincerely yours,

____

(Signature of accountant)

Acknowledged:

____

____

____

(Date)

[3] AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), describes the auditor's responsibilities to plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free of material misstatement, whether caused by error or fraud, and provides guidance on what should be done to meet those responsibilities.

.07 Audit of Not-for-Profit Financial Statements

[*Date*]

[*Name and address*]

Dear [*Contact*]

Agreement to Provide Services

This agreement is intended to describe the nature and scope of our services.

As agreed, we will audit the statement of financial position of [*Name of Client*] (the "*abbreviated name*") as of [date] and the related statements of activities and cash flows for the year then ended in accordance with auditing standards generally accepted in the United States of America. The financial records and financial statements are the responsibility of the [*Organization's*] management. In that regard, management is responsible for establishing and maintaining effective internal control over financial reporting, establishing and maintaining proper accounting records, selecting appropriate accounting principles, safeguarding company assets and complying with relevant laws and regulations. Management is also responsible for making all financial records and related information available to us.

Our responsibility is to express an opinion on the financial statements based on our audit. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management and evaluating the overall financial statement presentation.

At the conclusion of our audit, we will submit to you a report containing our opinion as to whether the financial statements, taken as a whole, are fairly presented based on accounting principles generally accepted in the United States of America. If during the course of our work it appears for any reason that we will not be in a position to render an unqualified opinion on the financial statements, or that our report will require an explanatory paragraph, we will discuss this with you. It is possible that because of unexpected circumstances, we may determine that we cannot render a report or otherwise complete the engagement. 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. If, in our professional judgment, the circumstances require, we may resign from the engagement prior to completion.

We will design our audit to provide reasonable rather than absolute assurance of detecting errors or fraud that would have a material effect on the financial statements. Our work will be based primarily upon selected tests of evidence supporting the amounts and disclosures in the financial statements and, therefore, will not include a detailed check of the [*Organization's*] transactions for the period. Accordingly, an audit performed in accordance with auditing standards generally accepted in the United States of America is not a guarantee of the accuracy of the financial statements, and there is a risk that material errors or fraud may exist and not be detected by us. Also, an audit is not designed to detect errors or fraud that are immaterial to the financial statements. However, we will inform you of any material errors or fraud that come to our attention. We will also inform you of illegal acts that come to our attention unless they are clearly inconsequential. In addition, during the course of our audit, financial statement misstatements may be identified, either through our audit procedures or through communication by your employees to us and we will bring these misstatements to your attention as proposed adjustments. Management is responsible for recording such adjustments in the financial statements or otherwise concluding and confirming in a representation letter provided to us at the conclusion of our audit, that the effects of the unrecorded adjustments are, both individually and in the aggregate, immaterial to the financial statements taken as a whole. At the conclusion of our audit we will communicate to management and all those charged with governance all such unrecorded adjustments.

An audit includes obtaining an understanding 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. An audit is not designed to provide assurance on internal control or to identify significant deficiencies or material weaknesses. However, we are responsible for ensuring that you are aware of any significant deficiencies or material weaknesses which come to our attention during our engagement.

Ownership of Working Papers

The working papers prepared in conjunction with our audit are the property of our Firm, constitute confidential information and will be retained by us in accordance with our Firm's policies and procedures.

Reproduction of Audit Report

If the [*Organization*] plans any reproduction or publication of our report, or any portion of it, copies of masters' or printers' proofs of the entire document should be submitted to us in sufficient time 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.

Management Representations

As required by auditing standards generally accepted in the United States of America, we will request certain written representations from management at the close of our audit to confirm oral representations given to us and to indicate and document the continuing appropriateness of such representations and reduce the possibility of misunderstanding concerning matters that are the subject of the representations. Because of the importance of management's representations to an effective audit and provided the audited financial statements and our report thereon are not included in registration statements under the Securities Act of 1933 or in a Private Placement Memorandum, the [*Organization*] agrees to release and indemnify [*Firm*] and its personnel from any liability and costs relating to our services under this agreement attributable to any misrepresentations by management.

Availability of Records

You agree that all records, documentation, and information we request in connection with our audit (including those pertaining to related parties) will be made available to us, that all material information will be disclosed to us, and that we will have full cooperation of your personnel.

Assistance by Your Personnel

We also ask that your personnel, to the extent possible, prepare various schedules and analyses for our staff. This assistance by your personnel will serve to facilitate the progress of our work and minimize costs to you.

Preparation of Tax Returns [*if applicable*]

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.

Other Services [*modify as necessary*]

We are always available to meet with you or other executives, or both, 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 are also prepared to provide services to assist you in any of these areas. We will also be pleased, at your request, to attend your directors' meetings.

Independence

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 and Tax Fees

Our charges to the [*Organization*] for the audit [*and tax return preparation*] services described above are expected to be $[*fee*], plus out-of-pocket expenses. The fee is based on anticipated cooperation from your personnel and the assumption that unexpected circumstances will not be encountered during the audit. If significant additional time is necessary, we will discuss it with you and arrive at a new fee estimate before we incur the additional costs. Bills will be rendered on a monthly basis with payment due upon presentation. Prior to the release of the audit report, we will require payment of 100 percent of all fees billed.

Our charges for other services will be agreed to separately.

* * *

The arrangements described in this letter will be updated annually.

Very truly yours,

[*FIRM*]

By: ____
[*Name*] [*Title*]

Acknowledged:

By: ____

Title: ______________________________________

Date: ______________________________________

.08 Audit of Not-for-Profit Financial Statements Subject to the Provisions of OMB Circular A-133[4]

[*Date*]

[*Name and address*]

Dear [*Contact*]

Agreement to Provide Services

This letter confirms our understanding of the services we will provide to [*Name of Client*] (the [*abbreviated name*]) for the year ending [*date*].[5]

We will audit the [*abbreviated name*]'s basic financial statements as of and for the year ending [*date*]. We will conduct our audit in accordance with auditing standards generally accepted in the United States of America (GAAS) and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. We also will report on the supplementary schedule of expenditures of federal awards that accompanies the basic financial statements.

In addition, we will audit the [*abbreviated name*]'s compliance with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs as defined in OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. We will conduct our audit of the [*abbreviated name*]'s compliance with those compliance requirements in accordance with GAAS, the standards applicable to financial audits contained in *Government Auditing Standards*, and the requirements of OMB Circular A-133.

The objectives of our audit are the expression of our opinions concerning:

- Whether the financial statements are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America (GAAP).
- Whether the schedule of expenditures of federal awards is presented fairly, in all material respects, in relation to the basic financial statements taken as a whole.
- Whether the [*abbreviated name*] complied with the types of compliance requirements described in the *Compliance Supplement* that are applicable to each of the [*abbreviated name*]'s major federal programs.
- A report on the financial statements that provides our opinion or disclaimer of opinion on the basic financial statements and on the schedule of expenditures of federal awards.
- A report on internal control over financial reporting and on compliance based on an audit of financial statements performed in accordance with the standards applicable to financial audits contained in *Government Auditing Standards*.
- A report that provides our opinion or disclaimer of opinion on compliance with requirements applicable to each major program and that reports on internal control over compliance in accordance with OMB Circular A-133.
- A schedule of findings and questioned costs.

---

[4] *Note to users of this sample engagement letter:* This sample engagement letter was derived from a sample letter in the AICPA Practice Aid, *Auditing Recipients of Federal Awards: Practical Guidance for Applying OMB Circular A-133, 2005–2006 Edition* (product no. 006621). That practice aid includes additional resources in paper and electronic form for a Circular A-133 audit.

[5] *Note to users of this sample engagement letter*: You should 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.

We also will complete the appropriate sections of and sign the OMB Data Collection Form that summarizes our audit findings. We will provide copies of our reports to you so that they can be included in the [*abbreviated name*]'s reporting package as defined in OMB Circular A-133. The [*abbreviated name*] is responsible for submitting the reporting package and OMB Data Collection Form to the appropriate recipients.

Our ability to express the opinions and render the reports referred to above, and the wording of our opinions and reports, will depend on the results of the audit and the facts and circumstances at the date of those reports. If circumstances preclude us from issuing unqualified opinions, we will discuss the reasons with you in advance. If circumstances preclude us from completing our audit and issuing our reports as we contemplate, we will advise you and other appropriate parties promptly and take appropriate action.

Financial Statement Audit

The [*abbreviated name*]'s management is responsible for the basic financial statements and the schedule of expenditures of federal awards as well as all representations 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; the prevention and detection of fraud; and the identification of and compliance with laws, regulations, and the provisions of contracts or grant agreements. 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.

Our responsibility is to express an opinion on the basic financial statements based on our audit, and is limited to the period covered by our audit. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements; therefore, our audit will involve judgment about the number of transactions to be examined and the areas to be tested. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the financial statement presentation.

We will plan and perform the audit to obtain reasonable rather than absolute assurance about whether the basic financial statements are free of material misstatement, whether caused by error or fraud. Accordingly, a material misstatement may remain undetected. In addition, an audit is not designed to detect error or fraud that is immaterial to the basic financial statements.

As part of our audit of the basic financial statements, we will obtain an understanding of the [*abbreviated name*]'s internal control over financial reporting 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 significant deficiencies in the design or operation of internal control over financial reporting.

We also will perform tests of the [*abbreviated name*]'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 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.

We will include in our reports information about the following, if any: significant deficiencies in internal control over financial reporting (reportable conditions); reportable conditions that are material weaknesses; fraud or illegal acts unless they are clearly inconsequential; material violations of contracts or grant agreements; and material abuse.

A schedule of expenditures of federal awards will accompany the [*abbreviated name*]'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.

Compliance Audit of Federal Programs

The [*abbreviated name*]'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 [*abbreviated name*] 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 [*abbreviated name*] 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 [*abbreviated name*]'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.[6]

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 [*abbreviated name*]'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 [*abbreviated name*]'s compliance with those requirements and performing such other procedures we consider necessary in the circumstances. Our audit does not provide a legal determination on the [*abbreviated name*]'s compliance with those requirements.

As part of our audit of compliance applicable to the [*abbreviated name*]'s major federal programs, we will obtain an understanding of the [*abbreviated name*]'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 also will follow up on prior audit findings by performing procedures to assess the reasonableness of the [*abbreviated name*]'s summary schedule of prior audit findings.

We will include in our reports information about the following, if any: significant deficiencies in internal control over major programs (reportable conditions), identifying any that are material weaknesses; 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.

---

[6] *Note to users of this sample engagement letter:* This paragraph should 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.

Other Communications Arising From the Audit

In connection with planning and performing our audit we will communicate certain matters to appropriate [*abbreviated name*] personnel and to its audit committee, 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.[7] 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 [*abbreviated name*]'s financial reporting process; and fraud involving senior management that is not otherwise included in our reports.

In planning and performing our audit, we will ask management, the audit committee, the internal auditor, and others within the entity about fraud or suspected fraud; allegations of fraud or suspected fraud; the risks of fraud; programs and controls established to prevent and detect fraud; whether management has communicated information about those programs and controls to the audit committee; and how management communicates to employees its views on business practices and ethical behavior.

We also may communicate in a management letter certain matters identified during the audit or possible ways to improve the [*abbreviated name*]'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.

Preparation of Tax Returns [*if applicable*]

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.

Other Matters

Other [Abbreviated Name] Responsibilities

The [*abbreviated name*] 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 [*abbreviated name*]'s personnel. An enclosure to this letter describes the assistance to be supplied by [*abbreviated name*] 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 [*abbreviated name*] 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.

The [*abbreviated name*] also is responsible for:

---

[7] *Note to users of this sample engagement letter: Government Auditing Standards*, paragraphs 4.08 and 4.09, specifies the parties to whom this communication should be made.

- 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 [*abbreviated name*] develops for its OMB Circular A-133 reporting package may fully or partially satisfy this responsibility.

Our reports on the [*abbreviated name*]'s internal control and compliance will state that they are intended solely for the information and use of the audit committee, 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 [*abbreviated name*] should make copies of our reports available for public inspection unless they are restricted by law or regulation, or contain privileged and confidential information.

Other Auditor Responsibilities

As required by GAAS, we will make specific inquiries of management about the representations embodied in the basic financial statements, the effectiveness of internal control, and the [*abbreviated name*]'s compliance with laws, regulations, and the provisions of contracts or grant agreements that govern federal programs. We also will obtain a representation letter from management about those matters.

If during our audit we become aware that the [*abbreviated name*] is subject to an audit requirement that is not encompassed in the terms of this engagement, we will communicate to management and the audit committee that those terms may not satisfy the relevant legal, regulatory, or contractual requirements.

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.

Peer Review Reports

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.

Other Services

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 [*abbreviated name*]. 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 [*abbreviated name*] 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.

Independence

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.

Fees

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 [*abbreviated name*]'s actual number of major programs.[8] We also will charge the [*abbreviated name*] 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 [*abbreviated name*] 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.

Our charges for other services will be agreed to separately.

* * *

The arrangements described in this letter will be updated annually.

Very truly yours,

[*FIRM*]

By: ____

[*Name*] [*Title*]

Acknowledged:

By: ____

[*Name*] [*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.*]

[8] *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.

AAM Section 4000
Internal Control

> The material included in these sections on internal control is presented for illustrative purposes only. The comments and illustrations are neither all inclusive nor are they prescribed minimums. They are intended as conveniences for users of this manual who may want assistance when developing materials to meet their individual needs.
>
> This manual is a nonauthoritative kit of practice aids and, accordingly, these sections on internal control do not include extensive explanation or discussion of authoritative pronouncements. Users of this manual are urged to refer directly to applicable authoritative pronouncements when appropriate.

TABLE OF CONTENTS

[*The next page is 4101.*]

AAM Section 4100
Introduction

Overview

.01 As discussed in AAM section 3125, on every audit, the auditor is required to obtain an understanding 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 you 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 Statement on Auditing Standards (SAS) No. 109, *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314), provides a framework to help you obtain your understanding of internal control. This framework breaks internal control into five components as identified in AAM section 4200.03. 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 Your understanding of internal control is used to—

- Identify types of potential misstatement.
- Consider factors that affect the risk of material misstatement.
- Design tests of controls, when applicable.
- Design substantive procedures.

.04 Your understanding of a client's internal control should be based on your previous experience with the client and the following:

- Inquiries of appropriate management, supervisory, and staff personnel.
- 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 SAS No. 109. Refer to AAM section 5100 for guidance pertaining to the design of further audit procedures (tests of controls or substantive procedures, or both) and AAM section 5200 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, Statement on Auditing Standards (SAS) No. 109, *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314), provides a framework to help you obtain an understanding of internal control. That framework is built on two concepts: objectives and components.

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

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

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

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

.04 Although an entity's internal control addresses objectives referred to in AAM section 4200.02, not all of these objectives and related controls are relevant to an effective audit of an entity's financial statements. 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, 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 stock-out. This control activity is part of the* ***operations*** *objective. Each store has a small deli that prepares sandwiches and some hot foods. These food preparation activities must comply with state health laws and regulations, and Jones has policies in place to help ensure that those laws and regulations are met. Those policies are directed at the* ***compliance*** *objective of the entity.*

.06 *The controls having to do with the ordering of inventory or compliance with state health laws and regulations are important to Jones Grocery, but ordinarily will not relate to the audit of the company's financial statement. If you were the auditor of Jones Grocery, you may wish to ask about and document these controls for client service or other purposes, but because these controls are not relevant to the audit, you are not required to do so.*

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

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

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

.09 Controls 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 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 SAS No. 109, is only a means to help you consider the impact of an entity's internal control in an audit. Your 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 are required to 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 since the issue of how to classify a particular control is irrelevant for your purposes. As an auditor, your primary consideration is to understand how the bank reconciliations, whether individually or in combination with other controls, affect financial statement assertions relating to cash.*

Effect of Information Technology on Internal Control

.14 An entity's use of IT may affect any of the five components of internal control relevant to the achievement of the entity's financial reporting, operations, or compliance objectives, and its operating units or business functions. For example, an entity may use IT as part of discrete systems that support only particular business units, functions, or activities, such as a unique accounts receivable system for a particular business unit or a system that controls the operation of factory equipment. Alternatively, an entity may have complex, highly integrated systems that share data and that are used to support all aspects of the entity's financial reporting, operations, and compliance objectives.

.15 The use of IT also affects the fundamental manner in which transactions are initiated, 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, and reconciliations and follow-up 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.
- Enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems.

.17 IT also poses specific risks to an entity's internal control, including—

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.
- Unauthorized access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or nonexistent transactions or inaccurate recording of transactions.
- Unauthorized changes to data in master files.
- Unauthorized changes to systems or programs.

- Failure to make necessary changes to systems or programs.
- Inappropriate manual intervention.
- Potential loss of data 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 should help you perform procedures to obtain an understanding of internal control. These procedures generally require the following steps:

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

Focus on the Small Business Entity

.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.
- 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 With a Pervasive Effect on the Organization

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

Understanding the Control Environment

.25 The control environment sets the tone of an organization. It influences the control consciousness of its people and is the foundation for all other components of internal control. In obtaining an understanding of your client's control environment, you should try to understand the 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, you should concentrate on the implementation of controls because controls may be established but not acted upon. The following paragraphs describe some factors you should consider when evaluating your client's control environment.

.26 ***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.

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

.28 For management's integrity and ethical values to have a positive effect on the entity, the following must exist.

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

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

- *Segregation of personal from business funds and activities*. Many small business owners intermingle their personal and business activities, for example, the company may pay the owner's credit card bills even if they contain non-business expenditures. You should consider the owner's attitude and the care with which he or she separates the personal from the business activities. It's not unusual for a business to pay the owner's credit card bills, but the more important question is "does the owner reimburse the company?" Owners who treat company assets as if they were personal assets set a bad example for employees who may be encouraged to do the same.
- *Dealing with signs of problems*. Consider how management deals with signs that problems exist, particularly when the cost of identifying and solving the problem could be high. For example, suppose

your client became aware of a possible environmental contamination on their premises. How would they react? Would they try to hide it, deny its existence, or act evasively if asked about it, or would they actively seek out your advice or the advice of their attorney?

- *Removal or reduction of incentives and temptations*. Individuals may engage in dishonest, illegal, or unethical acts simply because the owner-manager gives them strong incentives or temptations to do so. Removing or reducing these incentives and temptations can go a long way toward diminishing undesirable behavior.

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

  — Pressure to meet unrealistic performance targets, particularly for short-term results.

  — High performance-dependent rewards.

  — Upper and lower cutoffs on bonus plans.

  Temptations for employees to engage in improper practices include—

  — Nonexistent or ineffective controls, such as poor segregation of duties in sensitive areas, that offer temptations to steal or conceal questionable financial reporting practices.

  — Owner-managers who are unaware of actions taken by employees.

  — Penalties for improper behavior that are insignificant or unpublicized and thus lose their value as deterrents.

- *Management intervention*. There are certain situations where it is appropriate for management to intervene and overrule prescribed policies or procedures for legitimate purposes. For example, management intervention is usually necessary to deal with non-recurring and non-standard transactions or events that otherwise might be handled by the financial reporting information system. You should consider whether management has provided guidance on the situations and frequency with which intervention of established controls is appropriate. Management intervention should be documented and explained.

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

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

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

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

- The owner-manager's approach to taking and monitoring business risks.
- Attitudes and actions toward financial reporting and tax matters.
- Attitudes toward information processing and accounting functions and personnel.

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

.34 However, a dominant owner-manager does not necessarily cause you to assess control risk as high.

.35 *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.*

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

.37 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.

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

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

.39 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.

.40 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.

.41 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.

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

.43 *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.*

.44 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.

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

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

.47 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.

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

Other Control Components With a Pervasive Effect on the Organization

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

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

.51 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 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.

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

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

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

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

.55 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 AAM section 4200.81–.85.
- *Physical controls*. These activities encompass the physical security of assets, including adequate safeguards over access to assets and records such as secured facilities and authorization for access to computer programs and data files and periodic counting and comparison with amounts shown on control records. The extent to which physical controls intended to prevent theft of assets are relevant to the reliability of financial statement preparation, and therefore the audit, depends on circumstances such as when assets are highly susceptible to misappropriation. For example, these controls would ordinarily not be relevant when inventory losses would be detected pursuant to periodic physical inspection and recorded in the financial statements. However, if for financial reporting purposes management relies solely on perpetual inventory records, the physical security controls would be relevant to the audit.
- *Segregation of duties*. Assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of his or her duties. Segregation of duties is often a problem for small business entities. See AAM section 4200.123–.131 for further discussion and guidance.

.56 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. You should obtain an understanding of the process of reconciling detail to the general ledger for significant accounts.

.57 In obtaining an understanding of control activities, your 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. Your 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 such objective.

.58 You 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 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.

.59 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.

.60 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. While 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.

.61 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.

.62 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.

.63 ***Information and Communication Systems***. 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 transaction 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.

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

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

.65 The financial reporting information system is an integral part of an entity's information and communication system. Your consideration of the system should be made at the individual account and classes of transaction level. See AAM section 4200.106–.122 for additional guidance.

.66 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.

.67 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.
- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.

.68 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.

.69 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 isused 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.

.70 In obtaining an understanding of the financial reporting process, the auditor should understand the automated and manual procedures an entity uses to prepare financial statements and related disclosures, and how misstatements may occur. Such procedures include—

- *The procedures used to enter transaction totals into the general ledger (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.
- *The procedures used to initiate, authorize, record, and process journal entries in the general ledger.* An entity's financial reporting process used to prepare the financial statements typically includes the use of standard journal entries that are required on a recurring basis to record transactions such as 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.
- *The procedures used to initiate and record recurring and nonrecurring adjustments to the financial statements.* These are procedures relating to adjustments and reclassifications that are not reflected in formal journal entries.
- *The procedures used to combine and consolidate 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).
- *The procedures used to prepare 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.

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

.72 Examples of ongoing monitoring activities include the following:

- Management reviews of data produced by the entity's information system. Managers are in touch with operations and may question reports that differ significantly from their knowledge of operations. However, management should have a basis for believing the data are accurate. If errors exist in the information, management may make incorrect conclusions from its monitoring activities.
- Communications from external parties corroborate internally generated information or indicate problems. Customers implicitly corroborate billing data by paying their invoices. Conversely, customer complaints about billings could indicate system deficiencies in the processing of sales transactions. Similarly, bankers, regulators or other outside parties may communicate with the company on matters of accounting significance.
- External auditors regularly provide recommendations on the way internal control can be strengthened. Auditors may identify potential weaknesses and make recommendations to management for corrective action.
- Employees may be required to "sign off" to evidence the performance of critical control functions. The sign-off allows management to monitor the performance of these control functions.

Application to Medium and Large Businesses

.73 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

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

.75 Factors that influence the effectiveness of those charged with governance include—

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

.76 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

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

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

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

- Conclude that the internal auditors' activities are not relevant to the financial statement audit and give no further consideration to the internal audit function,
- Identify relevant internal auditor activities, but conclude that it would not be efficient to consider further the work of the internal auditors, or
- Decide that it would be efficient to consider how the internal auditors' work might affect the nature, timing, and extent of the audit. In this case, you should assess the competence and objectivity of the internal audit function as outlined in AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1).

.79 You may also request direct assistance from the internal auditors. If so, you should follow the guidance in AU section 322.27.

Formal Policies

.80 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

.81 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.

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

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

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

Acquisition of Hardware and Software

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

.85 *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.*

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

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

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

- Obtain recognized software from reputable sources and only accept delivery of the software in the manufacturer's sealed package.
- Make multiple generations of backups. A virus that is not detected initially may be copied onto more recent backup copies, while the older versions may not be infected.
- Prohibit the use of unauthorized programs introduced by employees.
- Prohibit downloading of untested software from sources such as dial-up bulletin boards.
- Use virus protection software to screen for virus infections.

Physical Security

.89 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.

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

Logical Access

.91 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.

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

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

User Controls Over Computer Service Organization Applications

.94 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).

.95 When using an outside computer service organization, most small businesses typically retain the responsibility for authorizing transactions and maintaining the related accountability. The computer service organization merely records user transactions and processes the related data. In these circumstances, the user (the small business) should maintain controls over the input and output to prevent or detect material misstatement. When the service organization initiates, executes, and does the accounting processing of the user organization's transactions, it may not be practicable for the user organization to implement effective controls for those transactions.

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

Application to Medium or Large Businesses

.97 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.

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

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

.100 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.

.101 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

.102 ***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.

.103 ***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.

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

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

.105 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

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

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

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

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

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

.109 *At Jones Grocery, sales are initiated by customers and recorded in the cash register. At the end of the day the cash register totals are reconciled to the cash on hand, and a deposit is prepared for the day's receipts. On a weekly basis, the daily cash register tapes are batched for each store, forwarded to Mrs. Jones, and entered into the computer. The computer generates a sales register, a sales analysis report, and posts the sales totals to the general ledger. Also, the processing of inventory transactions (receipt of goods, sales, spoilage, etc.) involves several processing activities that are linked in the inventory module of the software package. On the other hand, recording depreciation expense is fairly simple. Fixed assets and the related depreciation are maintained on a computer spreadsheet, and each month, Mrs. Jones prepares a journal entry to record depreciation.*

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

.111 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.

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

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

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

.114 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.

.115 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.

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

- Require all significant end user applications to be adequately tested before use.
- Prescribe documentation standards for significant end user applications.
- Provide for adequate access controls to data.

- Provide a mechanism to prevent or detect the use of incorrect versions of data files.
- Provide for appropriate applications controls, for example, edit checks, range tests, or reasonableness checks.
- Support meaningful user reconciliations.

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

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

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

.119 *At Jones Grocery, the sales analysis report described in AAM section 4200.109 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.*

.120 ***Other Significant Events and Conditions***. You should understand how the entity's information system captures other events and conditions that are significant to the financial statements. This might involve, for example, nonrecurring or unusual transactions or adjustments and nonrecurring estimates.

.121 *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.*

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

Segregation of Duties and Management Override

.123 Small businesses are typically characterized by—

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

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

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

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

.127 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.

.128 Management *override* should be distinguished from management *intervention*. Management *intervention* is discussed in AAM section 4200.29 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.

.129 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.

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

.131 When gaining an understanding of internal control, you generally assess the risk of management override.

Assessing Internal Control Strengths and Weaknesses

.132 When obtaining your understanding of internal control, you 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.

.133 Internal control strengths may indicate account balances, transaction classes, or assertions where you can assess control risk at low or moderate.[1] Internal control weaknesses usually indicate areas where substantive procedures are 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.

.134 In rare circumstances, your understanding of internal control may raise doubts about the auditability of an entity's financial statements. Concerns about the integrity of the entity's management may be so serious as to cause you to conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted. Concerns about the nature and extent of an entity's records may cause you to conclude it is unlikely that sufficient competent audit evidence will be available to support an opinion on the financial statements.

.135 If you determine the entity is unauditable, you should consider withdrawing from the engagement.

[1] Control risk may be assessed in quantitative terms, such as percentages, or in nonquantitative terms such as *high*, *medium*, or *low* risk.

Practical Guidance

Readers should 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 sub-appendixes (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, "Evaluation of Activity-Level Controls," 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 kit of practice aids. Users of this manual are urged to refer directly to applicable authoritative pronouncements when appropriate. Users should also note that this manual does not deal with specialized industry problems; reference should be made to applicable AICPA Audit and Accounting Guides.

TABLE OF CONTENTS

[*The next page is 5101.*]

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:

a. 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*);

b. When necessary, or when you have 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

c. 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 You 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 your risk assessment includes an expectation of the operating effectiveness of controls, you should test those controls to support the risk assessment. In addition, when the substantive procedures alone do not provide sufficient appropriate audit evidence, you 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 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), you 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, you 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, you 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 Your 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. It is critical that your audit procedures are linked clearly and responsive to your assessment. This linkage between risk assessment and audit procedures should be part of your 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 you "bridge" between your assessment of financial statement level risks and your 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, you 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, you 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 your professional judgment to determine:
  — 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, your 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, you may need to reconsider your 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 Your overall responses to address the assessed risks of material misstatement at the financial statement level may include:

- 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 your 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, you should consider an appropriate response. For example, you 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 your 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 you may take in response to your assessment of the risk of material misstatement due to fraud. When determining your overall audit response, you should consider your assessment of fraud risk concurrently with your assessment of the risk of material misstatement due to error. You 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 your audit opinion. These procedures consist of tests of controls and substantive tests.

.15 You 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, you should consider such matters as:

- 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 your 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 Your 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, you may determine that performing only substantive procedures is appropriate for specific relevant assertions and risks. In those circumstances, you may exclude the effect of controls from the relevant risk assessment. This may be because your 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, you need to be satisfied that performing only substantive procedures for the relevant assertions would be effective in reducing detection risk to an acceptably low level. You 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, you 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, your further audit procedures are likely to be primarily substantive procedures. In such cases, in addition to the matters referred to in paragraph .12 above, 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:

a. 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.

b. Their type, that is:

- 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. • 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 your inquiries is an equally integral part of the process.

.22 Inquiry normally involves:

- 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.

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/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. In those situations, the auditor should resolve any significant inconsistencies in the information obtained. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

.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.
- Their stated reasons for choosing a particular course of action.
- Their 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), as amended, 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 should be used whenever practical.

.30 AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1) as amended, describes analytical procedures as follows:

> Analytical procedures involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor. The auditor develops such expectations by identifying and using plausible relationships that are reasonably expected to exist based on the auditor's understanding of the client and of the industry in which the client operates. Following are examples of sources of information for developing expectations:
>
> *a.* Financial information for comparable prior period(s) giving consideration to known changes.
>
> *b.* Anticipated results—for example, budgets, or forecasts including extrapolations from interim or annual data.
>
> *c.* Relationships among elements of financial information within the period.
>
> *d.* Information regarding the industry in which the client operates—for example, cost of funds information.
>
> *e.* Relationships of the financial information with relevant nonfinancial information.

.31 Whenever analytical procedures are applied as substantive tests, the auditor must apply the following procedures:

a. Consider whether the relationship is plausible and predictable.

b. Consider whether the data used for the comparison is reliable.

c. Consider whether the account balance tested is consistent with the auditor's expectations. If it is not consistent, obtain the client's explanation for the variance and get evidence to corroborate the client's explanation.

.32 AU section 329 also requires that analytical procedures be performed at the planning and final review stages of the audit. See AU section 329 and AAM section 3155 for further guidance on analytical procedures.

The Selection of Audit Procedures

.33 Your risk assessments will have a bearing on your selection of audit procedures. The higher your assessment of risk, the more reliable and relevant the audit evidence you seek from substantive procedures. 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, you 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 you would have obtained by performing only one procedure.

.34 In determining the audit procedures to be performed, you should consider the underlying reasons for your assessment. These underlying reasons relate to both the inherent and control risks related to the assertion. For example, if you assessed risk of material misstatement to be low that a material misstatement might occur because of low inherent risk, you may determine that substantive analytical procedures alone may provide sufficient appropriate audit evidence. On the other hand, if you expect that there is a lower risk of material misstatement because the client has effective controls and you intend to design substantive procedures based on relying on the effective operation of those controls, you should perform tests of controls or dual-purpose tests in addition to analytical procedures or other substantive tests.

.35 You 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 Considering when to perform audit procedures, the auditor should also consider such matters as:

- Your assessed risk of misstatement. In general, the higher the risk, the more likely it is that you 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 you will be able to perform tests as of an interim date.
- When the information necessary to perform your procedures 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, you 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:

- 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. SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), 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 SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314), 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 SAS No. 109, 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 SAS No. 109 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.
- 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 your conclusion about the operating effectiveness of controls during the audit period may come from a variety of sources, including:

- Tests of controls performed during the current period.
- Risk assessment procedures performed during the current period.

---

[1] The auditor's strategy reflects the level of assurance the auditor plans to obtain regarding controls.

- Evidence provided in a Type 2 AU section 324, *Service Organizations* (AICPA, *Professional Standards*, vol. 1), report.
- Evidence obtained from the performance of procedures in previous audits.
- The information gathered and conclusions reached as part of your 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
  — Ethical values

Risk Assessment Procedures vs. Tests of Controls

.06 Risk assessment procedures allow you to evaluate the design effectiveness of internal controls for the purpose of assessing risks of material misstatement. Tests of controls build on your evaluation of design effectiveness and allow you to assess the operating effectiveness of controls during the operating period. The results of your 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 you will focus first on testing control activities, since 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, you 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, you should consider the following.

a. *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, your need to test the indirect control increases.

b. *The relative significance of the audit evidence of the complementary control to the auditor's conclusion on the effectiveness of the direct control.* Your 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, you 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), your conclusion may be based primarily on tests of the complementary controls and little on tests of the direct control. In those situations where you rely significantly on the operating effectiveness of the complementary control, you should 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.

c. *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, you may test four month-end reconciliations and draw a conclusion about the effectiveness of those reconciliations for an entire 12-month period. If you have tested the operating effectiveness of the complementary controls related to the reconciliation, the conclusion about the effectiveness of the reconciliation during the period you did not test will be more reliable than if you did not test the complementary controls.

d. *Evidence of operating effectiveness that may have been obtained as 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, you 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 you 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, you 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, you may consider the need to test the control environment or IT general controls relating to the entire entity beyond the required design and implementation assessment procedures you already have performed. If practical, you may limit your 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, you 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 should decrease. For example, in circumstances when you adopt a strategy at the assertion level that consists primarily of tests of controls, you 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 you have to support your opinion. In contrast, when performing an audit of the financial statements, you ordinarily perform 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, you have 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 you perform to test controls has a direct bearing on the relevance and reliability of your 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:

- 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, and in these situations, you 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 should 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, you 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, you should supplement the observation with other observations or inquiries of entity personnel, and you 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 you substantial audit evidence about the operating effectiveness of the control during the entire audit period. That is, once you have determined that an IT application control has been implemented (placed in operation), you may draw a conclusion about the operating effectiveness of the IT portion of the control activity, so long as you have 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, you should continue to test spreadsheet controls even after their implementation.

Dual Purpose Tests

.24 Some audit procedures may simultaneously provide audit evidence that both:

- Supports the relevant assertion or detects material misstatement, and
- Supports 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, you 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, you should consider carefully 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, you should consider how the outcome of the tests of controls may affect your determination about the extent of substantive procedures to be performed. For example, if controls are found to be ineffective, you should consider whether the sample size you designed for the dual purpose test will be adequate or 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 your 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, you 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 your tests of controls depends on your objective.

a. When controls are tested as of a point in time, you have obtained audit evidence that the controls operated effectively only at that time.

b. If you test controls throughout a period, you 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 your purpose, for example, when testing controls over the client's physical inventory counting at the period end. If, on the other hand, you need audit evidence of the effectiveness of a control over a period, audit evidence pertaining only to a point in time may be insufficient, and you should supplement your tests with others that provide audit evidence that the control operated effectively during the period under audit. For example, for an automated control, you may test the operation of the control at a particular point in time. You then may perform tests of controls to determine whether the control operated consistently during the audit period, or you 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 you perform to supplement tests of controls at a point of time may be part of your tests of controls over your client's monitoring of controls.

Updating Tests of Controls Performed During an Interim Period

.31 You 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 you test controls during an interim period or as of an interim date, you should:

a. Obtain audit evidence about the nature and extent of any significant changes in internal control that occurred during the remaining period, and

b. Determine what additional audit evidence should be obtained for the remaining period.

.33 To determine what additional audit evidence you should obtain to update tests of controls performed in advance of the balance sheet date, you should consider:

a. The significance of the assessed risks of material misstatement at the relevant assertion level.

b. The specific controls that were tested during the interim period.

c. The degree to which audit evidence about the operating effectiveness of those controls was obtained.

d. The length of the remaining period.

e. The extent to which the auditor intends to reduce further substantive procedures based on the reliance of controls.

f. The control environment.

g. The volume or value of transactions processed in the remaining period.

.34 When you test controls as of or during an interim period, you may obtain additional evidence about the operating effectiveness of controls during the remaining period by performing procedures such as:

a. Extending the testing of the operating effectiveness of controls over the remaining period, or

b. Testing the client's monitoring of controls.

.35 For example, you 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.
- The same procedures you 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, you may use audit evidence obtained in prior audits to support your conclusion about the operating effectiveness of controls in the current audit. If you plan to use evidence obtained in prior periods, you should consider:

a. Whether the use of this evidence is appropriate.

b. The length of the time period that may elapse before retesting the control.

.37 The following table summarizes the factors you should consider when determining whether to use audit evidence about the operating effectiveness you 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 you plan to use audit evidence about the operating effectiveness of controls obtained in prior audits, you should:

a. Obtain audit evidence about whether changes in those specific controls have occurred subsequent to the prior audit.

b. Perform audit procedures to establish the continuing relevance of audit evidence obtained in the prior audit.

.39 Even when you use audit evidence about the operating effectiveness of controls obtained in prior periods, you still should evaluate the design effectiveness and implementation of controls in the current period. The procedures performed as described in the paragraph above may help you to fulfill this responsibility; however, you 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 have changed, you will need to determine whether the design of controls remains effective in light of the changed business processes.

.40 You may not rely on audit evidence about the operating effectiveness of controls obtained in prior audits for controls that:

a. Have changed significantly since the prior audit.

b. Pertain to business processes that have changed significantly since the prior audit.

c. Mitigate significant risks.

For any control that meets one of the above criteria, you 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 you plan to rely on controls that have not changed since they were last tested, you should test the operating effectiveness of these controls at least once every third 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 you plan to use audit evidence obtained in prior audits, you should test the operating effectiveness of *some* controls each audit. However, when you are 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 your tests of controls affects the sufficiency of the audit evidence you obtain to support the auditor's assessment of the operating effectiveness of controls. You should design sufficiently extensive tests of controls to obtain the desired level of assurance that the controls are operating effectively:

a. At the relevant assertion level, and

b. Either throughout the period, or as of the point in time when you plan to rely on the control.

.45 Factors the auditor may consider in determining the extent of tests of controls include the following:

a. The frequency of the performance of the control by the entity during the period.

b. The length of time during the audit period that the auditor is relying on the operating effectiveness of the control.

c. 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.

d. The extent to which audit evidence is obtained from tests of other controls that meet the same audit objective.

e. 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.

f. The expected deviation from the control.

Sampling Considerations

.46 You 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 it is applied frequently. When a control is applied periodically (for example, monthly reconciliations of accounts receivable subsidiary ledger to the general ledger), you 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 You should consider the expected deviation from the control when determining the extent of tests. As the rate of expected deviation from a control increases, you should increase the extent of testing of the control. However, if the rate of expected deviation is expected to be too high, you may determine that tests of controls for a particular assertion may not be effective. In this case you may conclude that a control deficiency exists and you should consider its severity and whether it should be communicated to those charged with governance and/or management.

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, you may be able to limit the testing of an IT application control to one or a few instances of the control operation, provided that you determine 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 your 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 you encounter deviations in the operation of controls, those deviations will have an effect on your assessment of operating effectiveness. A control with an observed nonnegligible deviation rate is not an effective control. For example, if you design a test in which you select a sample of, say, 25 items and expect no deviations, the finding of one deviation would be considered a nonnegligible deviation because, based on the results of your test of the sample, the desired level of confidence has not been obtained.

.51 There are sources of audit evidence beyond your tests of controls that contribute to your assessment of the operating effectiveness of controls. The extent of misstatements you detect by performing substantive procedures also may alter your 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 should be substituted for the one supported by the procedures you used to assess control risk.

Investigating Additional Implications of Identified Deviations

.52 When you detect control deviations during the performance of tests of controls, you 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, you 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 your 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, you determine 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, you 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, you should determine whether:

- Additional tests of controls are necessary, or
- How the potential risks of misstatement will be addressed using substantive procedures.

Once you have 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

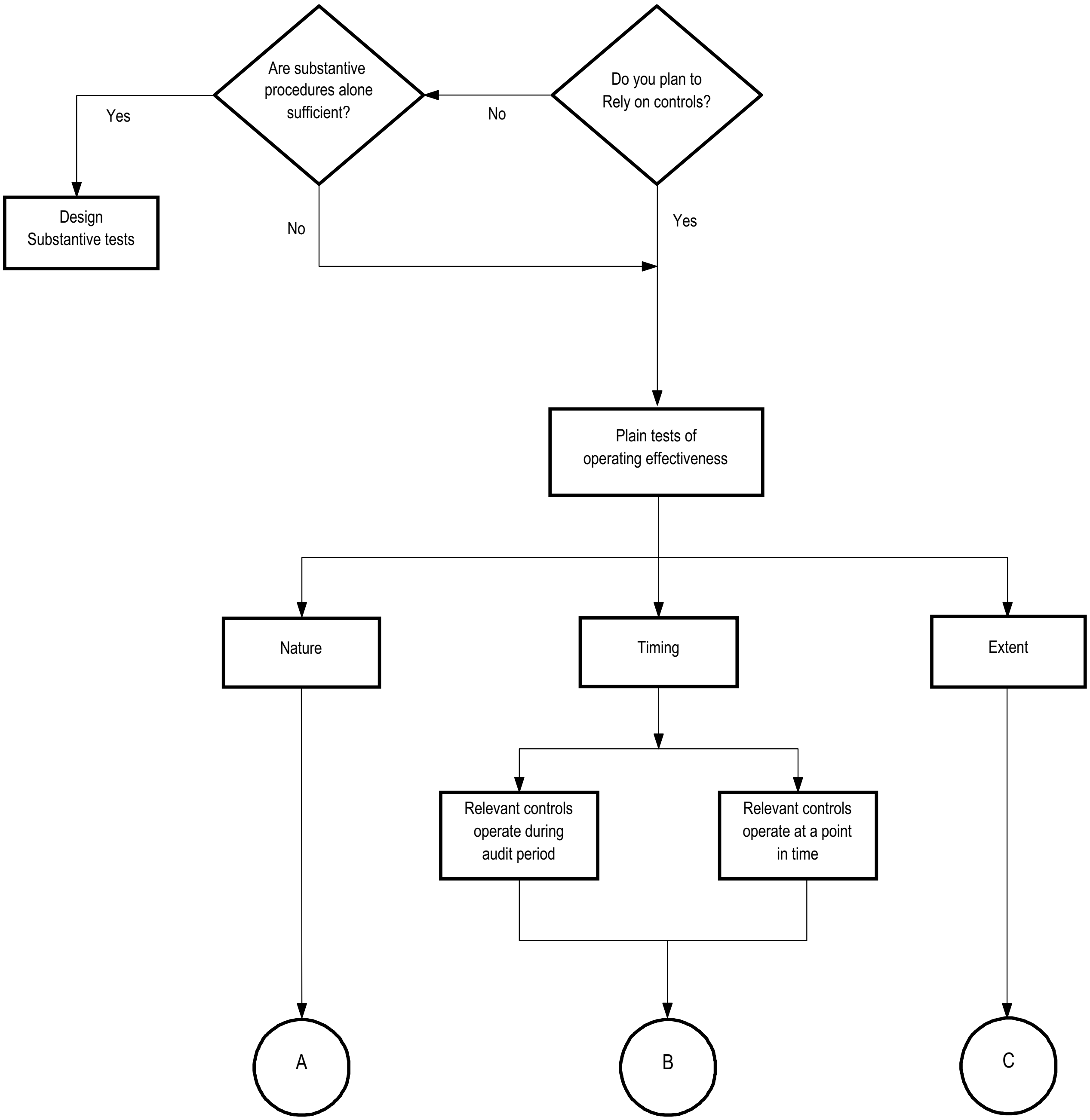
.56 You should consider whether deviations in the operation of controls have been caused by an underlying control deficiency. When evaluating the reason for a control deviation, you should consider:

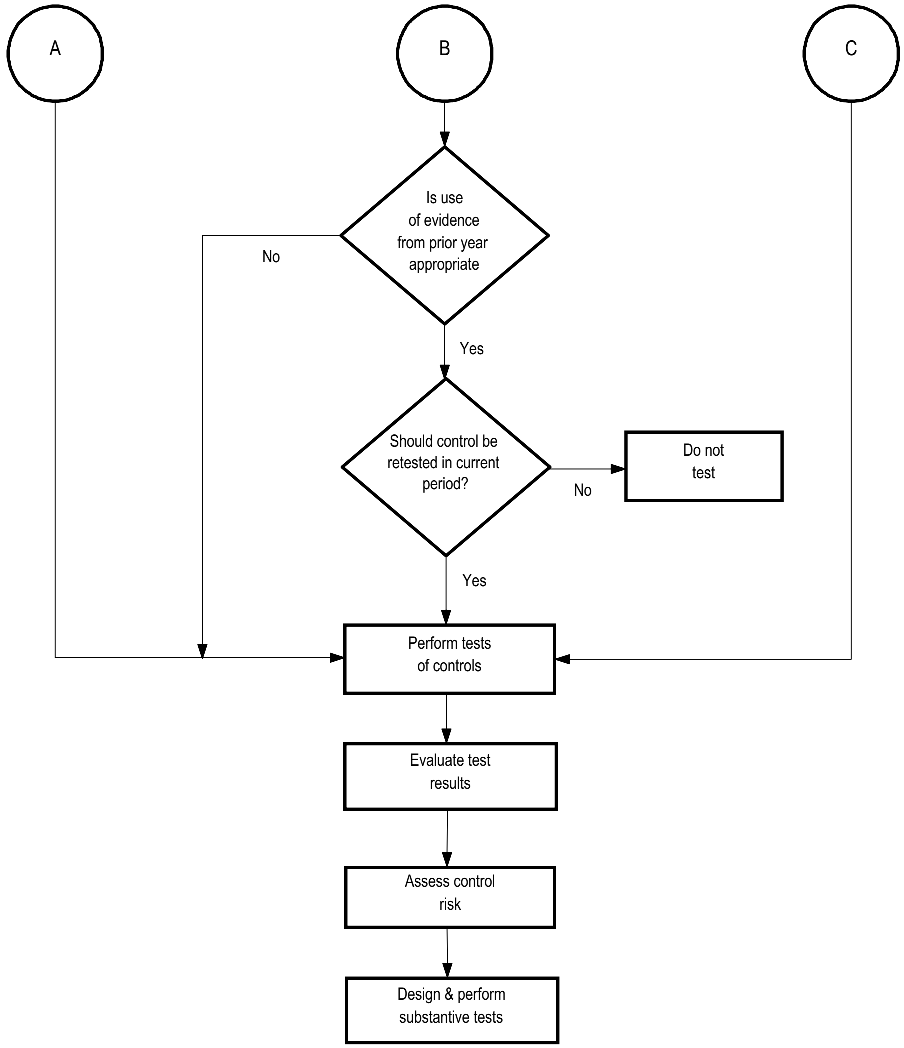
- Whether the control is automated (in the presence of effective information technology general controls, an automated application control is expected to perform as designed),
- The degree of intervention by entity personnel contributing to the deviation (for example, was the deviation evidence of a possible override), and
- If management was aware of the deviation, its actions in response to the matter.

.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 your considerations related to tests of controls.





Documentation

.59 In regards to the performance of further audit procedures, the auditor should document:

a. The overall responses to address the assessed risks of misstatement at the financial statement level

b. The nature, timing, and extent of the further audit procedures

c. The linkage of those procedures with the assessed risks at the relevant assertion level

d. The results of the audit procedures

e. 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. SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), 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 your 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 In general, your substantive procedures should be responsive to your assessed risks of material misstatement. However, you should perform certain tests regardless of your risk assessment since your risk assessment may not identify all risks.

- *Substantive tests of material items*. You should perform substantive procedures for all relevant assertions for each material class of transactions, account balance, and disclosure. For example, if you determine that long-term debt is a material account, you should perform substantive tests for all assertions that are relevant to long-term debt, even if you have determined that it is unlikely that the assertion could contain a material misstatement. You may determine that the risk of the entity not having the obligation to repay the debt (the obligation assertion) is low, but nevertheless, you 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, you are precluded from relying solely on risk assessment procedures or tests of controls to support your conclusion.
- *Substantive tests related to the financial statement reporting system*. On all your engagements you should:
    - — Agree the financial statements, including their accompanying notes, to the underlying accounting records.
    - — Examine material journal entries and other adjustments made during the course of preparing the financial statements.
    - — The nature and extent of your 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 Statement on Auditing Standards (SAS) No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314), 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 your audit approach to significant risks consists only of substantive procedure, your substantive procedures should include either of the following:

a. Tests of details only.

b. 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 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, you should 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 your expectation depends on (among other things):
  - — Your 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 your 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 your expected amount and the recorded amount that you can accept, the more precise your expectation should 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 you drawing erroneous conclusions about your substantive analytical procedures.

AU section 316.57–.67, *Consideration of Fraud in a Financial Statement* (AICPA, *Professional Standards*, vol. 1), directs you to perform certain procedures to assess the risk of management override of controls.

.08 AU sec. 329.09–.21 provides additional guidance on the design of substantive analytical procedures.

Timing of Substantive Procedures

Substantive Procedures Performed at an Interim Date

.09 In some circumstances, you may choose to perform substantive procedures at an interim date. When you perform procedures as of a date in advance of year end, you increase the risk that you will fail to detect a material misstatement that may exist at year end. This risk increases as the length of the period between your interim tests and year end increases. The following table summarizes factors you may consider 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 you 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	You will be able to perform all necessary procedures to cover the remaining period	Your 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 table above, the circumstances of the engagement may result in you performing certain tests at an interim date. For example, your client may require you to 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, you 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 you to send and receive confirmations of customers and to complete your test work.

.12 Your 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 you need to perform your procedures. That information should be sufficient to allow you to investigate:

a. Significant unusual transactions or entries (including those at or near the period end).

b. Other causes of significant fluctuations or fluctuations that did not occur.

c. 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:

- 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 you perform substantive procedures at an interim date, you should perform tests that cover the remaining period and provide a reasonable basis for extending your audit conclusions from the interim date to the period end. Those additional tests may be either of the following:

a. Substantive procedures.

b. A combination of substantive procedures and tests of controls.

.15 When you perform substantive procedures at an interim date, you may reconcile the account balance at the interim date to the balance in the same account at year end. The reconciliation will allow you to:

- Identify amounts that appear unusual.
- Investigate these amounts.
- Define the appropriate population to perform substantive analytical procedures or tests of details to test the remaining period.

.16 If you detect misstatements in classes of transactions or account balances at an interim date, you should consider whether:

- Your initial assessment of risk remains appropriate or should be modified.
- Your planned substantive procedures covering the remaining period remain adequate considering your updated risk assessment.

Substantive Procedures Performed in Previous Audits

.17 In most cases, audit evidence from substantive procedures you 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 fundamentally be the same. 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. Whenever you use audit evidence from a prior period in the current audit, you 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 your substantive procedures. However, the nature of your 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 your tests of details, you ordinarily think in terms of sample size. However, you also should 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 sub-populations 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. 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 generally accepted accounting principles 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 SAS No. 106, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1, AU sec. 326), 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:

a. The overall responses to address the assessed risks of misstatement at the financial statement level

b. The nature, timing, and extent of the further audit procedures

c. The linkage of those procedures with the assessed risks at the relevant assertion level *d*. The results of the audit procedures

e. 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. SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), establishes standards and provides guidance regarding documentation in the context of the audit of financial statements.

[*The next page is 5401*.]

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), a decision must be made about how many items to apply the procedures to—that is, the extent of testing. The greater the risk of material misstatement, the less detection risk that can be accepted; 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—

a. In tests of controls in internal control to evaluate operating effectiveness from prescribed controls.

b. In substantive tests of details of account balances and classes of transactions.

c. In dual-purpose tests that assess control risk and test whether the monetary amount of a transaction is correct.

.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 is usually more efficient to audit individually significant items and obtain audit assurance about the remaining balance through analytical procedures than to perform audit sampling. As the size and sophistication of the client's internal control increases, the auditor is more likely to use audit sampling to perform tests of controls and tests of balances.

.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 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 combined results of the test of large sales invoices, inquiry and observations, analytical procedures, and other auditing procedures performed related to overstatement of sales.

.08 The auditor should remember that 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.

a. The concept that some items exist for which, in the auditor's judgment, acceptance of some sampling risk is not justified, and that these should be examined 100 percent (See AU section 350.21). This simply reminds the auditor that some of the items encountered in an examination of financial statements may be so significant individually or may have such a high likelihood of being in error or misstated that *all* such items should be examined.

b. The suggestion that the efficiency of a sample may be improved by separating items subject to sampling into relatively homogeneous groups based on some characteristic (See AU section 350.22). This indicates that audit efficiency can sometimes be improved by, for example, stratifying or segregating the items constituting a balance or class of transactions into groups based on individual dollar value or some other characteristic.

c. A requirement that the auditor consider tolerable misstatement in planning audit sampling applications in the examination of account balances and classes of transactions (See AU section 350.18). This asks the auditor to consider, in the early stages of an audit, how much misstatement the auditor will be able to tolerate for each balance and class of transactions that is sampled, in combination with misstatements in other accounts, and still render an unqualified opinion on the financial statements. AU section 350 asks the auditor to consider tolerable misstatement and to recognize that it is one of the factors influencing sample size. There is no requirement to document or quantify tolerable misstatement.

d. A requirement that the auditor select a sample that can be expected to be representative of the population (See AU section 350.24). Simply put, this means that each item in the population being sampled should have *a chance* of being selected, not necessarily *an equal chance* of being selected. This does not mean that the auditor is required to use a random or probability sample.

e. A requirement that the auditor consider selected sample items to which the auditor is unable to apply planned audit procedures to determine their effect on the evaluation of the sample (See AU section 350.25). 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.

f. A requirement that the auditor project the misstatement results of the sample to the items from which the sample was selected (See AU section 350.26). Since the sample is expected to be representative of the population from which it was selected, misstatements found are also expected to be representative of the population. This merely asks the auditor to measure the likely misstatement in the population from which the sample was drawn and to consider it in reaching conclusions.

g. A requirement that the auditor consider, in the aggregate, projected misstatement results for all audit sampling applications and all known misstatements from nonsampling applications, along with other relevant audit evidence, when evaluating whether the financial statements taken as a whole may be materially misstated (See AU section 350.30).

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. Statement on Auditing Standards (SAS) No. 108, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), states that the auditor should prepare a written audit plan or program, and SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), states that audit documentation of tests of operating effectiveness of controls and substantive tests of details that involve inspection of documents or confirmation should include an identification of the items tested. The identification of the items tested may be satisfied by indicating the source from which the items were selected and the specific selection criteria, for example:

- When a haphazard or random sample is selected, the documentation should include identifying characteristics (for example, the specific invoice numbers of the items included in the sample).
- When all items over a specified dollar amount are selected from a listing, the documentation need describe only the scope and the identification of the listing (for example, all invoices over $25,000 from the December sales journal).
- When a systematic sample is selected from a population of documents, the documentation need only provide an identification of the source of the documents and an indication of the starting point and the sampling interval (for example, a systematic sample of shipping reports was selected from the shipping log for the period from X to Y, starting with report number 14564 and selecting every 250th report from that point).

With regard to audit sampling applications, the audit program might document such items as the objectives of the sampling application and the audit procedures related to those objectives. Examples of items that the auditor may document for tests of controls are discussed in AAM section 5400.26. Examples of items that the auditor typically documents for substantive tests are discussed in AAM section 5400.56.

Determining Extent of Testing in a Small Business 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 as useful since there may be large populations of data.

.13 AU section 350.01 defines audit sampling: "The application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class." This definition allows some alternative approaches to sampling to determine the extent of testing in a small business engagement. These alternatives, by not using audit sampling and thus eliminating the requirements of AU section 350, may provide a more effective and efficient audit approach for a small business engagement.

.14 These alternative approaches include:

a. Procedures applied to 100 percent of a certain group (strata) of transactions or balances.

b. Testing unusual items without applying procedures to the remainder of the population.

c. Other tests that involve application of procedures to less than 100 percent of the items in the population without drawing a conclusion about the entire account or class of transactions.

.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

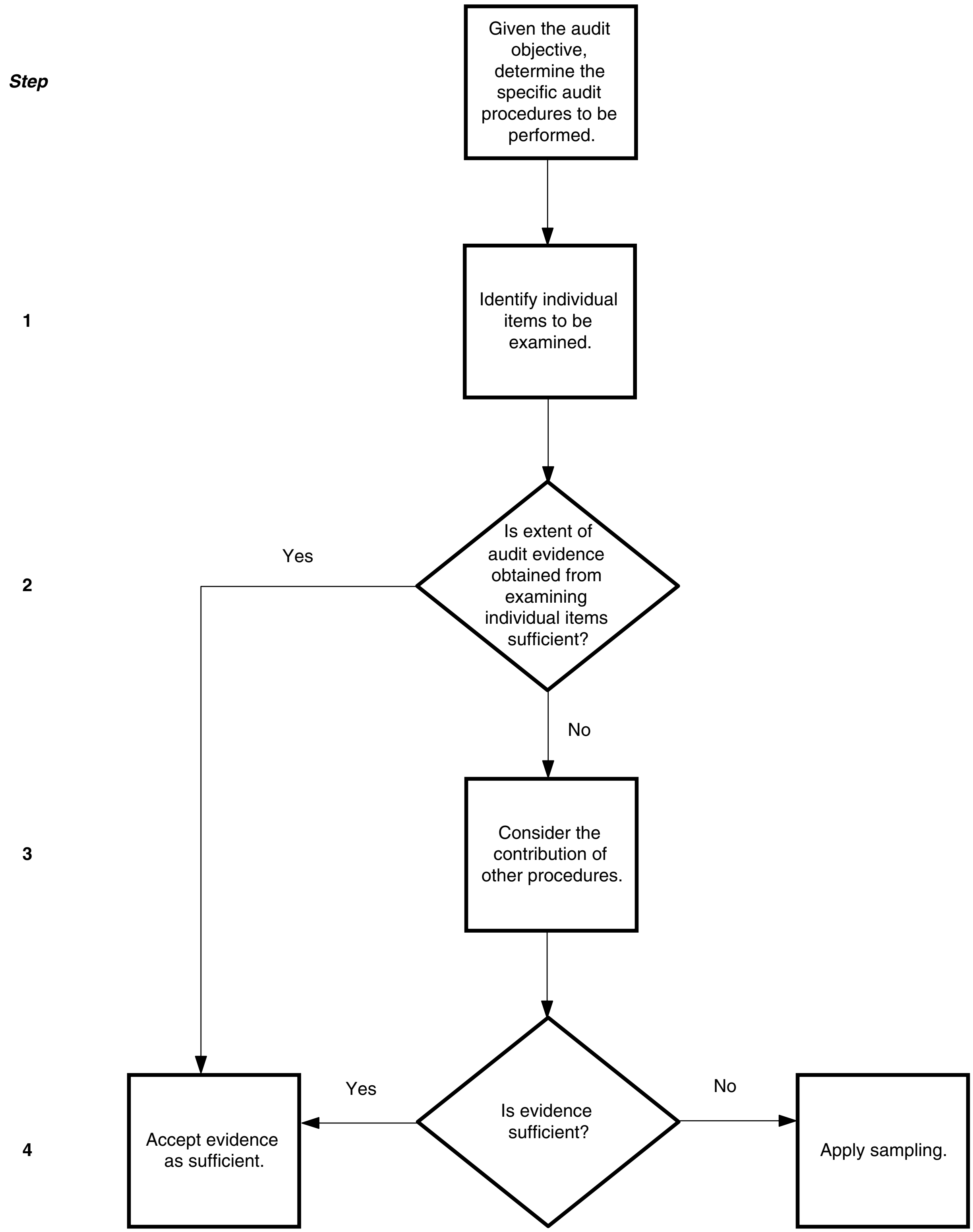
.17 An auditor should apply professional judgment in determining which individual items in an account balance or class of transactions need to be examined. In evaluating individual items, the auditor should consider factors such as size of the item, whether the item is unusual, prior experience with the client, and whether the item involves a related party.

.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). Also, the auditor may decide to confirm the receivables that have unusual characteristics (for example, receivables with either large credit balances or those that are very delinquent).

Flowchart 1
An Audit Sampling Approach for a Small Business



Is Extent of Audit Evidence Obtained Sufficient?

.19 Some factors in evaluating the sufficiency of audit evidence obtained in tests of details for a particular account balance or class of transactions are:

a. The individual importance of the items examined. If the items examined, account for a high percentage of the total population, then the auditor may be reasonably assured that there is an acceptably low risk of an undetected misstatement.

b. The nature and cause of misstatements. If during the course of the audit, misstatements are discovered, those misstatements should be evaluated to determine if they are due to differences in principle or in application, are errors or fraud or are due to misunderstanding of instructions or carelessness.

c. Possible relationship of the misstatement to other phases of the audit. If it is determined that the misstatement is due to fraud this would require a broader consideration of the possible implications than would the discovery of an error.

d. The characteristics of the sample to the population. The auditor may obtain some knowledge of the types of items in the population if the characteristics in the sample are similar in nature and the same controls are followed for processing the transactions.

.20 If an auditor has examined a substantial number of individual amounts and found no evidence of problems from the other procedures performed—and the remaining population totals less than an amount that would be material to the financial statements—there is often no need to sample the remaining population. Otherwise, the auditor should extend tests to the remaining population unless an alternative approach can be justified.

Consider Contribution of Other Procedures

.21 The auditor should also consider whether other evidence obtained contributes to conclusions regarding the account balance or class of transactions. The auditor often considers the contribution of other procedures at the same time the extent of audit evidence obtained from examining individual items is considered.

.22 The auditor may use a combination of analytical procedures and substantive tests of details to support an opinion on the financial statements. In deciding whether other audit procedures make a contribution, the auditor should consider whether they support the audit objectives in the area, whether they indicate potential problems, and whether the evidence is consistent with the previous evidence obtained.

.23 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

.24 There are three factors that the auditor may consider in evaluating the sufficiency of audit evidence obtained from examining individual items and contributed by other procedures, and in determining whether the remaining items in the population should be tested.

.25 First, the auditor should consider whether the dollar amount of the remaining population is equal to or greater than an amount that would be material to the financial statements. If the remaining population is less than material, the auditor may decide that no additional testing by sampling is necessary. Second, the auditor should consider the degree of risk involved (that is, how susceptible the account is to misstatement, and whether there have been problems with this area in prior audits). Third, the auditor should consider the sufficiency of all the audit evidence obtained so far (the extent of audit evidence obtained by testing individual items along with the contribution of other procedures).

Audit Sampling for Tests of Controls

.26 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:

a. *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.

b. *Define the deviation conditions*. A deviation condition is a situation that indicates that the controls were not performed. For example, if the auditor is examining purchase invoices for evidence of approval of an expenditure (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.'"

c. *Define the population*. The population selected must be appropriate for the objective being tested. For example, if the auditor is testing the operating effectiveness of a prescribed control designed to ensure that all shipments were billed, the auditor would not detect deviations by sampling from billed items. An appropriate population for detecting such deviations usually includes the record of all items shipped.

d. *Defining the period covered by the test*. For samples to be representative of the period under audit, the population generally should include all transactions processed during the period. Often, auditors perform tests of controls during interim work. The auditor should determine what additional evidence needs to be obtained for the remaining period. Often, the auditor obtains the additional evidence by extending the test to the transactions occurring in the remaining period. However, it is not always efficient to include all transactions executed throughout the period under audit in the population to be sampled. In some cases, it might be more efficient to use alternative approaches to test the performance of the control during the remaining period. In these cases the auditor would define the population to include transactions for the period from the beginning of the year to an interim date and consider the following factors in determining what, if any, additional evidence needs to be obtained for the remaining period:

- The significance of the assertion involved.
- The specific controls that were tested during the interim period.
- Any changes in controls from the interim period.
- The extent to which substantive tests were changed as a result of the controls.
- The results of the tests of controls performed during the interim period.
- The length of the remaining period.
- The audit evidence about design or operation that may result from the substantive tests performed in the remaining period.

The auditor selects sampling units from a physical representation of the population. For example, if the auditor defines the population as all customer receivable balances as of a specific date, the physical representation might be a printout of the customer accounts receivable trial balance as of that date. Making selections from a controlled source minimizes differences between the physical representation and the population. The auditor should consider whether the physical representation includes the entire population. If the auditor reconciles the selected physical representation and the population and determines that the physical representation has omitted items in the population that should be included in the overall evaluation, the auditor should select a new physical representation or perform alternative procedures on the items excluded from the physical representation.

e. *Defining the sampling unit*. The auditor should define the sampling unit in light of the control being tested. A sampling unit may be, for example, a document, an entry, or a line item, 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.

f. *Determine the method of selecting the sample*. Any sample that is selected should be representative of the population and all items should have an opportunity to be selected. Random-number selection 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 AAM section 5400.62.

g. *Determine the sample size*. Sample sizes for tests of controls are affected by (*a*) the risk of assessing control risk too low, (*b*) the tolerable rate, (*c*) the expected population deviation rate, and (*d*) any effects of small population sizes.

   Guidance for determining sample size when performing nonstatistical sampling begins with AAM section 5400.29. A description of statistical sampling begins with AAM section 5400.32.

h. *Perform the sampling plan*. Once the sample has been selected, the auditor should examine the selected items to determine whether they contain deviations from the prescribed control. If the auditor selects a voided item, and the auditor obtains reasonable assurance that the item has been properly voided and does not represent a deviation from the prescribed control, he or she should replace the voided item. If the auditor selects an unused item, he or she should obtain reasonable assurance that it actually represents an unused item, and not a deviation from the control, and then replace the unused item. If the auditor is unable to examine a selected item because it cannot be located or for any other reason, and the auditor is unable to apply the planned audit procedures or appropriate alternative procedures to selected items, he or she should consider the selected items to be deviations from the controls for purposes of evaluating the sample. In addition, the auditor should consider the reasons for this limitation and the effect that such a limitation might have on his or her understanding of internal control and assessment of control risk.

i. *Evaluate the sample results*. Guidance for evaluating nonstatistical sampling results begins with AAM section 5400.31 and guidance for evaluating statistical sampling results begins with AAM section 5400.33.

j. *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, 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 (or desired confidence or assurance level), the tolerable deviation rate, and the expected population deviation rate used in the application.
- The method of sample-size determination.
- The method of sample selection (specific selection criteria).
- A description of how the sampling procedure was performed and a list of the deviations identified in the sample.
- The evaluation of the sample and a summary of the overall conclusion.

.27 ***Factors Affecting Sample Sizes for Tests of Controls.*** Sample sizes for tests of controls are affected by the following factors:

a. *Acceptable risk of assessing control risk too low*. The risk of assessing control risk too low is the risk that the 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.

b. *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.

c. *Tolerable rate.* Tolerable rate is the maximum rate (%) of deviation from a prescribed control that the auditor is willing to accept without altering the planned assessed level of control risk. Higher tolerable rates will permit smaller sample sizes.

d. *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.

.28 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

.29 ***Sample Sizes Using Nonstatistical Sampling.*** The auditor using nonstatistical sampling for tests of controls uses his or her professional judgment to consider the factors described in AAM section 5400.27 in determining sample sizes.

.30 Neither AU section 350 nor the Audit Guide *Audit Sampling*, require the auditor to compare the sample size for a nonstatistical sampling application with a corresponding sample size calculated using statistical theory. Auditors might find it helpful to be familiar with the tables in AAM section 5400.34–.37. 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.

.31 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.

.32 ***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.

.33 Applying attributes sampling involves performing the following steps:

a. *Decide on the attributes to test*. The tests of controls may include the testing of one or more attributes. Proper evaluation of the results may require testing and evaluating each attribute separately.

b. *Define the population from which the sample items should be selected*. The auditor should make sure that the population is appropriate for the audit objective as described in AAM section 5400.26.

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.
- *Tolerable rate*. Higher assessments of control risk will permit higher tolerable deviation rates as shown in the following table:

Relationship Between Tolerable Rates and the Auditor's Planned Assessed Levels of Control Risk

Planned Assessed Level of Control Risk	*Tolerable Rate*
Low	2%–5%
Moderate	6%–12%

- *Expected population deviation rate*. The auditor's expectations may be based on prior year's tests and the control environment. The prior year's results should be considered in light of changes in the entity's internal control and changes in personnel. Sample sizes will increase significantly as the expected population deviation rate increases from zero. If the deviation rate in the sample turns out to be higher than the rate specified by the auditor in determining the sample size, the sample results will not support the auditor's planned assessed level of control risk.

d. *Determine the appropriate sample size*. Sample sizes are found in the tables in AAM section 5400.34 and .35. The table in AAM section 5400.34 is designed for a risk of assessing control risk too low of 5 percent, and the table in AAM section 5400.35 is designed for a 10 percent risk of assessing control risk too low. With the tolerable rate and the expected population deviation rate, the auditor may find the sample size from the table. The numbers in parentheses are the number of deviations that may be found in the sample and still support the auditor's planned assessed level of control risk.

e. *Randomly select the sample from the population.* The section beginning at AAM section 5400.62 describes the methods that may be used to select a random sample.

f. *Perform the audit procedures to identify deviations in the sample.*

g. *Calculate the statistical results.* Using the tables in AAM section 5400.36 and .37 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 audit guide *Audit Sampling*, do not require specific documentation of audit sampling applications. See AAM section 5400.10 for certain documentation requirements of SAS No. 103. Examples of items that the auditor typically documents for tests of controls are discussed in AAM section 5400.26.

.34

Statistical Sample Sizes for Test of Controls— Five Percent Risk of Assessing Control Risk Too Low (with number of expected errors in parentheses)

Expected Population Deviation Rate	Tolerable Rate										
	2%	3%	4%	5%	6%	7%	8%	9%	10%	15%	20%
0.00%	149(0)	99(0)	74(0)	59(0)	49(0)	42(0)	36(0)	32(0)	29(0)	19(0)	14(0)
.25	236(1)	157(1)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
.50	*	157(1)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
.75	*	208(2)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.00	*	*	156(2)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.25	*	*	156(2)	124(2)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.50	*	*	192(3)	124(2)	103(2)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.75	*	*	227(4)	153(3)	103(2)	88(2)	77(2)	51(1)	46(1)	30(1)	22(1)
2.00	*	*	*	181(4)	127(3)	88(2)	77(2)	68(2)	46(1)	30(1)	22(1)
2.25	*	*	*	208(5)	127(3)	88(2)	77(2)	68(2)	61(2)	30(1)	22(1)
2.50	*	*	*	*	150(4)	109(3)	77(2)	68(2)	61(2)	30(1)	22(1)
2.75	*	*	*	*	173(5)	109(3)	95(3)	68(2)	61(2)	30(1)	22(1)
3.00	*	*	*	*	195(6)	129(4)	95(3)	84(3)	61(2)	30(1)	22(1)
3.25	*	*	*	*	*	148(5)	112(4)	84(3)	61(2)	30(1)	22(1)
3.50	*	*	*	*	*	167(6)	112(4)	84(3)	76(3)	40(2)	22(1)
3.75	*	*	*	*	*	185(7)	129(5)	100(4)	76(3)	40(2)	22(1)
4.00	*	*	*	*	*	*	146(6)	100(4)	89(4)	40(2)	22(1)
5.00	*	*	*	*	*	*	*	158(8)	116(6)	40(2)	30(2)
6.00	*	*	*	*	*	*	*	*	179(11)	50(3)	30(2)
7.00	*	*	*	*	*	*	*	*	*	68(5)	37(3)

* Sample size is too large to be cost-effective for most audit applications.
Derived from AICPA Audit Guide *Audit Sampling*, New Edition as of April 1, 2001.
Note: This table assumes a large population.

.35

Statistical Sample Sizes for Test of Controls— Ten Percent Risk of Assessing Control Risk Too Low (with number of expected errors in parentheses)

Expected Population Deviation Rate	Tolerable Rate										
	2%	3%	4%	5%	6%	7%	8%	9%	10%	15%	20%
0.00%	114(0)	76(0)	57(0)	45(0)	38(0)	32(0)	28(0)	25(0)	22(0)	15(0)	11(0)
.25	194(1)	129(1)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
.50	194(1)	129(1)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
.75	265(2)	129(1)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.00	*	176(2)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.25	*	221(3)	132(2)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.50	*	*	132(2)	105(2)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.75	*	*	166(3)	105(2)	88(2)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
2.00	*	*	198(4)	132(3)	88(2)	75(2)	48(1)	42(1)	38(1)	25(1)	18(1)
2.25	*	*	*	132(3)	88(2)	75(2)	65(2)	42(1)	38(2)	25(1)	18(1)
2.50	*	*	*	158(4)	110(3)	75(2)	65(2)	58(2)	38(2)	25(1)	18(1)
2.75	*	*	*	209(6)	132(4)	94(3)	65(2)	58(2)	52(2)	25(1)	18(1)
3.00	*	*	*	*	132(4)	94(3)	65(2)	58(2)	52(2)	25(1)	18(1)
3.25	*	*	*	*	153(5)	113(4)	82(3)	58(2)	52(2)	25(1)	18(1)
3.50	*	*	*	*	194(7)	113(4)	82(3)	73(3)	52(2)	25(1)	18(1)
3.75	*	*	*	*	*	131(5)	98(4)	73(3)	52(2)	25(1)	18(1)
4.00	*	*	*	*	*	149(6)	98(4)	73(3)	65(3)	25(1)	18(1)
5.00	*	*	*	*	*	*	160(8)	115(6)	78(4)	34(2)	18(1)
6.00	*	*	*	*	*	*	*	182(11)	116(7)	43(3)	25(2)
7.00	*	*	*	*	*	*	*	*	199(14)	52(4)	25(2)

* Sample size is too large to be cost-effective for most audit applications.
Derived from AICPA Audit Guide *Audit Sampling*, New Edition as of April 1, 2001.
Note: This table assumes a large population.

.36

Statistical Sampling Results Evaluation Table for Tests of Controls— Upper Limits at Five Percent Risk of Assessing Control Risk Too Low

Sample Size	Actual Number of Deviations Found 0	1	2	3	4	5	6	7	8	9	10
25	11.3	17.6	†	†	†	†	†	†	†	†	†
30	9.5	14.9	19.6	†	†	†	†	†	†	†	†
35	8.3	12.9	17.0	†	†	†	†	†	†	†	†
40	7.3	11.4	15.0	18.3	†	†	†	†	†	†	†
45	6.5	10.2	13.4	16.4	19.2	†	†	†	†	†	†
50	5.9	9.2	12.1	14.8	17.4	19.9	†	†	†	†	†
55	5.4	8.4	11.1	13.5	15.9	18.2	†	†	†	†	†
60	4.9	7.7	10.2	12.5	14.7	16.8	18.8	†	†	†	†
65	4.6	7.1	9.4	11.5	13.6	15.5	17.4	19.3	†	†	†
70	4.2	6.6	8.8	10.8	12.6	14.5	16.3	18.0	19.7	†	†
75	4.0	6.2	8.2	10.1	11.8	13.6	15.2	16.9	18.5	20.0	†
80	3.7	5.8	7.7	9.5	11.1	12.7	14.3	15.9	17.4	18.9	†
90	3.3	5.2	6.9	8.4	9.9	11.4	12.8	14.2	15.5	16.8	18.2
100	3.0	4.7	6.2	7.6	9.0	10.3	11.5	12.8	14.0	15.2	16.4
125	2.4	3.8	5.0	6.1	7.2	8.3	9.3	10.3	11.3	12.3	13.2
150	2.0	3.2	4.2	5.1	6.0	6.9	7.8	8.6	9.5	10.3	11.1
200	1.5	2.4	3.2	3.9	4.6	5.2	5.9	6.5	7.2	7.8	8.4

† Over 20 percent.

Derived from AICPA Audit Guide *Audit Sampling*, New Edition as of April 1, 2001.

Note: This table presents upper limits as percentages. This table assumes a large population.

.37

Statistical Sampling Results Evaluation Table for Tests of Controls— Upper Limits at Ten Percent Risk of Assessing Control Risk Too Low

Sample Size	Actual Number of Deviations Found 0	1	2	3	4	5	6	7	8	9	10
20	10.9	18.1	†	†	†	†	†	†	†	†	†
25	8.8	14.7	19.9	†	†	†	†	†	†	†	†
30	7.4	12.4	16.8	†	†	†	†	†	†	†	†
35	6.4	10.7	14.5	18.1	†	†	†	†	†	†	†
40	5.6	9.4	12.8	16.0	19.0	†	†	†	†	†	†
45	5.0	8.4	11.4	14.3	17.0	19.7	†	†	†	†	†
50	4.6	7.6	10.3	12.9	15.4	17.8	†	†	†	†	†
55	4.1	6.9	9.4	11.8	14.1	16.3	18.4	†	†	†	†
60	3.8	6.4	8.7	10.8	12.9	15.0	16.9	18.9	†	†	†
70	3.3	5.5	7.5	9.3	11.1	12.9	14.6	16.3	17.9	19.6	†
80	2.9	4.8	6.6	8.2	9.8	11.3	12.8	14.3	15.8	17.2	18.6
90	2.6	4.3	5.9	7.3	8.7	10.1	11.5	12.8	14.1	15.4	16.6
100	2.3	3.9	5.3	6.6	7.9	9.1	10.3	11.5	12.7	13.9	15.0
120	2.0	3.3	4.4	5.5	6.6	7.6	8.7	9.7	10.7	11.6	12.6
160	1.5	2.5	3.3	4.2	5.0	5.8	6.5	7.3	8.0	8.8	9.5
200	1.2	2.0	2.7	3.4	4.0	4.6	5.3	5.9	6.5	7.1	7.6

† Over 20 percent.

Derived from AICPA Audit Guide *Audit Sampling*, New Edition as of April 1, 2001.

Note: This table presents upper limits as percentages. This table assumes a large population.

Audit Sampling for Substantive Tests of Details

.38 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.

.39 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.

.40 When an auditor plans any audit sampling application, the first consideration is the specific account balance or class of transactions and the circumstances in which the procedure is to be applied. The auditor generally identifies items or groups of items that are of individual significance to an audit objective. For example, an auditor planning to use audit sampling as part of the tests of an inventory balance as well as observing the physical inventory would generally identify items that have significantly large balances or that might have other special characteristics.

.41 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.

.42 A population for audit sampling purposes does not necessarily need to be an entire account balance or class of transactions. In some circumstances, an auditor might examine all the items that constitute an account balance or class of transactions that exceed a given amount or that have an unusual characteristic; the auditor might either (1) apply other auditing procedures (for example, analytical procedures) to items that do not exceed a given amount or possess an unusual characteristic or (2) apply no auditing procedures to them because there is an acceptably low risk of material misstatement existing in the remaining items.

.43 Once a decision has been made to use audit sampling, the auditor must choose between statistical and nonstatistical sampling. The choice is primarily a cost-benefit consideration. Statistical sampling uses the laws of probability to measure sampling risk. Any sampling procedure that does not measure the sampling risk is a nonstatistical sampling procedure.

.44 *Determining the test objectives*. A sampling plan for substantive tests of details might be designed to (1) test the reasonableness of one or more assertions about a financial statement amount (for example, the existence of accounts receivable) or (2) make an independent estimate of some amount (for example, the last in, first out (LIFO) index for a LIFO inventory). The auditor should carefully identify the characteristic of interest (for example, the misstatement) for the sampling application that is consistent with the audit objective.

.45 *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.

.46 *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.

.47 *Choosing an audit sampling technique*. Either statistical or nonstatistical sampling is appropriate for substantive tests of details. The most common statistical approaches are classical variables sampling and probability-proportional-to-size (PPS) sampling.

.48 *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.

.49 *Determining the sample size*. Accounting populations tend to include a few very large amounts, a number of moderately large amounts, and a large number of small amounts. Auditors consider the variation in a characteristic when they determine an appropriate sample size for a substantive test, and, generally, the variation of the items' recorded amounts as a means of estimating the variation of the audited amounts of the items in the population. A measure of this variation, or scatter, is called the standard deviation. Sample sizes generally decrease as the variation becomes smaller. Sample sizes for unstratified populations with high variation are generally very large.

.50 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.

.51 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.

.52 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.

.53 The effect of population size on the appropriate sample size varies according to the audit sampling method used.

.54 *Performing the sampling plan*. The auditor generally should apply auditing procedures appropriate for the particular audit objectives to each sample item.

.55 *Evaluating the sample results*. In evaluating sample results, the auditor should:

- Project the misstatements found in the sample to the population from which the sample was selected and add that amount to the misstatements discovered in any items examined 100 percent.

- Compare the tolerable misstatement for the account balance or class of transactions with the total projected misstatement, adjusted for corrected misstatements. If the total projected misstatement is less than tolerable misstatement for the account balance or class of transactions, the auditor should consider the risk that such a result might be obtained even though the true monetary misstatement for the population exceeds the tolerable misstatement. The auditor should also aggregate the projected misstatement in the balance or class, after adjustments, if any, with other known or likely misstatements in other balances or classes to evaluate whether the financial statements taken as a whole are materially misstated.
- Consider the qualitative aspects of misstatements. If the sample results suggest that the auditor's planning assumptions were in error, appropriate action is taken.

.56 *Documenting the sampling procedure*. AU section 350 and the audit guide *Audit Sampling*, do not require specific documentation of audit sampling applications. See AAM section 5400.10 for certain documentation requirements of SAS No. 103. Examples of items that the auditor typically documents for substantive tests include:

- The objectives of the test the accounts and assertions affected.
- The definition of the population (the source from which the items were selected) and the sampling unit, including how the auditor determined the completeness of the population.
- The definition of a misstatement.
- The risk of incorrect acceptance, the risk of incorrect rejection, and the tolerable misstatement.
- The audit sampling technique used.
- The method of sample selection (specific selection criteria).
- A description of the performance of the sampling procedures and a list of misstatements identified in the sample.
- The evaluation of the sample and a summary of the overall conclusion. A summary of the overall conclusion (if not evident from the results).
- Any qualitative factors considered significant in making the sampling assessments and judgments.

.57 ***Nonstatistical Sampling for Substantive Tests of Details***. Neither AU section 350 nor the audit guide *Audit Sampling*, require the auditor to compare the sample size for a nonstatistical sampling application with a corresponding sample size calculated using statistical theory. Auditors might find familiarity with sample sizes based on statistical theory helpful when applying professional judgment and experience in considering the effect of various planning considerations on sample size.

.58 The following table "Factors Influencing Sample Sizes for a Substantive Test of Details in Sample Planning" summarizes the effects of various factors on sample sizes for substantive tests of details. (The table is provided only to illustrate the relative effect of different planning considerations on sample size and is not intended as a substitute for professional judgment).

Factors Influencing Sample Sizes for a Substantive Test of Details in Sample Planning

Factors	*Conditions Leading to:* 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		

.59 The following model, based on the statistical theory underlying PPS sampling, illustrates a method of assisting an auditor in gaining an understanding of the relative size of samples for substantive tests of details. The factors presented are based on certain judgments and may differ as auditors' judgments differ in the circumstances. The model illustrates the relative effect of difference planning considerations on sample size only and is not intended as a substitute for professional judgment.

.60 The steps in determining the sample size using this model are:

a. Consider the level of inherent risk for the particular assertion(s).

b. Consider the effectiveness of the controls in preventing and detecting material misstatements.

c. Combine steps *a.* and *b.* using the following categories:

1. Maximum.
2. Slightly below minimum.
3. Moderate.
4. Low.

d. Determine tolerable misstatement.

e. Assess the risk that other substantive procedures designed to test the same assertion will fail to detect a material misstatement in the particular assertion(s).

1. Maximum.
2. Moderate.
3. Low.

f. Estimate the population's recorded amount after deducting any items that will be examined 100 percent.

g. Select the appropriate assurance factor from the following table:

Assurance Factors

Assessment of Inherent and Control Risk	*Risk That Other Substantive Procedures Will Fail to Detect a Material Misstatement*			
	Maximum	*Slightly Below Maximum*	*Moderate*	*Low*
Maximum	3.0	2.7	2.3	2.0
Slightly below maximum	2.7	2.4	2.0	1.6
Moderate	2.3	2.1	1.6	1.2
Low	2.0	1.6	1.2	1.0

Estimate the sample size using the following formula:

$$\text{Population's recorded amount} \,/\, \text{Tolerable misstatement} \times \text{Assurance factor} = \text{Sample size}$$

h. Adjust the sample size estimate to reflect any differences in efficiency between the nonstatistical approach and the statistical approach underlying this model. In practice auditors typically adjust the sample size from 10 percent to 50 percent if the sample is not selected in a statistically efficient manner.

.61 Stratification is particularly important to increasing the efficiency of the sample. If the nonstatistical sample design is planned without stratification, the auditor should increase the sample size. The auditor selects the sample so that it can be expected to be representative of the population from which it has been selected. Before selecting the sample, the auditor generally identifies individually significant items, and may then select the sample from the remaining items using the systematic selection method, which automatically stratifies the sample, or stratify the remaining items into groups and allocate the sample size accordingly.

.62 ***Evaluating the Sample Results***. The misstatement in the sample must be projected to the items from which the sample was selected. One method of projecting the amount of misstatement found in a sample is to divide the amount of misstatement in the sample by the fraction of total dollars in the population included in the sample. For example, if a $100 misstatement is found in a sample of 10 percent of the population, the projected misstatement would be $1,000 ($100/.10).

.63 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 x 2).

[*The next page is 5501.*]

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 1-888-777-7077.

- **Audit and Accounting Guides (AICPA)**

  Each guide describes relevant matters, conditions, and procedures unique to a particular industry, and illustrates treatments of financial statements and reports to caution auditors and accountants about unusual problems.

- **Audit Risk Alerts (AICPA)**

  Audit Risk Alerts complement the guidance provided in many of the Audit and Accounting Guides by describing current economic, regulatory, and professional developments that can have a significant impact on engagements.

- **Professional Standards (AICPA)**

  The publication features the outstanding pronouncements on professional standards issued by the AICPA, including standards for audits, compilations, and reviews.

- **Accounting Standards—Original Pronouncements (FASB)**

  This publication contains the original text of accounting standards pronouncements with superseded sections and amendments clearly noted.

- **Accounting Standards—Current Text (FASB)**

  This publication is organized as follows: General Standards—generally applicable to all enterprises; Industry Standards—applicable to enterprises operating in specific industries. It includes comprehensive summaries of each subject, plus applicable standards, illustrations and examples.

- **Financial Statement Preparation Manual (AICPA)**

  This publication provides sample statements and checklists for a variety of business enterprises and governmental units.

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

  The practice aids are invaluable to anyone who prepares financial statements and reports. The material has been updated to reflect AICPA, FASB, and GASB pronouncements and interpretations as well as SEC regulations.

- **Auditing Estimates and Other Soft Accounting Information (AICPA)**

  This practice guide provides nonauthoritative guidance for handling the audit problems related to the audit of soft accounting information, including how AU section 342, Auditing Accounting Estimates, *may be applied by practicing auditors.*

- **Accounting Trends & Techniques (AICPA)**

  This publication contains reporting methods, based on a cumulative survey; significant accounting presentations, discussions and trends. By following the lead of these industry front-runners, you can apply the latest techniques and improve your own reporting performance.

- **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.

- **Technical Practice Aids (AICPA)**

  This publication contains all outstanding AICPA Statements of Position and Practice Bulletins and offers carefully thought-out responses to selected inquiries received by the AICPA Technical Hotline and AICPA Technical and Industry Committees.

- **Auditing Practice Releases (AICPA)**

  These publications are intended to provide practitioners with nonauthoritative practical assistance concerning auditing procedures. Topics include: Confirmation of accounts receivable and audits of inventories.

- **Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools (AICPA)**

  By focusing on unique reporting and auditing matters of commodity entities, this publication gives you nonauthoritative practical guidance on reporting on and auditing these financial statements.

- **Audit Implications of Electronic Document Management and The Information Technology Age: Evidential Matter (AICPA)**

  These two Auditing Procedures Studies contain helpful and valuable guidance about the implications of electronic evidence on an audit.

- **Standard Confirmation Forms (AICPA)**

  This form may be used to request a full report on credit balance, liabilities and contingent liabilities. It may also be used for a confirmation of bank balance only.

- **EITF Abstracts—A Summary of Proceedings of the FASB Emerging Issues Task Force**
- **Accountants' Handbook by Carmichael, Lilien & Mellman (Wiley)**
- **Montgomery's Auditing by O'Reilly, Hirsch, Defliese, and Jaenicke (Wiley)**
- **Handbook of Modern Accounting by Davidson & Weil (McGraw-Hill)**
- **Kohler's Dictionary for Accountants by Coopers & Ijiri (Prentice-Hall)**

[*The next page is 6001.*]

AAM Section 6000
Audit Documentation

TABLE OF CONTENTS

[*The next page is 6101.*]

AAM Section 6100
Audit Documentation—General

.01 Audit documentation[1] is the record of audit procedures performed, relevant audit evidence obtained, and conclusions reached by the auditor in the engagement. SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), provides authoritative guidance on the functions and nature, general content, and ownership and confidentiality of audit documentation.

.02 Other SASs contain specific documentation requirements and can be found in Appendix A of SAS No. 103. 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. Furthermore, paragraph 83 of SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316.83), includes documentation requirements regarding the auditor's consideration of fraud and paragraph 51 of SAS No. 100, *Interim Financial Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 722.51), includes documentation requirements the auditor should be aware of.

.03 The auditor should 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 (GAAS) 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 SAS No. 103 provides authoritative guidance on audit documentation. SAS No. 103 supersedes SAS No. 96 of the same name. SAS No. 103:

- Requires the auditor to 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.
- Provides enhanced guidance on matters that should be documented, including guidance on documentation that should be retained.
- 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 that the auditor assemble the audit documentation to form the final audit engagement file within 60 days following the report release date. After this date, the SAS requires the auditor not to delete or discard existing audit documentation, and appropriately document any subsequent additions.
- Specifies a minimum file retention period of five years from the report release date.

---

[1] Audit documentation also may be referred to as working papers.

SAS No. 103 is effective for audits of financial statements for periods ending on or after December 15, 2006. Earlier application is permitted.

General Discussion

.05 These sections present points of view on the organization and preparation of audit documentation.

.06 Proper planning is important in the design of specific audit documentation if they are to serve the objective of aiding the auditor in the conduct of his work. For example, a well-planned working paper may be designed to provide information that will be needed later in the preparation of tax returns and other required reports, such as those to regulatory bodies, and may therefore eliminate the need for examining the same documents twice to obtain necessary information. The quality, type, and content of the audit documentation are matters of the auditor's professional judgment. The individual preferences of auditors and firms may be informal common practices or expressed as part of a firm's formal written policies and procedures. A firm should consider the nature of its practice and the services commonly provided to its clients, as well as professional standards in developing its procedures and policies on audit documentation. Those procedures and policies should permit the flexibility necessary to meet the needs of individual engagements.

[*The next page is 6201.*]

AAM Section 6200

Basic Elements of Format

.01 Audit documentation formats generally include at least the following for identification purposes:

- A title or heading comprised of (*a*) the name of the client, (*b*) a caption that briefly describes the paper's contents, (*c*) the nature of the engagement, and (*d*) the applicable period or closing date covered by the engagement.
- The initials or names of the auditors who performed and reviewed the work presented in the paper and the date the paper was completed.

.02 In instances when audit documentation requires more than one page, some auditors present the heading on only the lead page, fasten or staple all the applicable pages together as a unit and number each page, for example, 1 of 5, 2 of 5, and so forth. Many auditors index each working paper in some organized pre-established manner. This provides for ease in cross-referencing to other relevant papers, for more organized indexing and filing, and for a form of control over the audit documentation. (See AAM section 6400, *Organization and Filing (Indexing)*.)

.03 Some auditors purchase standard analysis paper that includes preprinted blocks for the initials or signature of the preparer and reviewer, and the dates on which the paper was prepared and reviewed. Others design their own signature and reference blocks and have them imprinted on all of their analysis paper and lined pads. These signature blocks may include captions such as the following:

— prepared by client and tested by

— prepared by

— date prepared

— date tested

— reviewed by

— date reviewed

— source

— audit documentation reference

— footed by

— extensions checked by

.04 Some auditors prefer to identify client preparation of schedules and analysis by notations or codes, such as *PBC*, for prepared by client, rather than use a detailed signature and reference block.

[*The next page is 6301.*]

AAM Section 6300
Content of Audit Documentation

.01 The content of audit documentation varies with the circumstances and needs of the auditors on individual engagements. Some firms, however, include various general and specific instructions on audit documentation content in their policies concerning the working papers.

.02 The AICPA's Auditing Standards Board issued SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), which supersedes SAS No. 96. SAS No. 103 is effective for audits of financial statements for periods ending on or after December 15, 2006. Earlier application is permitted. Among other things, the SAS:

- Requires the auditor to 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.
- Provides enhanced guidance on matters that should be documented, including guidance on documentation that should be retained.
- States that oral explanations on their own do no 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 that the auditor assemble the audit documentation to form the final audit engagement file within 60 days following the report release date. After this date, the SAS requires the auditor not to delete or discard existing audit documentation, and appropriately document any subsequent additions.
- Specifies a minimum file retention period of five years from the report release date.

.03 Examples of audit documentation are audit programs, analyses, memoranda, letters of confirmation and representation, abstracts or copies of entity documents, and schedules or commentaries prepared or obtained by the auditor. Audit documentation may be in paper form, electronic form or other media.

.04 The audit documentation should be sufficient to (*a*) enable members of the engagement team with supervision and review responsibilities to understand the nature, timing, extent and results of auditing procedures performed, and the evidence obtained; (*b*) indicate the engagement team member(s) who performed and reviewed the work; and (*c*) show that the accounting records agree or reconcile with the financial statements or other information being reported on.

.05 In determining the nature and extent of the documentation for a particular audit area or auditing procedure, the auditor should consider the following factors:

- Risk of material misstatement associated with the assertion, or account or class of transactions
- Extent of judgment involved in performing the work and evaluating the results

- Nature of the auditing procedure
- Significance of the evidence obtained to the assertion being tested
- Nature and extent of exceptions identified
- The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or evidence obtained

General Considerations

.06 The following are some general considerations on audit documentation content that may be helpful.

- Audit documentation should be sufficiently intelligible, clear and neat so that another auditor who has had no previous connection to the audit can review the workpapers and understand:
  - — The nature, timing, and extent of auditing procedures performed to comply with SASs and applicable legal and regulatory requirements;
  - — The results of the audit procedures performed and the audit evidence obtained;
  - — The conclusions reached on significant matters; and
  - — That the accounting records agree or reconcile with the audited financial statements or other audited information.
- The content of an individual working paper or group of related papers should include identification of the (1) source of the information presented (for example, fixed assets ledger, cash disbursements journal), (2) the nature and extent of the work done and conclusions reached (by symbols and legend, narrative, or a combination of both), and (3) appropriate cross-references to other working papers.
- Before completion of the engagement, all questions or exceptions in the working papers should be resolved. If for some reason the auditor must leave the assignment without resolving all items, he should provide an open items listing on a separate temporary paper for the in-charge auditor's attention. An unresolved exception or incomplete explanation in the working papers may be construed by some as indication of an inadequate audit.
- Information and comments in the audit documentation generally represent statements of fact and professional conclusions. Accordingly, language should be clear and free from such vague judgmental adjectives as *good* or *bad*. Conclusions should be supported by documented facts, especially if they concern the adequacy of the client's records.
- Working papers should be viewed as an integrated presentation of information. The auditor should cross-reference working papers to call attention to interaccount relationships and to reference a paper to other working papers summarizing or detailing related information.
- The preparer should view the working papers as if he were the in-charge auditor. All inferences and conclusions should be supported in the working papers and no misleading or irrelevant statements should be made.
- It is preferable to have negative figures in audit documentation indicated by parentheses instead of red figures to preserve their identity if the papers are photocopied or microfilmed.

Specific Considerations

.07 Audit documentation should include abstracts or copies of significant contracts or agreements that were examined to evaluate the account for significant transactions. Additionally, audit documentation of tests of operating effectiveness of controls and substantive tests of details that involve inspection of documents or confirmation should include an identification of the items tested.

.08 Furthermore, the auditor should document 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 this section, 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.

.09 SAS No. 103 amends SAS No. 59, *The Auditors' Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341). The amendment adds a requirement for the auditor to document:

- The conditions or events that led him or her to believe that there is substantial doubt about the entity's ability to continue as a going concern
- The work performed in connection with the auditors evaluation of management's plans
- The auditor's conclusion as to whether substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains or is alleviated
- The consideration and effect of that conclusion on the financial statements, disclosures, and the audit report

Timesaving Considerations

.10 There are a number of ways to save time and avoid unnecessary detail in audit documentation preparation. The following examples may be helpful.

- Whenever possible, have the client's employees prepare schedules and analyses. (This, of course, presupposes that the client has the necessary personnel to prepare the materials.)
- Use of a detailed audit program may eliminate the need for lengthy comments in the audit documentation on the scope of audit procedures. (However, some believe that such comments are still necessary when a detailed program is used; this is a matter of individual firm judgment.)
- Analyze asset (or liability) accounts and their related expense or income accounts on the same working paper. Examples include property, plant, and equipment, accumulated depreciation and related depreciation expense; notes receivable, accrued interest receivable and interest income; notes

payable, accrued or prepaid interest, and interest expense; and accrued taxes and related provisions for tax expense.

- Avoid unnecessary computations. For example, if only the totals are meaningful and can be tested by a single independent computation, check the total and avoid unnecessary checking of details.
- Consider using carryforward analyses for accounts that tend to remain constant each year or vary only in accordance with a constant predetermined formula. Examples may include long-term assets and related depreciation or amortization such as plant, equipment, and intangibles, long-term debt with predetermined payment schedules, and capital stock.
- Consider using adding machine tapes instead of writing separate lists. Enter names or explanations on the tapes, when appropriate.
- Use symbols (tick marks) whenever possible, especially when the same symbol applies to several working papers.

Symbols (Tick Marks)

.11 When using symbols, it should be helpful to consider the following basic concepts:

- Symbols are merely a shorthand means of explaining a work step performed on a particular item of data. Symbols serve as means of conserving time and space and, if properly used, may ease review of the audit documentation.
- For a working paper to be clear to a reviewer or other reader, each symbol must be clearly explained. The explanation may be located on the same page as the items subjected to the work step, or on a separate legend that is clearly cross-referenced to and from the page that presents the applicable items.
- Symbols should be kept simple, distinctive and clear so they can be quickly written by the preparer and easily identified by a reviewer.

.12 Applying these basic concepts is not that simple. Various auditors have conflicting notions about symbols. For example, some believe a set of standardized symbols can expedite preparation and review. Others believe that a set of standardized symbols is impractical because it lacks flexibility. Because it is generally agreed that symbols are an effective timesaver, it is desirable for firms to establish and communicate a policy on their use to maximize their potential effectiveness.

.13 Commonly used symbols, as noted, should be simple and distinctive, not elaborate hieroglyphics. The most common are variations on a simple checkmark—for example, a checkmark with a slash, a checkmark with a circle at the end, a double checkmark, and any one of these within a circle. This abbreviated listing alone provides eight distinctive tick marks. Symbols may also include circled letters or numbers.

[*The next page is 6401.*]

AAM Section 6400
Organization and Filing (Indexing)

.01 Some auditors organize their audit documentation during the course of an engagement into general categories such as the following:

- Planning and administration.
- Internal control understanding and assessment of control risk.
- Substantive test audit documentation arranged in order of the balance sheet and income statement classifications.
- Trial balances, consolidating working papers, journal entries (adjustments, reclassifications, eliminations for consolidation), and potential entries.
- Draft reports, financial statements, and notes.
- Programs, checklists, and questionnaires (some keep these as separate units, others interfile them among working papers by statement classifications).
- General matters such as current minutes, contracts, and articles of incorporation that may apply to future engagements as well as current work.

Under this approach, actual indexing and filing would be deferred until the conclusion of the engagement.

Predetermined Indexing

.02 Other practitioners and firms may use a predetermined indexing approach so that working papers can be indexed while the field work is still in progress. This offers the following advantages:

- Better control over audit documentation during the performance of field work.
- Constant arrangement of audit documentation in logical order to aid in review.
- Less time required in assembling and binding them into indexed files.
- Quicker access to specific audit documentation after it is filed.

.03 Predetermined indexing involves establishing a standard code for each section of the audit documentation, using letters and numbers, or numbers only. For example—

	Two Possible Alternatives	
Working trial balance—assets	B/S-A	T/B-1
Working trial balance—liabilities	B/S-L	T/B-2
Working trial balance—income & expense	P/L	T/B-3
Cash summary schedule	A	10
Receivables summary schedule	B	20
Inventory summary schedule	C	30

.04 Predetermined indexing requires recognition of the need for flexibility to meet unanticipated audit documentation needs or specialized industry requirements and it requires care to avoid undue complexity. Excessively complex references may obstruct rather than ease audit documentation preparation, cross-referencing and filing. Accordingly, it is helpful to develop an organizational plan adaptable to each section of the audit documentation. For example, some accountants classify working papers as lead schedules, primary detail, and secondary detail which might result in the following classification scheme for the above examples for cash:

	Using Letters and Numbers	*Using Only Numbers*
Lead schedule	(A)	(10)
Primary detail schedules	(A-1) (A-2) etc.	(10-1) (10-2) etc.
Secondary detail schedules	(A-1-1) (A-1-2) (A-1-3)	(10-1-1) (10-1-2)
	(A-2-1) (A-2-2) (A-2-3)	(10-2-1) (10-2-2)

.05 Predetermined (standardized) indexing systems may be printed on separate pages for reference during the performance of field work and insertion in the front of 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 workpapers filed behind the lead schedule without being individually indexed. At the completion of the engagement, the pages can be consecutively numbered within each account group (for example, 1 of 10, 2 of 10, etc.), since there typically are not numerous or complex layers of supporting schedules, extensive cross-referencing can be avoided.

.07 On large engagements, particularly those with detailed charts of accounts, firms may consider it necessary to develop more complex indexing systems. In one such system, standard index number series are assigned as follows:

Current audit documentation	1000—7000
Permanent file	7100—9999

.08 In this system, each index number consists of four digits, with the addition decimals if necessary. Numbers ending with double zero are reserved for lead schedules whose total agrees with a line item on the working trial balance (index 1400). Single zeros are used for specific types of accounts (such as 2010, petty cash funds).

.09 Certain index numbers can be permanently assigned to each major financial statement classification. For instance, index 2000 may be assigned to cash. If various bank accounts exist, the cash schedules are assigned index numbers 2002, 2003, etc. Documentation such as supporting confirmations and lists of outstanding checks would be assigned index numbers commencing with 2001.1, 2001.2, etc. As for the permanent audit documentation file, index 9300, for example, may be assigned to internal control. Accordingly, flowcharts and related questionnaires would be assigned index numbers in that series.

Current and Permanent Files

.10 Audit documentation files are generally classified as current files and permanent (continuing) files. Current files contain information that is pertinent to a single engagement. Permanent files include information relevant to several recurring engagements. Some firms have their binder or file covers preprinted as current or permanent accompanied by pertinent portions of their uniform audit documentation indexes.

.11 A common challenge to many auditors is to keep the permanent file complete and current, and free from outdated or irrelevant materials that belong in an inactive file of superseded materials.

.12 Some auditors who have confronted one too many unwieldy permanent files believe all audit documentation should be classified as current with certain materials designated as matters of continuing interest to be carried forward each year until they become outdated. Under this approach, a firm may preprint its complete index on one type of file or binder cover and provide space to indicate whether specific contents are continuing or carry forward in nature.

.13 The permanent files should be reviewed and updated, as needed, annually. Examples of documents that may be found in permanent files are listed in AAM section 6400.16.

Practice Tip

The audit documentation files should contain copies of final executed documents. Any drafts or unsigned versions of documents should be replaced with final versions.

Audit Documentation Retention

.14 In December 2005, the AICPA's Auditing Standards Board issued SAS No. 103, *Audit Documentation*, (AICPA, *Professional Standards*, vol. 1, AU sec. 339) which supersedes SAS No. 96, of the same name. SAS No. 103 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. SAS No. 103 is effective for audits of financial statements for periods ending on or after December 15, 2006. Earlier application is permitted.

.15 Determining the proper periods for retaining records is a major decision for practitioners. Records should be preserved for only as long as they serve a useful purpose or until all legal requirements are met. Record retention periods vary among firms; however, retention periods should generally correspond with the longest statute of limitations prevailing in each state for breach of contract, breach of fiduciary duty, and professional liability claims.

.16 Audit documentation may be retained permanently or for periods corresponding with the longest state statute of limitations, as noted above. Generally, certain audited financial statement workpaper data, such as accounts receivable confirmations are destroyed after ten years. Examples of audit documentation that should be retained permanently include auditor's reports, reports filed with the SEC, tax returns for current clients, and audit documentation for current clients. Some firms divide the retention period into two parts, records are first filed in the office and later placed in storage (for example, three years in the office and then permanently in storage). Other records, such as audit documentation files for former clients, may be retained for three years in the office, seven years in storage and then destroyed after the retention period. No material should be destroyed without the specific approval of the engagement partner. An annual schedule should be established for reviewing and purging firm data. Since there is substantial variation in the retention periods used by firms, each firm should carefully consider its requirements and consult with legal counsel before adopting a retention period.

.17 For further guidance on record retention, see the AICPA *Management of an Accounting Practice Handbook.*

Ownership and Confidentiality of Audit Documentation

.18 Audit documentation is the property of the auditor, and some states recognize this right of ownership in their statutes.

.19 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.

.20 The auditor should adopt reasonable procedures to prevent unauthorized access to the audit documentation.

.21 The auditor should adopt reasonable procedures to retain and access audit documentation for a period of time sufficient to meet the needs of his practice or to satisfy any legal or regulatory requirements for record retention. Such period should not be shorter than five years from the report release date.

Index Topics

.22 The following is a list of topics to consider in developing a standard index for audit documentation. This list is detailed, but is by no means all-inclusive. For example, specialized industries such as life insurance and banking need other specialized topics. Several of the topics may be eliminated, condensed or expanded, depending on the auditor's needs and preferences. Topics that some auditors prefer to include in both the permanent and current files or only in the permanent files are followed by the letter (P).

Planning and administration

- Time & Budget data
- General correspondence & memos
- Planning memos—current
- Planning notes & confirm copies for use in next engagement
- Engagement letters
- Schedules & analyses to be prepared by client
- Minutes
- Checklist of an administrative nature if required by firm policy

Audit or work program (Note 1)

Matters of continuing concern

- Client's industry—background (P)
- Description & brief history of client (P)
- Data & ratio analysis of client's operations (P)
- Client's facilities (P)
- Articles of incorporation (P)
- Bylaws (P)
- Current contracts & agreements (P)
  - — Debt agreements (P)
  - — Leases (P)
  - — Labor contracts (P)
  - — Agreements with officers & key people (P)

  - — Pension plans (P)
  - — Profit-sharing plans (P)
  - — Stock warrants (P)
  - — Stock options (P)
  - — Other agreements (P)
  - — Client's accounting policies & procedures (P)
  - — Carryforward analyses (Note 2)

Internal control

- Internal control questionnaire, narrative, flowcharts, etc. (Note 3)
- Initial assessment of control risk memos
- Tests of controls

Reports, financial statements and footnotes, trial balances, and assembly sheets

- Reports & financial statements (including letter, if any, on reportable conditions in internal control)
- Consolidating working papers
- Consolidation eliminating entries
- Trial balance
- Adjusting journal entries
- Reclassification journal entries
- Recap of possible adjusting entries
- Assembly sheets supporting footnote disclosures (if the information is not included elsewhere in the audit documentation)
- Disclosure checklists (if required by firm policy)
- supporting schedules (if required for reports to regulatory bodies or other reports)
- Tax return information & work sheets (Note 4)

Assets

- Cash
- Marketable securities (and related income)
- Notes receivable (and related interest)
- Accounts receivable
  - — Summary and analyses
  - — Confirmation procedures (Note 2 and 5)
- Allowance for doubtful accounts & notes (Note 2)
- Inventories
  - — Summary and analysis
  - — Price tests, cost & market

- — Obsolescence review
- — Observation, test counts & cutoff data
- — LIFO determinations

- Prepaid expenses
- Other current assets
- Investments
- Property, plant & and accumulated depreciation, depletion & amortization (Note 2)
- Intangible deferred charges & amortization (Note 2)
- Other assets
- Intercompany accounts

Liabilities

- Notes payable (and related interest)
- Accounts payable
- Accrued liabilities other than income taxes
- Accrued income taxes (current & deferred), related provisions & credits (Note 2)
  - — Federal
  - — State & local
- Other current liabilities
- Long-term debt (including current maturities and capitalized leases) (Note 2)
- Other long-term liabilities
- Deferred income (Note 2)

Commitments and contingencies

- Attorney's letters
- Abstractors of commitments & contingencies noted during review of minutes, contracts & agreements, confirmation responses, etc.
- Subsequent events review
- Management representation letter

Equity (capital accounts) (Note 2)

- Capital stock
- Additional paid-in capital
- Treasury stock
- Retained earnings
- Partnership capital

Revenue and expenses

- Operating revenues
- Cost of sales
- Selling, general & administrative
- Other operating expenses
- Other income
- Other expense
- Extraordinary & unusual items
- Secondary schedules
  - — Maintenance & repairs
  - — Taxes other than income taxes
  - — Rents
  - — Royalties
  - — Advertising costs
  - — Legal fees
  - — Interest expense recap

Notes to User:

1. Alternate practices of filing audit programs include:
   (a) Putting the program in a binder that is separate and distinct from current and permanent files.
   (b) Putting the Signed off program in the current file.
   (c) Keeping a master copy of the program in the permanent file with the signed off copies dispersed among the related audit documentation segments in the current file.
2. Certain classifications may lend themselves to carry-forward audit documentation. Examples include allowances for doubtful accounts, brief summaries of confirmation response statistics, accumulated depreciation and amortization, deferred income taxes and open tax positions, long-term debt, and capital accounts.
3. Internal control questionnaires may be filed as separate binders or as part of current of permanent files.
4. Some firms and practitioners keep tax return preparation working papers in files that are completely separate from other types of engagement working papers.
5. For situations involving voluminous responses or bulk inventory listings, the bulk materials may be filed in separate binders that are cross referenced to the pertinent audit documentation (for example: accounts receivable, accounts payable, and inventory).

[*The next page is 7001.*]

AAM Section 7000

Correspondence, Confirmations & Representations

> These samples are presented for illustrative purposes only. They are intended as mere conveniences for users of this Manual who may want points of departure when designing their own formats to meet their individual needs. These illustrations are neither all inclusive nor are they prescribed minimums. Auditors and accountants are to rely on professional standards and their individual professional judgment in determining what may be needed in the circumstances.

TABLE OF CONTENTS

[*The next page is 7101.*]

AAM Section 7100

Control of Confirmations and Correspondence

.01 Generally, clients prepare correspondence and confirmation requests on their own letterhead and submit to the auditor the signed originals and copies. The auditor may obtain one or more copies to serve as file copies for the current 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 of he or she disagrees with the information stated on the request. Negative confirmation requests may be used to reduce audit risk to an acceptable level when (*a*) the combined assessed level of inherent and control risk is low, (*b*) a large number of small balances is involved, and (*c*) the auditor has no reason to believe that the recipients of the requests are unlikely to give them consideration.

.04 The confirmation requests should be reviewed to the extent the auditor considers necessary. For example, the auditor may perform the following for accounts receivable confirmation requests before they are mailed:

- Compare the names and addresses to the client's records.
- Compare balances per confirmation requests to the subsidiary ledger.

.05 The requests would then be stuffed in envelopes and submitted to the post office under the auditor's control.[1]

.06 The auditor controls the mailings and receipt of responses so that the confirmation process is independent of the client.

.07 Mailing envelopes have the auditor's office or post office box number as the return address so that undeliverable letters are returned to the auditor and not to the client. For mailings, the auditor may provide the envelopes or affix a label on the client's envelope that covers the client's return address and replaces it with the auditor's address.

.08 Reply envelopes addressed to the auditor are enclosed with the request letter. Reply envelopes generally have prepaid postage to encourage responses. Some auditors also use codes on the reply envelopes so that responses may be sorted by engagement before the mail is opened. This feature may be particularly useful when there are several engagements that involve voluminous mailings.

---

[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. 9330.01–.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 account numbers listed below, statement(s) of our account(s) and the related paid checks for the period from (*balance-sheet date*) to (*two weeks subsequent to the balance-sheet date*) inclusive.

Account Number	*Account Name*
____________________	____________________
____________________	____________________
____________________	____________________
____________________	____________________

Sincerely,
[*Name of Customer*]

____

By: ____________________

____

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

(B) The request should be sent at least ten days prior to the audit date so the bank will be able to provide the information requested and to render the cutoff statements as requested. If the request does not reach the bank before the cutoff date, the cutoff statement will include transactions after that date.

(C) The letter may also include requests for:

- Confirmation of all securities or other items held for the clients account as of the closing date for collection or safekeeping, or as agent or trustee (a listing should be provided including titles and account numbers).
- Confirmation of the list of authorized signers for the above accounts. (This may have been previously requested at a preliminary date in connection with assessment of control risk.)

.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 space provided below whether the amount above agrees with your records. If not, please send the auditors any information you have that will help them reconcile the difference.

After signing and dating your reply, please return it directly to the auditors. A stamped, addressed enveloped is enclosed for your convenience.

Very truly yours,

[*Client's Authorized Signature*]

____

The foregoing information is in agreement with my records as of December 31, 20XX with the following exceptions (if any):

____

____

____

Date: ________________________________ Signed: ________________________________

.06 Securities and Cash in Custodian or Trust Accounts

[*Prepared on Client's Letterhead*]

[*Date*]

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

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

(If a list is not obtained from the client, the auditor should complete the following for each account:

	Name of Account	Account No. [Note (A)]	Amount Held
1.	______________________	________________________	________________________
2.	______________________	________________________	________________________
3.	______________________	________________________	________________________)

Please also indicate to the auditors whether to your knowledge any of the securities are pledged or otherwise encumbered.

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

Very truly yours,

[*Client's Authorized Signature*]

Notes: (A) Use the custodian or trustee's account number.

(B) This letter may be expanded, if necessary, to request cutoff statements of activity (principal and interest) in the accounts.

(C) Sometimes this request is combined with a request for cutoff bank statements and the standard form to confirm account balance information with financial institutions. However, it may be more practical to send separate letters because a bank's commercial banking and trust departments are usually separate operations.

.07 Securities Held by Brokers

[*Prepared on Client's Letterhead*]

[*Date*]

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

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

1. Securities held by you for our account.

2. Securities out for transfer to our name.

3. Any amounts payable to or due from us.

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

Very truly yours,

[*Client's Authorized Signature*]

Notes: (A) The request should be sent so it reaches the broker sufficiently in advance of the listing date for the broker to respond in a practical manner.

(B) It may be helpful to include the account number(s) used by the broker for the client's account(s).

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

Cash Count

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

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

Securities Count

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

Date and Time: ____________________ Signed: ______________________________

Title: ______________________________

Cutoff Bank Statement(s)

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

Date and Time: ____________________ Signed: ______________________________

Title: ______________________________

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

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

.09 Accounts Receivable—Positive

[*Prepared on Client's Letterhead*]

[*Customer Name*]
[*Address*]

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

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

If the amount is not in agreement with your records, please check and complete "B" below.

After checking the appropriate response, please sign and date your reply and mail it directly to our auditors in the enclosed envelope. DO NOT SEND ANY PAYMENTS to our auditors.

Very truly yours,

[*Client's Authorized Signature*]

A ____________ The balance above agrees with my records.

B ____________ My records show a balance of $________.

The difference may be due to the following:

____

____

____

____
[*Signed by*]

____
[*Date*]

.10 Accounts Receivable—Negative

[*May be a sticker or stamp used on client's statements to customers*]

PLEASE CHECK THIS STATEMENT

If this statement is *not correct* please write promptly (using the enclosed envelope), giving details of any differences, directly to our auditors,

[Name of auditors]

____

[Address of auditors]

____

who are now conducting an audit of our financial statements.

If you do not write to our auditors, they will consider this statement to be correct.

Remittances should NOT be sent to the auditors.

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

(B) The auditor should consider sending confirmation requests at the time of the client's regular monthly billings. Coordination of confirmation procedures with the client's routine preparation and mailing of statements may offer efficiency to both the auditor and client.

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

.11 Notes Receivable

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name*]
[*Address*]

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

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

If the above information is in agreement with your records, please so indicate by signing in the place provided below and return the copy of this letter directly to our auditors in the enclosed envelope.

If the above is not in agreement with your records, please so note in the space provided the particulars shown in your records and any information which may help reconcile the difference from our records. **Payments should not be sent to the auditors.**

Very truly yours,

[*Client's Authorized Signature*]

The above information is correct as of (*date*) with the following exceptions (if any):____________________

____

____

____

____

____

____

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 at (*date*):

1. Quantities on hand; for each lot please indicate the following:
   - *a.* Lot number (list each lot separately)
   - *b.* Date received
   - *c.* Kind of merchandise
   - *d.* Unit of measure or package
     - (1) Number of units
     - (2) Kind of units (box, can, crate, quart, pound, dozen, etc.)
2. A statement about how you determined the above requested quantities; specify whether they were determined by physical count, weight or measure, or if they represent your book record.
3. A list of negotiable or nonnegotiable warehouse receipts issued, if any, and whether or not such receipts have, to your knowledge, been assigned or pledged.
4. Statement of any known liens against this merchandise.
5. Amount of unpaid charges, if any, as of (*date*).

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

Very truly yours,

[*Client's Authorized Signature*]

.13 Inventories Held by Warehouses or Others When Listing Is Provided by Client

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Warehouse*]
[*Address*]

Our auditors (*name and address of auditors*) are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the following information about the merchandise held by you for our account as of (*date*):

1. The correctness of the quantities shown on the enclosed listing of such merchandise prepared from our records (a second copy is enclosed for your files). If the enclosed listing differs from the quantities you held for us as of (*date*), please include details of the specific differences in your response to our auditors.

2. Your statement on how you determined the correctness of the quantities you are confirming; please specify whether determined by physical count, weight or measure, or whether the quantities are from your records.

3. A list of negotiable or nonnegotiable warehouse receipts issued, if any, and whether or not such receipts have, to your knowledge, been assigned or pledged.

4. Statement of any known liens against these goods.

5. Amount of any unpaid charges as of (*date*).

Please mail your reply directly to (*name and address of auditors*). A stamped, addressed envelope is enclosed for your convenience.

Very truly yours,

[*Client's Authorized Signature*]

.14

STANDARD CONFIRMATION INQUIRY FOR LIFE INSURANCE POLICIES

LIFE INSURANCE **STANDARD CONFIRMATION INQUIRY**

Developed by American Institute of Certified Public Accountants
Life Office Management Association
and Million Dollar Round Table

RETURN TO: [ ]

[ ]

Date:

Your completion of the following report will be sincerely appreciated. IF THE ANSWER TO ANY ITEM IS "NONE," PLEASE SO STATE. Use the enclosed envelope to return the original directly to our accountant (see name to left).

Yours truly,

____
(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

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)

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* (AC P16 and P40), provides reduced disclosure requirements for nonpublic companies. Part C of this letter assumes companies have elected the reduced disclosures allowed by that statement. Paragraph 8 of FASB Statement No. 132 describes the reduced disclosure requirements. For companies not electing the reduced disclosures, information required for disclosure can be obtained from Parts B and D of the letter.

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Actuary*]
[*Address*]

In connection with the audit of our financial statements for the period ending (*balance-sheet date*) by our independent auditors (*name and address of auditors*), please furnish them the information described below as it pertains to the XYZ Pension Plan, which is a defined benefit plan. For your convenience in response to those requests, you may supply pertinent sections, properly signed and dated, of your actuarial report, or pension expense report, if they are available and if they contain the requested information.

A. Please provide a brief description of the following:

1. The employee group covered.
2. The benefit provisions of the plan used in the calculation of the net periodic pension cost for the period and of the accumulated benefit obligation and the projected benefit obligation at the end of the period. Please identify any such benefit provisions that had not taken effect in the year. Please also provide the date of the most recent plan amendment included in your calculation. Please identify any participants or benefits excluded from the calculations, such as benefits guaranteed under an insurance or annuity contract.
3. The 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 should select information from employer records to compare with the census data used by the actuary. In addition, the auditor may wish to have the actuary select certain census data from his/her files to compare with the employer's records.*

B. Please provide the following information on the net periodic pension cost for the period ending on __________:

1. Service cost* $__________
2. Interest cost* __________
3. Expected return on assets* __________
4. Other components* __________
   a. Amortization of unrecognized net loss or (gain) from earlier periods __________
   b. Amortization of unrecognized prior service cost __________
   c. Amortization of the remaining unrecognized net obligation or (asset) existing at the date of the initial application of FASB Statement No. 87—transition obligation or (asset) __________
   d. Amount of loss (or gain) recognized due to a settlement or curtailment. __________
   e. Net total of components ($a + b + c + d$) $__________
5. Net periodic pension cost: ($1 + 2 - 3 + 4e$) $__________
6. The above measurement of the net periodic pension cost is based on the following assumptions:
   Weighted-average discount rate ________%
   Weighted-average rate of compensation increase ________%
   Weighted-average expected long-term rate of return on plan assets ________%

   Please describe the basis on which the above rates were selected and whether the basis is consistent with the prior period.

   Please briefly describe the other assumptions used in the above measurement.

* FASB recently issued Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*. 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. A 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.

7. The calculations of the items shown in B1 and B5 are based on the following:

    Asset information at __________

    Census data __________

    Measurement date (must not be more than three months before the end of the last fiscal year) __________

    Please describe any adjustments made to project the census data forward to the measurement date or to project the results calculated at an earlier date to those shown in B1 to B5.

C. Please provide the following information for disclosure in the financial statements for the period ending ____________:

	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 Statement 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, *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 Statement 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*.	__________
11. The above amount of the projected benefit obligation is measured based on the following assumptions:	
Weighted-average discount rate	__________%
Weighted-average rate of compensation increase	__________%
Please provide a brief description of the other assumptions used in the measurement.	
12. The calculation of the items shown in C1 to C10 is based on the following:	
Asset information at	__________
Census data at	__________
Measurement date (must be not more than three months before the current fiscal year end)	__________

Please describe any adjustments made to project the census data forward to the measurement date or to project the results calculated at an earlier date to those shown in C1 to C10.

13. Please describe any significant events noted subsequent to the current year's measurement date and as of the date of your reply to this request and the effects of those events, such as a large plant closing, which could materially affect the amounts shown in C1 to C10.

14. Please describe any significant transactions between the employer or related parties and the plan during the period, including, if applicable, the amounts and types of securities of the employer and related parties included in plan assets and the amount of future annual benefits covered by insurance contracts issued by the employer or related parties.

D. Please provide an analysis for the period showing beginning amounts, additions, reductions, and ending amounts of the:*

1. Projected benefit obligation, ____________
2. Fair value of plan assets, ____________
3. Unrecognized prior service cost, ____________
4. Unrecognized net loss (gain), ____________
5. Net transition obligation (asset), and ____________
6. Accumulated benefit obligation (ending amount only). ____________

E. Please provide our independent auditors with descriptions and the amounts of gains or losses from combinations, divestitures, settlements, curtailments or termination benefits during the year, such as:

1. Purchases of annuity contracts,
2. Lump-sum cash payments to plan participants,
3. Other irrevocable actions that relieved the company or the plan of primary responsibility for a pension obligation, and eliminates significant risks related to the obligation and assets,
4. Any events that significantly reduced the expected years of future service of employees,
5. Any events that eliminated for a significant number of employees the accrual of defined benefits for some or all of their future service, or
6. Any special or contractual termination benefits offered to employees.

F. Please provide the amounts of anticipated cash payments for benefits for each of the next five years, as well as the expected aggregate amount of benefit payments for the subsequent five-year period (years six through ten).

G. Was all of the information above determined in accordance with FASB Statement Nos. 87, 88, and 89 (including the FASB's Guides to Implementation of Statements 87 and 88 and the American Academy of Actuaries', "An Actuary's Guide to Compliance with Statement of Financial Accounting Standards No. 87") to the best of your knowledge? If not, please describe any differences.

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*].

Very truly yours,

____

[*Client's Authorized Signature*]

* See footnote * in paragraph .15, Pension Plan Actuarial Information.

.16 Pension Plan Assets Held by Trustee

[*Prepared on Client's Letterhead*]

[*Date*]

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

Our auditors (*name and address of auditor*) are conducting an audit of our financial statements. Accordingly, please provide our auditors directly with a listing of the assets including market values as of (*date*) for our employees' pension trust (*title and trustee's account number*).

Please also provide the auditors with the following information about our employees' pension trust for the period from (*beginning of period*) to (*end of period*) [see note below]:

1. Contributions by the Company during the above period.
2. Contributions by employees during the above period.
3. Payments to beneficiaries during the above period.
4. Any unpaid fees due for services rendered to (*balance-sheet date*).

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

Very truly yours,

[*Client's Authorized Signature*]

Note: A listing of the assets might not be requested if one had already been received by the client. In that case, the auditor might want the trustee to confirm the total market value per the listing.

.17 Notes Payable

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name*]
[*Address*]

Our auditors (*name and address of auditors*) are conducting an audit of our financial statements.

Accordingly, please confirm directly to them the following information relating to our note(s) payable to you, as of (*date*):

Date of note	________
Original amount	$________
Unpaid principal	
Balance	$________
Periodic payments required	$________
Payment periods	________
Maturity date	________
Interest rate	________%
Date to which interest has been paid	________
Amount and description of collateral	________
Description of terms, for example, demand provisions, prepayment penalties, etc.	________
Any other direct or contingent liabilities to you ("None" or description)	________

If the above information is in agreement with your records at that date, please so indicate by signing in the place provided below and return the copy of this letter directly to our auditors in the enclosed envelope.

If the above is not in agreement with your records, please note in the space provided the particulars shown in your records and any information which may help reconcile the difference from our records.

Very truly yours,

[*Client's Authorized Signature*]

____

The above information is correct as of (*date*) with the following exceptions (*if any*): ____________________

____

Date: ______________________________ Signature: ______________________________

Title: ______________________________

.18 Mortgage Debt

[*Prepared on Client's Letterhead*]

[*Date*]

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

Our auditors (*name and address of auditors*) are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the following information about our mortgage indebtedness to you as of (*date*):

1. Original amount $________
2. Date of note ________
3. Unpaid principal balance $________
4. Interest rate ________%
5. Terms for payment of principal ________
6. Date to which interest has been paid ________
7. Nature of mortgage and description or address of property mortgaged ________
8. Amounts on deposit with you in escrow for:
   a. Insurance $________
   b. Real estate taxes $________
9. Amounts paid during the period (*dates from and to*) for:
   a. Insurance $________
   b. Taxes $________
10. Amounts on deposit with you for the "reserve for repairs" $________
11. The nature of defaults, if any ________
12. Description of terms, e.g., prepayment penalties, demand provisions, etc. ________

A return envelope is enclosed for your reply.

Very truly yours,

[*Client's Authorized Signature*]

Note: Many of the items requested will vary with the circumstance of the particular mortgage or other debt involved. The above sample assumes the indenture involves an escrow arrangement for insurance and real estate taxes and a deposit account for repairs.

.19 Accounts Payable

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name*]
[*Address*]

In connection with the audit of our financial statements, please confirm directly to our auditors (*name and address of auditors*), the amount of our liability to you as of (*date*). Please attach a statement of our account due. If no balance is due, please attach a statement of our account showing payments made.

Please mail your reply directly to (*name of auditors*). A stamped, addressed envelope is enclosed for your convenience.

Very truly yours,

[*Client's Authorized Signature*]

____

Our records indicate that a balance of $_________ was from (*name of client*) at (*date*).

Date: ___________________________________ Signature: ____________________________________

Title:____

.20 Obligation to Lessor

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Lessor*]
[*Address*]

Our auditors (*name and address of auditors*) are conducting an audit of our financial statements as of (*balance-sheet date*) and for the (*time period*) then ended. In connection with this audit, please provide directly to our auditors the following information as of (*balance-sheet date*) regarding the lease dated (*date lease was executed*) of (*brief identification of property under lease*) which we are leasing from you:

1. Inception and expiration dates for the lease period, from ______________ to ______________
2. Amount of monthly rent ______________
3. Renewal options (if any):
   a. Dates of renewal period, from ______________ to ______________
   b. Amount of monthly rent for renewal ______________
4. Purchase options (if any):
   a. Amount of purchase price ______________
   b. Inception and expiration dates of option, from ______________ to ______________
   c. Percent of monthly rent (if any) applicable towards purchase price ______________
5. Dates and descriptions of amendments or supplementary understandings, if any, to the lease mentioned above.
6. The amount of outstanding delinquent payments, if any.
7. A statement that there are no defaults, or the nature of defaults, if any.

A return envelope is enclosed for your reply.

Very truly yours,

[*Client's Authorized Signature*]

____

Note: The content of this type of letter will vary based on the auditor's professional judgment in the circumstances. To provide additional illustrative language, the above letter is not made parallel with the illustration at AAM section 7200.23.

.21 Property Out on Lease

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Lessee*]
[*Address*]

Our auditors (*name and address of auditors*) are conducting an audit of our financial statements as of (*balance-sheet date*) and for the (*time period*) then ended. In connection with this audit, please confirm directly to our auditors the following information regarding the lease dated (*execution date of lease*) of (*brief identification of property under lease*) which you are leasing from us:

1. Inception and expiration dates of lease period from ______________ to ______________
2. Amount of monthly rent ______________
3. Total rent payments made ______________
4. Date of last payment ______________

A return envelope is enclosed for your reply.

[*Client's Authorized Signature*]

____

Notes: (A) If the leased property is of a mobile or portable nature such as a bulldozer or television camera, the confirmation may also include a request for specific serial numbers of significant equipment.

(B) In certain circumstances, the auditor may wish to consider confirming additional information such as renewal options, purchase options, and amendments or supplementary understandings.

.22 Register—Capital Stock

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Registrar*]
[*Address*]

Our auditors (*name and address of auditors*) are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the following information as of the close of business (*balance-sheet date*) about each class of our preferred and common stock:

1. Authorized number of shares ______________
2. Issued number of shares ______________
3. Outstanding number of shares ______________

Please also indicate the amount of any unpaid registrar fees due you as of (*balance-sheet date*).

A return envelope is enclosed for your convenience.

Very truly yours,

[*Client's Authorized Signature*]

The above information agrees with our records at (balance-sheet date) with the following exceptions:_____

____

____

____

____

Signed: ____ Date: ____

[*Name and Title*]

Notes: (A) It may be helpful to include the registrar's account number for the client's account to receive a timely response.

(B) Some auditors prefer that the confirmation request include identification of each class of stock.

(C) The above illustration assumes the client has a separate transfer agent (see AAM section 7200.25).

.23 Transfer Agent—Capital Stock

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Transfer Agent*]
[*Address*]

Our auditors (*name and address of auditors*) are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the following information as of (*balance-sheet date*) about each class of our preferred and common stock:

1. Authorized number of shares ________________
2. Number of shares issued and outstanding ________________
3. Number of outstanding shares registered in the name of our Company ________________

Please also indicate the amount of any unpaid transfer agent fees due you as of (*balance-sheet date*).

A return envelope is enclosed for your convenience.

Very truly yours,

[*Authorized Signature for Client*]

The above information agrees with our records at (*balance-sheet date*) with the following exceptions: ______

____

____

____

____

Signed: ______________________________ Date: ______________________________

[*Name and Title*]

Notes: (A) It may be helpful to include the transfer agent's account number for the client's account to receive a timely response.

(B) Some auditors prefer that the confirmation request include identification of each class of stock.

(C) Depending on the auditor's judgment in the circumstances the confirmation request may also include inquiries about such matters as (i) the number of shares issued to each of specifically mentioned officers and directors, (ii) specified information about shareholders owning more than a stated percent of the total outstanding shares, and (iii) amounts deposited during the year for the payment of dividends.

.24 Request for Confirmation of Money Market Fund

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name*]
[*Address*]

Our auditors, (*name and address of auditors*) are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the balance of our money market fund account(s) as of (*date*).

Please indicate in the space provided below the account number(s) and balance(s) of our account(s) per your records.

Please sign and date your reply and return it directly to the auditors. A stamped, self-addressed envelope is enclosed for your convenience.

Very truly yours,

[*Client's Authorized Signature*]

____

Account No.	*Date*	*Balance*

Date:________________________ Signed: ____________________________

.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 information listed below, which we believe is a complete and accurate description of our contingent liabilities, including oral and written guarantees, with your financial institution. Although we do not request nor expect you to conduct a comprehensive, detailed search of your records, if during the process of completing this confirmation additional information about other contingent liabilities, including oral and written guarantees, from your financial institution comes to your attention, please include such information below.

Name of Maker	Date of Note	Due Date	Current Balance

Interest Rate	Date Through Which Interest is Paid	Description of Collateral	Description of Purpose of Note

Information related to oral and written guarantees is as follows:

____

____

____

____

Please confirm whether the information about contingent liabilities presented above is correct by signing below and returning this directly to our independent auditors (*name and address of CPA firm*).

Sincerely,
[*Name of Customer*]

____

By: _____________________________
[*Authorized Signature*]

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

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[11]
First United Bank
Anytown, USA 00000

Dear Financial Institution Official:

In connection with an audit of the financial statements of (*name of customer*) as of (*balance-sheet date*) and for the (*period*) then ended, we have advised our independent auditors that as of the close of business on (*balance-sheet date*) there (were) (were not) compensating balance arrangements as described in our agreement dated (*date*). Although we do not request nor expect you to conduct a comprehensive, detailed search of your records, if during the process of completing this confirmation additional information about other compensating balance arrangements between (*name of customer*) and your financial institution comes to your attention, please include such information below. Withdrawal by (*name of customer*) of the compensating balance (was) (was not) legally restricted at (*date*). The terms of the compensating arrangements at (*date*) were:

EXAMPLES:

1. The Company has been expected to maintain an average compensating balance of 20 percent of its average loan understanding, as determined from the financial institution's ledger records adjusted for estimated average uncollected funds.

2. The Company has been expected to maintain an average compensating balance of $100,000 during the year, as determined from the financial institution's ledger records without adjustment for uncollected funds.

3. The Company has been expected to maintain a compensating balance, as determined from the financial institution's ledger records without adjustment for uncollected funds, of 15 percent of its outstanding loans plus 10 percent of its unused line of credit.

4. The Company has been expected to maintain as a compensating balance noninterest bearing time deposits of 10 percent of its outstanding loans.

In determining compliance with compensating balance arrangements, the Company uses a factor for uncollected funds of _____ (business) (calendar) days.[1]

There (were the following) (were no) changes in the compensating balance arrangements during the (*period*) and subsequently through the date of this letter.

The Company (was) (was not) in compliance with the compensating balance arrangements during the (*period*) and subsequently through the date of this letter.

There (were the following) (were no) sanctions (applied or imminent) by the financial institution because of noncompliance with compensating balance arrangements.[2]

---

[11] This letter should be addressed to a financial institution official who is responsible for the financial institution's relationship with the client or is knowledgeable about the compensating balance arrangements. Some financial institutions centralize this function by assigning responsibility for responding to confirmation requests to a separate function. Independent auditors should ascertain the appropriate recipient.

[1] Not applicable if compensating balances are based on the financial institution's ledger records without adjustment for uncollected funds. If some other method is used for determining collected funds for compensating balance purposes, the method used should be described.

[2] Applicable only if the financial institution has applied sanctions during the (*period*) or notified the Company that sanctions may be applied. Indicate details.

During the (*period*), and subsequently through the date of this letter, (no) (the following) compensating balances were maintained by the Company at the financial institution on behalf of an affiliate, director, officer, or any other third party and (no) (the following) third party maintained compensating balances at the bank on behalf of the Company. (Withdrawal of such compensating balances (was) (was not) legally restricted.)

Please confirm whether the information about compensating balances presented above is correct by signing below, and returning this letter directly to our independent auditors (*name and address of CPA Firm*).

Sincerely,

[*Name of Customer*]

____

By: ______________________________

[*Authorized Signature*]

Dear CPA Firm:

The above information regarding the compensating balance arrangements with this financial institution agrees with the records of this financial institution.‡ Although we have not conducted a comprehensive, detailed search of our records, no information about other compensating balance arrangements, came to our attention. [Note exceptions below or in an attached letter.]

____

____

____

____

____

____

[*Name of Financial Institution*]

By: ______________________________ ______________

[*Officer*] [*Date*]

____

[*Title*]

‡ See footnote ‡ in paragraph .25, Confirmation of Contingent Liabilities.

.27 Confirmation of Lines of Credit

[*Date*]

Financial Institution Official[#]
First United Bank
Anytown, USA 00000

Dear Financial Institution Official:

In connection with an audit of the financial statements of (*name of client*) as of (*balance-sheet date*) and for the (*period*) then ended, we have advised our independent auditors of the information listed below, which we believe is a complete and accurate description of our line of credit from your financial institution as of the close of business on (*balance-sheet date*). Although we do not request nor expect you to conduct a comprehensive, detailed search of your records, if during the process of completing this confirmation additional information about other lines of credit from your financial institution comes to your attention, please include such information below.

The Company has available at the financial institution a line of credit totaling $(*amount*). The current terms of the line of credit are contained in the letter dated (*date*). The related debt outstanding at the close of business on (*date*) was $(*amount*).

The amount of unused line of credit, subject to the terms of the related letter, at (*date*) was $(*amount*).

Interest rate at the close of business on (*date*) was _____ %.

Compensating balance arrangements are: ____

____

____

____

This line of credit supports commercial paper (or other borrowing arrangements) as described below:

____

____

____

[#] This letter should be addressed to a financial institution official who is responsible for the financial institution's relationship with the client or is knowledgeable about the lines of credit. Some financial institutions centralize this function by assigning responsibility for responding to confirmation requests to a separate function. Independent auditors should ascertain the appropriate recipient.

Please confirm whether the information about lines of credit presented above is correct by signing below and returning this letter directly to our independent auditors (*name and address of CPA Firm*).

Sincerely,

[*Name of Client*]

____

By: __________________________________
[*Authorized Signature*]

____

Dear CPA Firm:

The above information regarding the line of credit arrangements agrees with the records of this financial institution.‡ Although we have not conducted a comprehensive, detailed search of our records, no information about other lines of credit came to our attention. [Note exceptions below or in an attached letter.]

____

____

____

____

____
[*Name of Financial Institution*]

By: _____________________________ _____________
[*Officer*] [*Date*]

____
[*Title*]

‡ See footnote ‡ in paragraph .25, Confirmation of Contingent Liabilities.

.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. 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," explain. 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 or guarantees or other transactions since (*beginning of period of audit*) to which the Company (or specify any pension, retirement, savings, or similar plan provided by the client) was, or is to be, a party?

2. Do you or any related-party of yours have any 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*]

See definitions which follow.

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*]

____

____

____

Our auditors, ______________________________ [*name and address of auditors*], are conducting an audit of our financial statements. Accordingly, please confirm there has been no access to our safe deposit box number _____ between _____ and _____ o'clock.

Please indicate in the space below if the above is in agreement with your records. If it is not, please furnish the auditors any details concerning access to our safe deposit box during the period indicated.

After signing and dating your reply, please mail it directly to our auditors in the enclosed envelope.

Very truly yours,

____

[*Client's Authorized Signature*]

According to our records, there has been no access to the above described safe deposit box during the period specified, except as follows: ____

____

Signed:____ Date: ____

[*Name and Title*]

.30 Insurance In Force Confirmation Request

[*Date*]

____

____

____

Our auditors, ________________ [*name and address of auditors*], are conducting an audit of our financial statements. In that connection, please confirm the details of our insurance coverage in force at ________________ [*balance-sheet date*] as described below:

Policy number	________	________
Insurance company	________	________
Type of coverage	________	________
Amount of coverage	________	________
Co-insurance, if any	________	________
Term of policy	________	________
Gross premium	________	________
Amount of unpaid premiums	________	________
Loss payees, if other than us	________	________
Claims pending at ________________ [*date*]	________	________

Please compare this information with your records and inform our auditors, in the space, if it is, or is not, in agreement with your records. After signing and dating your reply, please mail it directly to our auditors in the enclosed envelope.

Very truly yours,

____

[*Client's Authorized Signature*]

The above information agrees with our records at ________________ [*balance-sheet date*] with the following exceptions:

____

____

____

____

Signed: ________________________ Date: ________________________

[*Name and Title*]

[*The next page is 7301.*]

AAM Section 7300
Inquiries to Legal Counsel[A]

.01 Illustrative Inquiry Letter to Legal Counsel[B]

[*Prepared on Client's Letterhead* (see Note C)]

[*Date* (see Note D)]

[*Name of Lawyer*]
[*Address of Lawyer*]

Dear ____________________ :

In connection with an audit of our financial statements at (*balance-sheet date*) and for the (*period*) then ended, management of the Company has prepared, and furnished to our auditors (*name and address of auditors*), a description and evaluation of certain contingencies, including those set forth below involving matters with respect to which you have been engaged and to which you have devoted substantive attention on behalf of the Company in the form of legal consultation or representation. These contingencies are regarded by management of the Company as material for this purpose (management may indicate a materiality limit if an understanding has been reached with the auditor). Your response should include matters that existed at (*balance-sheet date*) and during the period from that date to the date of your response.

Pending or Threatened Litigation

(excluding unasserted claims)

> [Ordinarily the information would include the following: (1) the nature of the litigation, (2) the progress of the case to date, (3) how management is responding or intends to respond to the litigation (for example, to contest the case vigorously or to seek an out-of-court settlement), and (4) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.]

Please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated and an identification of the omission of any pending or threatened litigation, claims, and assessments or a statement that the list of such matters is complete.

Unasserted Claims and Assessments

(considered by management to be probable of assertion, and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome)

> [Ordinarily management's information would include the following: (1) the nature of the matter, (2) how management intends to respond if the claim is asserted, and (3) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.]

Please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated.

We understand that whenever, in the course of performing legal services for us with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, if you have formed a professional conclusion that we should disclose or consider disclosure concerning such possible claim or assessment, as a matter of professional responsibility to us, you will so advise us and will consult with us concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5. Please specifically confirm to our auditors that our understanding is correct.

Please specifically identify the nature of and reasons for any limitation on your response.

> [The auditor may request the client to inquire about additional matters, for example, unpaid or unbilled charges or specified information on certain contractually assumed obligations of the company, such as guarantees of indebtedness of others.]

Very truly yours,

[*Authorized Signature for Client*]

Notes: (A) If a client has not needed to retain legal counsel, the auditor may express an unqualified opinion on the financial statements even though he has not obtained a letter from legal counsel of the Company. In these circumstances, the auditor should obtain written representation from the Company that legal counsel has not been retained for matters concerning business operations that may involve current or prospective litigation.

(B) Extracted from AU section 337, the appendix to *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* . [See Note D.]

(C) Auditors should carefully consider the provisions of AU section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, (AICPA, *Professional Standards*, vol. 1) in drafting this letter.

(D) Sending of this letter should be timed so that the lawyer's response is dated as close to the auditor's opinion date as practicable. However, the auditor and client should consider early mailing of a draft inquiry as a convenience for the lawyer in preparing a timely response to the formal inquiry letter.

.02 Illustrative Inquiry Letter to Legal Counsel If Management Has Not Provided Details About Pending or Threatened Litigation

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Lawyer*]
[*Address of Lawyer*]

In connection with an audit of our financial statements at (*balance-sheet date*) and for the (*period*) then ended, please furnish to our auditors (*name and address of auditors*), the information requested below for which you have been engaged to provide legal consultation or representation.

Pending or Threatened Litigation, Claims and Assessments

(excluding unasserted claims and assessments)

Please furnish a list of all pending or threatened litigation, claims, and assessments your firm is handling on our behalf including the following:

1. The nature of the litigation (including the amount of monetary or other damages sought).

2. The progress of the case to date.

3. How management is responding or intends to respond to the litigation (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 Statement of Financial Accounting Standards No. 5, as a matter of professional responsibility to us. *Please specifically confirm to our auditors that our understanding is correct*.

We have represented to our auditors that there are no unasserted claims which are not specifically identified in this letter that you advised us are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5.

(If unasserted claims exist, management's listed information should include the following: (1) the nature of the matter; (2) how management intends to respond if the claim is asserted; and (3) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.)

Please furnish our auditors any explanation you consider necessary to supplement the foregoing information, including an explanation of these matters as to which your views may differ from those stated.

Please specifically identify the nature of and reasons for any limitation on your response.

[The auditor may request the client to inquire about additional matters, for example, unpaid or unbilled charges or specified information on certain contractually assumed obligations of the organization, such as guarantees of indebtedness of others.]

Very truly yours,

[*Authorized Signature for Client*]

Notes: (A) Auditors should carefully consider the provisions of AU section 337 in drafting this letter.

(B) Sending of this letter should be timed so that the lawyer's response is dated as close to the auditor's opinion date as practicable. However, the auditor and client should consider early mailing of a draft inquiry as a convenience for the lawyer in preparing a timely response to the formal inquiry letter.

(C) If a client has not needed to retain legal counsel, an unqualified opinion may be expressed on the financial statements even though a letter from legal counsel has not been obtained. In these circumstances, a written representation should be obtained from the Company that legal counsel has not been retained for matters concerning its operations that involve current or prospective litigation.

.03 Improving Inquiry Techniques

If inquiries to legal counsel are not sufficiently detailed or specific, deficiencies in attorneys' responses may result. A conference between the auditor and the attorney may be necessary to clarify the attorney's written response and AU section 337, paragraph .10 provides for such a conference. However, to improve the auditor's ability to receive all of the information necessary to complete his/her audit, he/she may wish to consider the following matters in an inquiry to legal counsel:

a. A request that the attorney specify the effective date of his/her response if it is other than the date of the reply.

b. A request that the attorney mail the response so that it will be received by a certain date.

c. A request that the nature of any litigation specifically identify (i) the proceedings, (ii) the claim(s) asserted, (iii) the amount of monetary damages sought, or if no amounts are indicated in preliminary case filings, a statement to that effect, and (iv) the objectives sought by the plaintiff, if any, other than monetary or other damages, such as performance or discontinued performance of certain actions.

d. A request that the attorney avoid such vague phrases as "meritorious defenses," "without substantial merit," and "reasonable chance" in expressing an opinion on the outcome of litigation.

e. If an opinion cannot be expressed on the outcome of litigation, a request that the attorney so state together with his/her reasons for that position.

f. A request that the attorney specify to what extent potential damages are covered by insurance. (It may be possible to obtain the opinion of the insurer's counsel regarding the applicability of insurance coverage.)

g. A request that the attorney provide a summary of material litigation, claims, and assessments settled during the period.

h. A statement that confirmation of the understanding regarding disclosure of unasserted claims and assessments is an integral part of the audit inquiry and that failure to so confirm will require a follow-up contact.

i. A statement that the attorney's response will not be quoted or referred to in the financial statements without first consulting with him/her.

[*The next page is 7401.*]

AAM Section 7400

Management Representations and Representation Letters

.01 AU section 333, *Management Representations* (AICPA, *Professional Standards*, vol. 1), requires an auditor to obtain written representations from management for all financial statements and periods covered by the auditor's report. The specific written representations obtained by the auditor will depend on the circumstances of the engagement and the nature and basis of presentation of the financial statements.*

.02 Written representations from management ordinarily confirm representations explicitly or implicitly given to the auditor, indicate and document the continuing appropriateness of such representations, and reduce the possibility of misunderstanding concerning the matters that are the subject of the representations. Such representations from management are part of the evidential matter the independent auditor obtains, but they are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit.

Specific Representations

.03 In connection with an audit of financial statements presented in accordance with generally accepted accounting principles, specific representations should relate to the following matters:

Financial Statements

a. Management's acknowledgment of its responsibility for the fair presentation in the financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.

b. Management's belief that the financial statements are fairly presented in conformity with generally accepted accounting principles.

Completeness of Information

c. Availability of all financial records and related data.

d. Completeness and availability of all minutes of meetings of stockholders, directors, and committees of directors.

e. Communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.

f. Absence of unrecorded transactions.

---

* The AICPA recently released 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*). Auditors may find this practice aid useful when conducting audits in accordance with generally accepted auditing standards (GAAS). This TPA 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 TPA 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 aggregated by the auditor during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.[†] (A summary of such items should be included in or attached to the letter.)[‡]

h. Management's acknowledgement of its responsibility for the design and implementation of programs and controls to prevent and detect fraud.

i. Knowledge of fraud or suspected fraud affecting the entity involving (1) management, (2) employees who have significant roles in internal control, or (3) others where the fraud could have a material effect on the financial statements.

j. Knowledge of any allegations of fraud or suspected fraud affecting the entity received in communications from employees, former employees, analysts, regulators, short sellers, or others.

k. Plans or intentions that may affect the carrying value or classification of assets or liabilities.

l. Information concerning related-party transactions and amounts receivable from or payable to related parties.

m. Guarantees, whether written or oral, under which the entity is contingently liable.

n. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with the AICPA's Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties.*

o. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.

p. Unasserted claims or assessments that the entity's lawyer has advised are probable of assertion and must be disclosed in accordance with Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies* (AC C59).[|]

q. Other liabilities and gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5.

r. Satisfactory title to assets, liens or encumbrances on assets, and assets pledged as collateral.

s. Compliance with aspects of contractual agreements that may affect the financial statements.

Subsequent Events

t. Information concerning subsequent events.

The representation letter ordinarily should be tailored to include additional appropriate representations from management concerning matters specific to the entity's business or industry.

[†] If management believes that certain of the identified items are not misstatements, management's belief may be acknowledged by adding to the representation, for example,

"We do not agree that items XX and XX constitute misstatements because [*description of reasons*]."

[‡] AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), states that the auditor may designate an amount below which misstatements need not be accumulated. Similarly, the summary of uncorrected misstatements included in or attached to the representation letter need not include such misstatements. The summary should include sufficient information to provide management with an understanding of the nature, amount, and effect of the uncorrected misstatements. Similar items may be aggregated.

[|] If the entity has not consulted a lawyer regarding litigation, claims, and assessments, the auditor normally would rely on the review of internally available information and obtain a written representation by management regarding the lack of litigation, claims, and assessments; see Auditing Interpretation No. 6, "Client Has Not Consulted a Lawyer" of AU section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional Standards*, vol. 1, AU sec. 9337.15–.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 generally accepted accounting principles, is presented for illustrative purposes only. The introductory paragraph should specify the financial statements and periods covered by the auditor's report, for example, "balance sheets of XYZ Company as of December 31, 20X1 and 20X0, and the related statements of income and retained earnings and cash flows for the years then ended." The written representations to be obtained should be based on the circumstances of the engagement and the nature and basis of presentation of the financial statements being audited.

.09 If matters exist that should be disclosed to the auditor, they should be indicated by modifying the related representation. For example, if an event subsequent to the date of the balance sheet has been disclosed in the financial statements, the final paragraph could be modified as follows: "To the best of our knowledge and belief, except as discussed in Note X to the financial statements, no events have occurred. . ." In appropriate circumstances, item 9 could be modified as follows: "The company has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities, except for its plans to dispose of segment A, as disclosed in Note X to the financial statements, which are discussed in the minutes of the December 7, 20X1, meeting of the board of directors." Similarly, if management has received a communication regarding an allegation of fraud or suspected fraud, item 8 could be modified as follows: "Except for the allocations discussed in the minutes of the December 7, 20X1, meeting of the board of directors (or disclosed to you at our meeting on October 15, 20X1), we have no knowledge of any allegations of fraud or suspected fraud affecting the company received in communications from employees, former employees, analysts, regulators, short sellers, or others."

.10 The qualitative discussion of materiality used in the illustrative letter is adapted from FASB Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*.

.11 Certain terms are used in the illustrative letter that are described elsewhere in authoritative literature. Examples are fraud, in 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 the United States of America.
2. We have made available to you all—
   a. Financial records and related data.
   b. Minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.
3. There have been no communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.
4. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.
5. We believe that the effects of the uncorrected financial statement misstatements summarized in the accompanying schedule are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.
6. We acknowledge our responsibility for the design and implementation of programs and controls to prevent and detect fraud.
7. We have no knowledge of any fraud or suspected fraud affecting the entity involving—
   a. Management,
   b. Employees who have significant roles in internal control, or
   c. Others where the fraud could have a material effect on the financial statements.
8. We have no knowledge of any allegations of fraud or suspected fraud affecting the entity received in communications from employees, former employees, analysts, regulators, short sellers, or others.
9. The company has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
10. The following have been properly recorded or disclosed in the financial statements—
    a. Related-party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.

b. Guarantees, whether written or oral, under which the company is contingently liable.

c. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with the AICPA's Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties* (AICPA, *Technical Practice Aids*). (Significant estimates are estimates at the balance sheet date that could change materially within the next year. Concentrations refer to volumes of business, revenues, available sources of supply, or markets or geographic areas for which events could occur that would significantly disrupt normal finances within the next year.)

11. There are no—

a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.

b. Unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies.*[1]

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

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

13. The company has complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

[*Add additional representations that are unique to the entity's business or industry.* (See paragraph .07 and Appendix B, "Additional Illustrative Representations," of AU section 333).]

[*Add any representations related to new accounting or auditing standards that are being implemented for the first time.*]

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

____

[*Name of Chief Executive Officer and Title*]

____

[*Name of Chief Financial Officer and Title*]

Notes: Depending on the nature, materiality, and complexity of fair values, management representations about fair value measurements and disclosures contained in the financial statements also may include representations about:

- The appropriateness of the measurement methods, including related assumptions used by management in determining the fair value and the consistency in application of the methods.
- The completeness and adequacy of disclosures related to fair values.
- Whether subsequent events require adjustments to the fair value measurements and disclosures included in the financial statements.

[1] In the circumstances discussed in footnote 7 of 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 FASB Statement No. 5, *Accounting for Contingencies*, and we have not consulted a lawyer concerning litigation, claims, or assessments.

[Source: AU section 328, paragraph .49, *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.

[Source: AU section 722, Appendix C]

.14 Illustrative Representation Letter—Audit of Personal Financial Statements

[*Date*]

[*To the Independent Auditor*]

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

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

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

1. The financial statements referred to above are fairly presented in conformity with generally accepted accounting principles.
2. We have made available to you all financial records and related data.
3. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.
4. We believe that the effects of the uncorrected financial statement misstatements summarized in the accompanying schedule are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.
5. We acknowledge our responsibility for the design and implementation of programs and controls to prevent and detect fraud.
6. We have no knowledge of any fraud or suspected fraud affecting the entity involving—
   a. Us.
   b. Others where the fraud could have a material effect on the financial statements.
7. We have no knowledge of any allegations of fraud or suspected fraud affecting us received in communications from analysts, regulators, short sellers, or others.
8. We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
9. The following have been properly recorded or disclosed in the financial statements:
   a. Related-party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.
   b. Guarantees, whether written or oral, under which we are contingently liable.
   c. Significant estimates and material concentrations known to us that are required to be disclosed in accordance with the AICPA's Statement of Position 94-6. [*Significant estimates are estimates at the balance sheet date that could change materially within the next year. Concentrations refer to volumes of business, revenues, available sources of supply, or markets or geographic areas for which events could occur that would significantly disrupt normal finances within the next year.*]

10. There are no—
    a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
    b. Unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies*.[2]
    c. Other liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5.
11. We have satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged as collateral.
12. We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

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

____

(James Person)

____

(Jane Person)

[2] 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 Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies*, and we have not consulted a lawyer concerning litigation, claims, or assessments.

.15 Illustrative Representation Letter to Other Accountants

[*Firm's Letterhead*]

[*Date*]

____

____

____

In connection with the report you have been requested to reissue on the financial statements of ____________ ______________ [*client's name*] for the year ended __________________________ [*date*], which statements are to be included comparatively with similar statements for the year ended __________________________ [*date*], we make the following representations.

We have audited (or reviewed or compiled) the balance sheet of __________________________ [*client's name*] as of __________________________ [*balance-sheet date*] and the related statements of earnings, retained earnings, and cash flows for the year then ended. Our procedures in connection with the engagement did not disclose any events or transactions subsequent to __________________________ [*predecessor's balance-sheet date*] which, in our opinion, would have a material effect upon the financial statements, or which would require mention in the notes to the financial statements of __________________________ [*client's name*] for the year then ended.

Should anything come to our attention prior to the date our report is issued which, in our judgment, would have a material effect upon the financial statements covered by your report, we shall notify you promptly.

Very truly yours,

____

[*Engagement Partner's Signature*]

____

Note: If any matters come to the firm's attention that may require revision of the previous financial statements, they should be included in a separate paragraph after approval by the engagement partner.

.16 Letter to Other Accountants Upon Whose Work We Plan to Rely

[*Firm's Letterhead*]

[*Date*]

____

____

____

We are auditing the financial statements of __________________________ [*client's name*], __________________________ [*parent company*]. The financial statements of __________________________ [*other accountants' client's name*] that you are auditing are to be included in the financial statements of __________________________ [*client's name*]. We will rely on your report on the financial statements in expressing an opinion on the (consolidated) financial statements of __________________________ [*client's name*] (and subsidiaries). In that connection, we will refer to your report.

Please confirm to us that your firm is independent with respect to __________________________ [*client's name*] and __________________________ [*other accountant's client's name*] within the meaning of Rule 101 of the Code of Professional Conduct of the American Institute of Certified Public Accountants.

Please provide us promptly, in writing, with the following information in connection with your current examination of the financial statements of __________________________ [*other accountant's client's name*] with respect to:

1. Related-party transactions or other matters that have come to your attention. We are aware of the following related parties: __________________________ [*names of known related parties*].

2. Any limitation on the scope of your examination that is related to the financial statements of __________________________ [*client's name*], or that limits your ability to respond to this inquiry.

Please update your letter to indicate any additional matters of the type designated above that have come to your attention through the date of your report on the financial statements of __________________________ [*other accountants' client's name*].

Very truly yours,

____

[*Engagement Partner's Signature*]

.17 Illustrative Updating Management Representation Letter

The following letter is presented for illustrative purposes only. It may be used in the circumstances described in paragraph .12 of 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 Audit Committees

.01 Illustrative Communication With Audit Committees

Addressee:[*]

Statement on Auditing Standards (SAS) No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380) issued by the AICPA Auditing Standards Board requires the auditor to communicate certain matters to those charged with governance. Those charged with governance includes those responsible for overseeing the strategic direction of the entity and obligations related to the accountability of the entity including the oversight of 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 term *board of directors* or *audit committee* used elsewhere in generally accepted auditing standards (GAAS). The following comments regarding the scope and results of our audit of (*name of client*) for the year ended December 31, 20X2 will assist you in overseeing the financial reporting and disclosure process for which management is responsible.

Scope of Audit

Our responsibility is to express an opinion on the financial statements based on our audit. This audit is to be conducted in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statements presentation.

Results of Audit

This part of the letter would address the following:

1. Management's choice of significant accounting policies and their application. This includes methods proposed for new transactions or events, significant unusual transactions, or controversial areas such as equity investments, off-balance-sheet financing or revenue recognition.

2. Procedures used by management to determine accounting estimates and the data the auditor has considered to determine the reasonableness of the estimates.[1]

3. Adjustments arising from the audit that could, in his judgment, either individually or in the aggregate, have a significant effect on the entity's financial reporting process.

---

[*] SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), establishes standards and provides guidance on the auditor's communication with those charged with governance in relation to an audit of financial statements. 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.

[1] In January 2003, the Auditing Standards Board issued AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1), which states that certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ markedly from management's current judgments. According to AU section 328.50, the auditor should determine that the audit committee is informed about the process used by management in formulating particularly sensitive accounting estimates, including fair value estimates, and about the basis for the auditor's conclusions regarding the reasonableness of those estimates.

4. Uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole.
5. In connection with a Securities Exchange Commission engagement, the auditor's judgments about the quality, not just the acceptability, of the entity's accounting principles as applied in its financial reporting. (See AU section 380.11 for further information.)
6. Other information presented by management that is included with the entity's audited financial statements. The auditor should discuss the nature of his/her responsibility for such information with the audit committee,* including procedures performed, if any, and the results.
7. Nature of and circumstances surrounding any disagreements with management about the application of GAAP, the determination of accounting estimates, or scope of the audit that could be significant to the entity's annual reporting.
8. Auditor's views about any accounting or auditing matters discussed by management with other auditors (opinion shopping).
9. Major discussions by management with the auditor about the initial or continued retention of the auditor.
10. Any serious difficulties encountered in conducting the audit.

This report is intended solely for the information and use of the audit committee,* management and others in the organization (or specified regulatory agency) and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

* See footnote * in paragraph .01, Illustrative Communication With Audit Committees.

.02 Report on Reportable Conditions[2]

[*Date of Auditor's Report on the Financial Statements*]

In planning and performing our audit of the financial statements of the ________________ (*client's name*) for the year ended ________________ (*financial statement date*), we considered its internal control in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on internal control. However, we noted the following matters involving internal control and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design and operation of internal control that, in our judgment, could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

Bank Reconciliations

Bank reconciliations have been prepared for the operating cash account, but they have not been in agreement with the general ledger, often by as much as ________________ . At ________________, the general ledger balance varied from the bank reconciliation by $________________ .

In prior years, the bank reconciliations did not reconcile exactly to the general ledger; however, the variances were not as significant as in 20XX. To maintain effective internal controls over cash, it is critical that bank accounts be reconciled to the general ledger monthly with differences identified and resolved immediately. At the present time, an adjusting journal entry should be made to bring the general ledger balance into agreement with the reconciled balance.

Accounts Payable

A listing of accounts payable as of ________________ could not be produced to support the general ledger amount. We were able to reconcile accounts payable to the general ledger amount by reviewing computer-generated payable listings dated ________________, along with examining unpaid invoices at the time of our field work.

As indicated in previous letters to the Board, accounts payable has been an ongoing problem due to the fact that the accounts payable listing is not reconciled to the general ledger monthly. Proper recording of accounts payable is a key to maintaining adequate financial statements. Whether computer-generated or manually

---

[2] In May 2006, the AICPA's Auditing Standards Board issued SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1), which supersedes SAS No. 60. SAS No. 112 requires the auditor to communicate, in writing, to management and those charged with governance, significant deficiencies and material weaknesses identified in an audit. SAS No. 112 is effective for audits of financial statements ending on or after December 15, 2006; earlier implementation is permitted. If applying SAS No. 112, the first paragraph of this report should be replaced with the following:

> In planning and performing our audit of the financial statements of the __________ (*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 controls 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 on 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.
>
> 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:

prepared, a detailed accounts payable listing should be reconciled monthly to the general ledger balance. All reconciliations should be reviewed and approved by someone other than the preparer, with the reviewer being responsible for ensuring that all differences are resolved.

Property and Equipment

Documentation provided to support the changes in property and equipment was not in agreement with the changes in the general ledger balances, for some categories, by as much as ______. Also, the computer-generated list of property and equipment was not in agreement with the total property and equipment recorded in the general ledger; therefore, this listing was not a useful resource.

The property and equipment computer listing should be reviewed, revised, and reconciled to the general ledger. Changes in property and equipment should be recorded timely and the detailed property and equipment listing should be reconciled to the general ledger balances monthly.

The procedures for recording fixed asset additions and deletions should be reviewed to determine their adequacy. Adjusting journal entries with regard to trade-ins, sales and other retirements of fixed assets should be reviewed by the Treasurer or someone other than the person preparing the entry. Examples of problems encountered include improper capitalization of assets when a like kind exchange or trade-in is involved and improper recording of gain or loss on sale of assets.

An annual or biannual physical inventory of equipment is an effective management tool to help maintain detail property and equipment records and strengthen controls of safeguarding equipment. The Board should consider making a physical inventory a standard procedure.

This report is intended solely for the information and the use of the Board of Directors, management, and others within the entity and is not intended to be and should not be used by anyone other than these specified parties.

Very truly yours,

____

[*Engagement Partner*]

.03 Report on Reportable Conditions That Also Identifies a Material Weakness[3]

[*Date of Auditor's Report on the Financial Statements*]

In planning and performing our audit of the financial statements of the ________________ (*client's name*) for the year ended ________________ (*financial statement date*), we considered its internal control in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on internal control. However, we noted the following matters involving internal control and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design and operation of internal control that, in our judgment, could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

Accrued Vacation

Although accrued vacation has not been recorded on the financial statements, the amount of accrued vacation must be considered in determining the fair presentation of the financial statements. The year end analysis of accrued vacation had a balance significantly lower than the prior year's balance. The details of the analysis were traced to the "attendance control cards." We found (1) the number of days earned on the listing did not agree to that recorded in the cards, (2) individuals were reported in the cards with earned vacation but were not on the listing, and (3) some of the cards appeared to not have been maintained.

Detailed records of vacation days earned and used by employees should be timely and accurately maintained. At least annually, these days should be converted to dollar amounts. Management should review the conversion and consider reporting this liability on the financial statements for complete recognition of liabilities.

Discussions with the Office Manager revealed that not all employees are required to notify her when they use vacation days. All employees should be required to inform the Office Manager of all vacation days taken. Employees should also be asked to periodically review their vacation records with the Office Manager and to indicate their agreement by signing the records.

Bad Debts

During 20XX, the Board approved the write-off of accounts receivable of about ________. The write-off was charged to revenue rather than to bad-debt expense.

---

[3] In May 2006, the AICPA's Auditing Standards Board issued SAS No. 112 which supersedes SAS No. 60. SAS No. 112 requires the auditor to communicate, in writing, to management and those charged with governance, significant deficiencies and material weaknesses identified in an audit. SAS No. 112 is effective for audits of financial statements ending on or after December 15, 2006; earlier implementation is permitted. If applying SAS No. 112, the first paragraph of this report should be replaced with the following:

> In planning and performing our audit of the financial statements of the __________ (*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 controls 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 on 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.
>
> 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:

Procedures for recording bad debt write-offs should be reviewed for adequacy. All adjusting entries should be reviewed by the Treasurer or a member of management other than the person preparing the journal entry.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe that the following reportable condition is a material weakness.[4]

Blank Checks

Blank checks are maintained in an unlocked cabinet along with the check signing machine.

Blank checks and the check signing machine should be locked in separate locations so as to prevent the embezzlement of funds.

This report is intended solely for the information and use of the Board of Directors, management, and others within the entity and is not intended to be and should not be used by anyone other than these specified parties.

Very truly yours,

____
[*Engagement Partner*]

[*The next page is 7601.*]

[4] If applying SAS No. 112, this paragraph should be replaced with the following:
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:

AAM Section 7600
Reliance Letter

.01 Illustrative Reliance Letter

Addressee:

The following is in response to your letter to our firm dated ________ .

We performed an audit of ABC Company's balance sheet dated December 31, 20X0, and the related statements of income, retained earnings, and cash flow for the year then ended. The financial statements were audited as of the financial statement date and the audit procedures performed were completed on March 28, 20X1 (*audit report date*). No additional audit procedures were performed subsequent to March 28, 20X1.

The audit was conducted in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. However, a properly designed and executed audit may not detect a material irregularity. For example, generally accepted auditing standards do not require that an auditor authenticate documents, nor is an auditor trained to do so. Also audit procedures that are effective for detecting a misstatement that is unintentional may not be effective for a misstatement that is intentional and is concealed through collusion between client personnel and third parties or among management or employees of the client.

We understand that you intend to rely on the report and associated statements in connection with (*describe as precisely as possible the transaction in connection with which the third party intends to rely on the report and statements*). It should be noted that the audit procedures performed in order to render an opinion on the financial statements of ABC Company may not be adequate or appropriate for this purpose. Because of the limitations inherent in the audit process we may not have detected all material misstatements. Accordingly, our audit was not intended for your benefit and should not be taken to supplant the inquiries and procedures that you should take to satisfy yourself as to ABC Company's credit-worthiness. We recommend that you perform your own due diligence investigation which should include but not be limited to the following steps (*itemize*). We emphasize that this list of procedures may not be all inclusive and that we cannot provide any assurance that the procedures we have mentioned will be sufficient for your purposes.

[*Signature*]

[*Date*]

[*The next page is 7701.*]

AAM Section 7700
Proposal Letter

.01 Illustrative Proposal Letter

[*Date*]

____

____

____

We appreciate this opportunity to present a proposal for (*nature of services*) and a brief description of our firm and services.

Our firm was formed in 20___. We have _____ partners and _____ staff and support personnel working with clients in accounting and auditing, taxation, and various consulting services. Although we serve all size clients, our clientele consists primarily of small and medium-size businesses such as yours.

Our professional objectives are to provide the highest quality services on a timely basis. As a member of the AICPA Division for Firm's Private Companies Practice Section, our accounting and auditing practice has been subjected to a review by another firm of CPAs. We received an unqualified opinion as a result of that review. We extend our client relationships to include ongoing contact and services to achieve our services objectives.

We have extensive experience in the ___________ industry. This experience and related understanding of your industry's operations permit us to design, perform, and complete engagements for your company effectively and at a reasonable cost.

Our services include the following:

- Accounting, Auditing, and Attestation Services

  Our accounting, auditing, and attestation services include annual or special audits, compilations and reviews of financial statements, and the examination and review of financial and other information under the attestation standards. We accompany our report on audited financial statements with a reportable conditions letter and a management letter that include suggestions to correct internal control weaknesses and recommendations for operational efficiencies. Our purpose in making these suggestions is to help you accomplish your operational objectives. These suggestions often result in cost savings.

- Tax Services

  We offer diversified tax services, including assistance in all phases of federal, state, and local income taxes; estate, inheritance, and gift taxes; and payroll and other taxes. These services include tax return preparation, tax research, and representation of clients at administrative proceedings before the various taxing authorities. The objectives of our tax services are to minimize taxes and potential problems.

- Consulting Services

  Our consulting services are designed to assist clients in improving efficiency and profitability. Our approach offers assistance in such areas as developing plans for problem identification or implementing more effective operating controls, evaluating information systems and installing or upgrading data processing systems.

____________________, an audit partner, will be primarily responsible for your engagement.

As you requested, our proposal is for ____________________ (*state nature of services*).

We estimate that our fees for the proposed services will be approximately $_______, plus out-of-pocket expenses, billable as the work progresses. Our fees are based on time spent on the engagement. Should we encounter any unforeseen circumstances requiring additional time, you will be notified promptly of the situation.

Our fee estimate is based on the assumption that your personnel will prepare certain schedules and analyses for us. We also anticipate their assistance in locating invoices and other documents for our examination.

Our firm is organized and staffed to help you satisfy our business needs. Please call ___________ with questions about this proposal.

Very truly yours,

____

[*Firm Signature*]

[*The next page is 8001.*]

AAM Section 8000
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.

TABLE OF CONTENTS

[*The next page is 8015.*]

AAM Section 8010

Audit Risk Alert—2006/07

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

NOTICE TO READERS
AUDIT RISK ALERT—2006/07

This Audit Risk Alert, prepared by the AICPA staff, is intended to help you identify the significant business risks that may result in the material misstatement of your client's financial statements. This Alert provides CPAs with an overview of recent economic, business, 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 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
Renee Rampulla, CPA
Senior Manager
Accounting and Auditing Publications

How This Alert Helps You

.01 This Audit Risk Alert helps you plan and perform your audits. The knowledge delivered by this Alert assists you in achieving a more robust understanding of the business and economic environment in which your clients operate. This Alert is an important tool in helping you identify the significant business risks that may result in the material misstatement of your client's financial statements. Moreover, this Alert delivers information about emerging practice issues and current accounting, auditing, and professional developments.

.02 This Alert is intended to assist auditors of both public and nonpublic companies. As such, references to AICPA *Professional Standards* (Generally Accepted Auditing Standards [GAAS] and Public Company Accounting Oversight Board [PCAOB] Professional Standards) are included. In citing the professional standards, references are made to the AICPA *Professional Standards* publication and the AICPA's *PCAOB Standards and Related Rules* publication, depending upon the applicable professional standard. Additionally, when referencing professional standards, this Alert cites section numbers and not the original Statement number, 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*.

.03 For a thorough discussion of recent developments and key issues in the area of independence and ethics, see the AICPA Audit Risk Alert *Independence and Ethics Alert—2006/07* (product no. 022477kk), and for a thorough discussion of recent Securities and Exchange Commission (SEC) and PCAOB developments, see the AICPA Audit Risk Alert *SEC and PCAOB Alert—2006/07* (product no. 022497kk). Both Alerts can be obtained by calling the AICPA at (888) 777-7077 or by going online at www.cpa2biz.com.

AICPA Industry Audit Risk Alerts

.04 To help auditors understand the relevant industry, regulatory, and other external factors, as well as business risks affecting their clients, the AICPA has developed industry-specific Audit Risk Alerts that can be used in conjunction with this Alert. The current list of AICPA industry Alerts is presented below. To obtain these Alerts, call the AICPA at (888) 777-7077 or go online at www.cpa2biz.com.

1. *Bank, Credit Unions and Other Depository and Lending Industry Developments—2006/07* (product no. 022297kk)
2. *Construction Contractors Industry Developments—2006/07* (product no. 022317kk)
3. *Employee Benefit Plans Industry Developments—2006* (product no. 022416kk)
4. *Government Auditing Standards and Circular A-133 Audits—2006* Circular A-133 Audits (product no. 022456kk)
5. *Health Care Industry Developments—2006/07* (product no. 022347kk)
6. *High-Technology Industry Developments—2006/07* (product no. 022407kk)
7. *Independence and Ethics Alert—2006/07* (product no. 022477kk)
8. *Insurance Industry Developments—2006/07* (product no. 022357kk)
9. *Investment Companies Industry Developments—2006/07* (product no. 022367kk)
10. *Manufacturing Industry Developments—2006/07* (product no. 022377kk)
11. *Not-for-Profit Organizations Industry Developments—2006* (product no. 022426kk)
12. *Real Estate Industry Developments—2006/07* (product no. 022397kk)
13. *Securities Industry Developments—2006/07* (product no. 022387kk)
14. *State and Local Governmental Developments—2006* (product no. 022436kk)

.05 In addition, the AICPA publishes the following Alerts:

1. *Compilation and Review Alert—2006/07* (product no. 022307kk)
2. *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk)

New Pronouncements and Other Guidance

Recent Auditing and Attestation Pronouncements and Related Guidance

.06 Presented in the following table is a list of auditing, attestation, and related guidance issued since the publication of last year's Alert. For information on recently issued 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 and the PCAOB Web site at www.pcaobus.org (public company audits only). As a reminder, AICPA auditing and attest standards are applicable only to audits and attestation engagements of nonissuers.

.07 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*, which is issued by the AICPA's Auditing Standards Team and is available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Authoritative+Standards+and+Related+Guidance+for+Non-Issuers/default.htm

Recent Auditing and Attestation Pronouncements and Related Guidance	
SAS No. 102, *Defining Professional Requirements in Statements on Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 120) Statement on Standards for Attestation Engagements (SSAE) No. 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 20) (December 2005)	These standards established two categories of professional requirements that are identified by specific terms. The words *must* or *is required* are used to indicate an unconditional requirement. The word *should* is used to indicate a presumptively mandatory requirement. The words *may, might, could,* and *should consider* represent actions that auditors have a professional obligation to consider. The provisions of SAS No. 102 and SSAE No. 13 were effective upon issuance. It is the Auditing Standards Board's intention to make conforming changes to AICPA literature over the next several years to remove any language that would imply a professional requirement where none exists.
SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339) (December 2005)	SAS No. 103 supersedes SAS No. 96 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.
SASs No. 104–No. 111, The Risk Assessment Standards (March 2006)	See "The Risk Assessment Standards" section in this Alert.
SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325) (May 2006)	The new 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. 113, *Omnibus Statement on Auditing Standards—2006* (AICPA, *Professional Standards*, vol. 1) (November 2006)	This SAS amends the following SASs: SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150); SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316); SAS No. 101, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1, AU sec. 328); SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a*

(continued)

	Going Concern (AICPA, *Professional Standards*, vol. 1, AU sec. 341); SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342); SAS No. 1, AU Section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1; and SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333). The amendments in paragraphs 1 through 5 of this SAS are effective for audits of financial statements for periods beginning on or after December 15, 2006. Earlier application is permitted. The amendments in paragraphs 7 through 14 of this SAS are effective for audits of financial statements for periods ending on or after December 15, 2006. Earlier application is permitted.
SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380) (December 2006)	The new standard supersedes SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380A), as amended. It establishes and provides guidance on the auditor's communication with those charged with governance in relation to an audit of financial statements. Although this Statement applies regardless of an entity's governance structure or size, particular considerations apply where all of those charged with governance are involved in managing an entity. It is effective for periods beginning on or after December 15, 2006.
SSAE No. 14, *SSAE Hierarchy* (AICPA, *Professional Standards*, vol. 1, AT sec. 50) (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 attest engagement, and amends the 11 attestation standards to reflect the terminology used in SSAE No. 13.
AICPA Technical Practice Aid section 8100.01–.02 (Nonauthoritative)	The title of section 8100.01 is "Determining the Effective Date of a New Statement on Auditing Standards for Audits of a Single Financial Statement," and the title of section 8100.02 is "Determining the Effective Date of a New Statement on Auditing Standards for Audits of Interim Periods."
PCAOB Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist* (February 2006) (Applicable to audits conducted in accordance with PCAOB standards only)	This standard applies if auditors report on the elimination of a material weakness in a company's internal control over financial reporting. The standard establishes a voluntary engagement that would be performed at the election of the company.

PCAOB Conforming Amendment to AT 101.04*f*, *Attest Engagements, Conforming Amendment to PCAOB Related Auditing and Professional Practice Standards Resulting from the Adoption of the Auditing Standard No. 4* (AICPA, *PCAOB Standards and Related Rules*, AT sec.101.04*f)* (February 2006) (Applicable to audits conducted in accordance with PCAOB standards only)	The conforming amendment states that Auditing Standard No. 4 must be used for reporting on whether a material weakness continues to exist for any purpose other than a company's internal use.
PCAOB Report on the Initial Implementation of 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. 300) (November 2005) (Applicable to audits conducted in accordance with PCAOB standards only)	This report reaffirms and amplifies previous guidance issued by the PCAOB in May 2005. The report focuses on reasons the PCAOB found audits performed were not always as efficient and effective as Auditing Standard No. 2 intended. The report also explains certain aspects of Auditing Standard No. 2, such as the terms *more than remote* and *strong indicators*.
PCAOB Overview of Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist (*AICPA, *PCAOB Standards and Related Rules*) (April 2006) (Applicable to audits conducted in accordance with PCAOB standards only)	This overview provides additional information on the provisions of Auditing Standard No. 4.
PCAOB Staff Questions and Answers, Adjustments to Prior-Period Financial Statements Audited by a Predecessor Auditor (AICPA, *PCAOB Standards and Related Rules*, AU sec. 100.08) (June 2006) (Applicable to audits conducted in accordance with PCAOB standards only)	The guidance explains that if prior-period financial statements that require adjustments were audited by a predecessor auditor, either the successor auditor or the predecessor auditor may audit the adjustments so long as the auditor is independent and registered with the PCAOB. The guidance continues to address questions regarding when the predecessor auditor audits the prior-period financial statement adjustments, when the successor auditor audits the prior-period financial statement adjustments, and when the successor auditor has not yet completed an audit of the current-period financial statements.

(continued)

PCAOB Staff Audit Practice Alert No. 1, *Matters Relating to Timing and Accounting for Options Grants* (AICPA, *PCAOB Standards and Related Rules*, sec. 400.01) (July 2006) (Applicable to audits conducted in accordance with PCAOB standards only)	This issuance was prompted by recent reports and disclosures about issuer practices related to the granting of stock options, including the *backdating* of such grants. The guidance identifies existing standards that could bear on auditors' work and applies them to the issues that have been raised regarding companies' stock option granting practices, but it does not establish new requirements.
PCAOB Staff Questions and Answers, *Auditing the Fair Value of Share Options Granted to Employees* (October 2006) (Applicable to audits conducted in accordance with PCAOB standards only)	The guidance provides direction for auditing a company's estimation of the fair value of stock options granted to employees pursuant to Financial Accounting Standards Board 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.

Recent Accounting Pronouncements and Related Guidance

.08 Presented in the following table 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 Financial Accounting Standards Board (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. 155	*Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*
FASB Statement No. 156	*Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140*
FASB Statement No. 157	*Fair Value Measurements*
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)*
FASB Interpretation No. 48	*Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*
FASB Emerging Issues Task Force (EITF) Issues	Go to www.fasb.org/eitf/ for a complete list of EITF Issues.
FASB Staff Positions (FSPs)	Go to www.fasb.org/fasb_staff_positions/ for a complete list of FSPs. Some of the recently issued FSPs address issues relating to FASB Statements No. 143 and No. 150, among others, and FASB Interpretation 46(R).

AICPA Technical Practice Aid (TPA) sections 2130.09–.35 (December 2005) (Nonauthoritative)	This TPA discusses various topics on the application of SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer,* to debt securities.
AICPA TPA sections 5600.07–.17 (November 2005) (Nonauthoritative)	This TPA discusses various lease topics.
AICPA TPA sections 6910.16–.20 (January 2006) (Nonauthoritative)	This TPA discusses nonregistered investment partnerships topics.

Recent Independence and Ethics Pronouncements

.09 The AICPA *Independence and Ethics Alert—2006/07* (product no. 022477) 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 that Alert to be aware of independence and ethics matters that will affect their practice.

Understanding the Entity and Its Environment and Assessing Risks

.10 An auditor should obtain an understanding of relevant industry, regulatory, and other external factors that may affect his or her client. These factors include:

- 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

.11 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 (for example, political, economic, social, technical, and competitive).

.12 The auditor should understand 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. 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.

.13 After gaining an understanding of the entity and its environment, the auditor needs to make risk assessments at the financial statement and relevant assertion levels based on that understanding.

.14 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 will help you gain a better understanding of your client's environment, will help you better assess risks of material misstatement of the financial statements, and will ultimately strengthen the integrity of your audits.

Certain Business and Economic Developments

Declining Housing Market and the Possibility of Rising Interest Rates

.15 Housing starts, a key indicator of economic performance, have been dropping. Median sale prices of existing homes have been dropping also. In addition, there is a high inventory of unsold homes. The issuing of construction permits has dropped to its lowest level since 1997, indicating a continued cooling of the housing market ahead. The consensus forecast for 2007 U.S. housing is 1.775 million units, down from an estimated 1.902 million units this year. Forecasters expect continued declines in 2008. Interest rate levels will significantly affect the future of the housing market. Buyers' confidence and fear of falling prices will also be big factors affecting the market's future. The cooling of the housing market will affect many businesses and may need to be considered in audit planning.

.16 If the economic and business environment weakens, risks to businesses and auditors multiply. Those risks include:

- Risk of fraudulent financial reporting and improper accounting estimates
- Impairment and recoverability risks
- Viability and liquidity risks
- High debt levels and collectibility of receivables
- Inventory obsolescence

.17 Auditors should have a solid understanding of the AICPA's professional standards, including AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1); AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1); AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1); and AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1).

.18 Auditors of public companies should remember that Item 303 of Regulation S-K requires SEC registrants to disclose in Management's Discussion and Analysis changes in accounting estimates that (1) have a material effect on the financial condition or results of operations of the company or trends in earnings or (2) would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition.

Possible Interest Rate Increases

.19 Predicting future interest rate levels is difficult. The Federal Reserve is still concerned about inflation, which makes future interest rate increases possible. Some possible auditor considerations include:

- Significant changes in, and the volatility of, general 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 utilizes reasonable interest rates in those cases in which interest rates affect the valuation of the investment or derivative.

Pension Protection Act

.20 On August 17, 2006, the Pension Protection Act was signed into law. In addition to expanding and improving defined contribution plans such as IRAs and 401(k) plans, the purpose of the Act is to strengthen the federal pension insurance program. The provisions of the Act are effective for fiscal years beginning after December 31, 2007.

.21 The major provisions of this legislation that may affect companies with pension plans are:

- Increased premiums and contributions required for underfunded plans and companies that terminate their plans. Requirements for accurate measurement and reporting of benefit obligation liabilities
- A prohibition on promising additional benefits to employees until they are funded
- Closure of loopholes that permitted companies to defer contributions to underfunded plans

.22 For technical explanations of the provisions of the Pension Protection Act, see www.house.gov/jct/x-38-06.pdf.

Stock Option Backdating

.23 News surrounding a number of companies participating in stock option backdating has recently surfaced, and some companies have announced restatements of previously issued financial statements. As a result, this may lead to legal and other contingencies requiring the recognition of an additional expense or disclosure in the financial statements. Auditors should be alert to possible risks associated with their clients' option grants and consider the following:

- Understanding the status and results of any investigations relating to the timing of options grants
- Making direct inquiries of members of management and the board of directors who should have knowledge of matters related to the granting and accounting for stock options
- Obtaining clients' public information related to the timing of options grants
- Understanding the terms and conditions of plans or policies under which options are granted (in particular, terms that allow exercise prices that are not equal to the market price on the date of grant or that delegate authority for option grants to management)
- Recognizing patterns of transactions or conditions that may indicate higher levels of inherent risk in the period under audit. Such patterns or conditions may include:
  - — Very high levels of option grants in relation to shares outstanding
  - — Situations in which option-based compensation is a large component of executive compensation
  - — Highly variable grant dates
  - — Patterns of significant increases in stock prices following the issuance of option grants
  - — High levels of stock-price volatility

Certain Auditing Issues and Developments

Defining Professional Requirements

.24 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, AU sec. 120), and SSAE No. 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (AICPA, *Professional Standards,* vol. 1, AT sec. 20). These provisions were effective upon issuance, and these standards established categories of professional requirements that are identified by specific terminology. The definition of these terms describes the degree of your responsibility when complying with professional standards. In addition, these terms are substantially similar to those defined by the PCAOB Interim Professional Auditing Standards Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards* (AICPA, *PCAOB Standards and Related Rules*). These sharply defined terms will result in the clarification of standards, so consider paying significant attention to them.

.25 When the terms *must* or *is required* are used in a standard, they indicate that you have an unconditional requirement to comply, in all cases, with that standard. If the term *should* is used in a standard, a presumptively mandatory requirement has been indicated. That is, you are expected to comply. In rare circumstances, you may depart from the requirement providing you document the justification on how you were able to sufficiently achieve the objectives of the requirement by performing alternative procedures.

.26 These standards also apply to explanatory material contained in the text of authoritative standards providing explanations and guidance on the professional requirements or identifying and describing other procedures or actions. Lastly, the terms *may, might,* and *could* are used in explanatory material and are there to assist you in your consideration when exercising professional judgment in performing your engagement.

Private Company Audit Documentation

.27 Over the course of the last four years, certain business failures and frauds have highlighted the need for auditors to focus more diligently on audit documentation and working paper retention. In response to this need, the ASB strengthened audit documentation requirements by issuing SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards,* vol. 1, AU sec. 339), in December of 2005. SAS No. 103 superseded SAS No. 96, *Audit Documentation,* and amended SAS No. 1, Section 530, *Dating of the Independent Auditor's Report* (AICPA *Professional Standards*, vol. 1, AU sec. 530). As a result, SAS No. 103 clarified, modified, and enhanced guidance for auditors to follow when documenting their work during the audits of private companies. The Statement is effective for audits of private company financial statements for periods ending on or after December 15, 2006, with earlier application permitted. While it is strongly recommended that auditors read the full text of the standard, a summary of some important revisions brought forth by the issuance of SAS No. 103 follows, along with suggestions to consider when implementing the guidance.

.28 Audit documentation is required to be sufficient so that an *experienced auditor*[1] who is not previously involved in the audit would understand the nature, timing, extent, and results of the auditing procedures performed, along with the evidence obtained and conclusions reached on significant matters. Keep in mind that if an objective reviewer of the documentation has to ask basic questions about the audit, the documentation probably does not contain the required content.

.29 Oral explanations alone cannot be used to support an auditor's work or conclusions but may still be used to clarify or explain the information included in the documentation. Therefore, if verbal justification is needed to support your work, it may suggest that your working papers lack sufficient documentation and do not contain all the information and linkages necessary to ensure that the required procedures were performed and that the proper evidence was obtained.

---

[1] Statement on Auditing Standards (SAS) No. 103, *Audit Documentation* (AICPA, *Professional Standards,* vol. 1, AU sec. 339), defines an *experienced auditor* as one who possesses competencies and skills that would have enabled him or her to perform the audit.

.30 When audit evidence contradicts or is inconsistent with your audit conclusions regarding significant issues or findings, SAS No. 103 provides guidance. The auditor should document and explain the contradictions that were addressed and how conclusions were formed. In addition, SAS No. 103 specifically addresses how you would document the oral discussions you had with your client's management or individuals overseeing the financial reporting process.

.31 Historically, the date of the auditor's report has been the last day an auditor completed his or her fieldwork. Under SAS No. 103 guidance, it is critical to note that you *should not* date your report earlier than the date you obtained sufficient appropriate audit evidence to support your opinion. Therefore, your audit documentation should have been reviewed, the financial statements should have been prepared (including disclosures), and management should have asserted its responsibility for those statements. At times, your report date may still correspond to your last day of fieldwork, but this synchronization may not always occur. If your report is dated subsequent to your fieldwork, the time period subject to subsequent events work will increase. This requirement will ordinarily result in a closer timing between the date of your report and the date you grant your client permission to use your report (report release date) in connection with the financial statements.

.32 Within *60 days* following the report release date (also known as the documentation completion date), an auditor should complete the assembling of the audit file or files. Subsequent document deletions are *prohibited*, and subsequent additions are subject to the guidance in AU section 390, *Consideration of Omitted Procedures After the Report Date* (AICPA, *Professional Standards*, vol. 1); and AU section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (AICPA, *Professional Standards*, vol. 1), as amended. Here are some suggestions to consider to assist in meeting this requirement:

- Getting it right the first time will reduce the efforts needed to assemble the final audit file or files later, so try to clearly document the audit
- While your audit is in progress and documentation is updated, discard superseded memos and files instead of waiting until the end
- Try to complete the audit on a timely basis so you may better manage your responsibility for subsequent events procedure
- Make sure that you and/or your staff have adequately scheduled your review time to meet the 60-day deadline
- Be aware of any applicable state laws or other documentation requirements that may apply because some jurisdictions have accelerated final documentation deadlines

.33 Audit documentation retention should not be shorter than *five years* from the report release date, but statutes, regulations, or your firm's quality control policies may specify a longer retention period. Some suggestions to consider when addressing document retention are:

- Engaging an objective third party to make specific recommendations to your policies and current documentation approach
- Determining if your audit files are safe and retrievable
- Assessing the functionality of current software programs in future environments because you may need to retain old hardware or purchase new software
- Being aware of state or regulator retention requirement periods that are longer than five years and adjusting your policies and documentation approach accordingly

.34 One final point to consider when implementing the guidance under SAS No. 103 is the use of the terms *must, should,* and *may*. Keep in mind your professional responsibilities as they relate to these terms, as described in SAS No. 102.

The Risk Assessment Standards

Statement on Auditing Standard	*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")*	Amends SAS No. 1, section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230) as amended
SAS No. 105, *Amendment to Statement on Auditing Standards No. 95*, Generally Accepted Auditing Standards (AICPA, *Professional Standards*, vol. 1, AU sec. 150)	Amends SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150)
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*	This statement supersedes SAS No. 1, section 310, *Appointment of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1, 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* (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 section 313, *Substantive Tests Prior to the Balance-Sheet Date* (AICPA, *Professional Standards*, vol. 1, AU sec. 313).
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. 350).

Some Highlights of the New Risk Assessment Standards

.36 Whether due to errors or fraud, the new risk assessment standards require the auditor to understand and respond to risks of material misstatements. That understanding should identify risks to your 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 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 you have previously done. Implementation of the SASs will most likely result in significant changes to your firm's audit methodologies and the training of your personnel. Therefore, it is recommended that you 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. 022526) at www.cpa2biz.com.

New Companion Audit Guide

.37 In December 2006, the AICPA issued an Audit Guide titled *Assessing and Responding to Audit Risk in a Financial Statement Audit* (product no. 012456). This Guide helps practitioners 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.

Communicating Internal Control Related Matters

.38 In May 2006, the 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.

.39 The standard requires that auditors (1) evaluate identified control deficiencies and determine whether these deficiencies, individually or in combination, are significant deficiencies or material weaknesses, and (2) 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.

.40 Some general examples of potential control deficiencies that you might find are:

- Lack of segregation of duties in the cash management function
- Management override of controls by owners of privately held companies or by project managers in the invoice approval process
- Inadequate monitoring of the financial accounting process to detect deficiencies in internal control by management
- Lack of client expertise in preparing financial statements

.41 The AICPA has published the Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk) to assist you in the implementation of this standard.

Auditing Variable Interest Entities

.42 FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities*, continues to present a challenge for accountants to understand. Last year's Alert discussed the issuance of five important FASB Staff Positions (FSPs) that provided additional guidance for this revised Interpretation. Subsequently, another FSP, FASB Interpretation No. 46(R)-6, *Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R)* (April 13, 2006), was issued this year. While referring directly to the authoritative guidance is strongly recommended, the AICPA issued Technical Practice Aid (TPA) 1400.29, "Consolidated

Versus Combined Financial Statements under FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities*" (www.aicpa.org/download/acctstd/FIN_46_R_TPAs.pdf), to assist you in tackling some of this guidance.

Variable Interest Entities Auditing Procedures

.43 Deciding whether a variable interest entity (VIE) needs to be consolidated is an ongoing process for your client. Determining that your client has appropriately addressed the provisions in FASB Interpretation No. 46 (R) is an ongoing process for you. Some important questions to consider in determining if your client (the primary beneficiary) must consolidate follow:

- Does the potential VIE have a sufficient equity investment at risk?
- Can the potential VIE finance its activities without additional support?
- Do the equity investors in the potential VIE lack any of the three characteristics of a controlling financial interest?
- Do the equity investors participate in the decision-making process of the potential VIE?
- Do the equity investors share in the returns and absorb losses generated by the potential VIE?
- If you previously determined that an entity does not meet the consolidation criteria, have new facts and circumstances occurred that may cause you to reconsider your assessment?

.44 In addition to the above, readers should consider referring to the AICPA's Practice Alert 2005-1, *Auditing Procedures With Respect to Variable Interest Entities*, for detailed steps and procedures when auditing VIEs. Excerpts from this document appeared in last year's Alert, and a complete copy can be obtained at www.aicpa.org/download/auditstd/pract_alert/pa_2005_1.pdf.

.45 Because FASB Interpretation No. 46(R) includes related party arrangements within its scope, you will need to consider the involvement of related parties as defined in FASB Statement No. 57, *Related Party Disclosures*, along with the guidance in AU section 334, *Related Parties* (AICPA, *Professional Standards*, vol. 1). To better assist you, the AICPA developed a nonauthoritative toolkit that addresses related parties and their transactions. A copy can be obtained at www.aicpa.org/news/relpty1.html.

Certain Accounting Issues and Developments

SEC Staff Accounting Bulletin 108

.46 On September 13, 2006, the 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.

.47 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 (the rollover approach). The other common approach quantifies the error as the cumulative amount by which the current year balance sheet is misstated (the 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.

.48 The 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.

.49 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 the SAB. 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.

Related FASB Project

.50 The FASB has received inquiries about the application of SAB No. 108 to the private sector. Public companies must adhere to the requirements of SAB No. 108. Private companies are not bound by SAB No. 108. As a result, concern was expressed 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. The FASB staff is currently drafting a proposed FSP that will provide 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. See the FASB Web site at www.fasb.org for the status of this project.

FASB Statement No. 157

.51 FASB Statement No. 157, *Fair Value Measurements,* defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements because the FASB previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. However, for some entities, the application of this Statement will change current practice.

.52 Note that FASB Statement No. 157 does not tell accountants how to specifically value assets and liabilities, nor does it tell accountants what judgments to make when developing estimates of the inputs that go into valuation techniques.

FASB Statement No. 158

.53 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 multi-employer 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.

.54 An entity with publicly traded equity securities shall initially apply the requirement to recognize the funded status of a benefit plan (paragraph 4) and the disclosure requirements (paragraph 7) as of the end of the fiscal year ending after December 15, 2006. An employer without publicly traded equity securities shall initially apply the requirement to recognize the funded status of a benefit plan (paragraphs 4 and 8) and the disclosure requirements (paragraphs 7 and 10) as of the end of the fiscal year ending after June 15, 2007.

FASB Interpretation No. 48

.55 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 Interpretation is applicable to all business enterprises, whether they are taxable businesses or tax-exempt organizations. Tax positions taken by any entity that may represent potential future obligations to a taxing authority (for example, IRS or state revenue department) may have to be recorded under this Interpretation. 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.

.56 The AICPA has issued a practice guide about FASB Interpretation No. 48. It is available at www.aicpa.org/fin48guide.

On the Horizon

.57 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 may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS.

.58 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/members/div/auditstd/drafts.htm
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/members/div/acctstd/edo/index.htm
Financial Accounting Standards Board (FASB)	www.rutgers.edu/Accounting/raw/fasb/draft/draftpg.html
Public Company Accounting Oversight Board (PCAOB)	www.pcaobus.org or www.pcaob.com
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/members/div/ethics/index.htm
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 links to the other standard-setting bodies listed above.

Auditing Pipeline—Nonpublic Companies

Proposed Amendment to SAS No. 69, The Meaning of *Present Fairly In Conformity With Generally Accepted Accounting Principles*

.59 The ASB has 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 FASB proposed Statement, which can be obtained at www.fasb.org.

Proposed SSAE Regarding Reporting on an Entity's Internal Control Over Financial Reporting

.60 In January 2006, the ASB issued a revised exposure draft of a proposed 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). In May 2006, the PCAOB announced plans to amend certain aspects of PCAOB Auditing Standard No. 2 to improve its implementation. Because the forthcoming changes to the PCAOB standard will be relevant to the revision of AT section 501, the ASB has decided to defer the issuance of final revised AT section 501 until the PCAOB issues its amendments and the ASB has time to consider them.

Auditing Pipeline—Public Companies

.61 Guidance issued by the PCAOB is included in the section of this Alert titled "Recent Auditing and Attestation Pronouncements and Related Guidance." For pending projects for both the PCAOB and the SEC, readers may refer to the *SEC and PCAOB Alert—2006/07* (product no. 022497kk), mentioned previously.

Accounting Pipeline

.62 Following are accounting pronouncements currently in the exposure 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.

Proposed FASB Statement, Earnings per Share—an amendment of FASB Statement No. 128

.63 This proposed Statement would amend FASB Statement No. 128, *Earnings per Share*, to clarify guidance for mandatorily convertible instruments, the treasury stock method, contracts that may be settled in cash or shares, and contingently issuable shares. Specifically, the proposed Statement would:

- Amend the computational guidance for FASB Statement No. 128 for calculating the number of incremental shares included in diluted shares when applying the Treasury Stock method
- Eliminate the provisions of FASB Statement No. 128 that allow an entity to rebut the presumption that contracts with the option of settling in either cash or stock will be settled in shares
- Require that shares that will be issued upon conversion of a mandatorily convertible security be included in the weighted-average number of ordinary shares outstanding used in computing basic earnings per share from the date when conversion becomes mandatory

Proposed FASB Statement, Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140

.64 The exposure draft *Accounting for Transfers of Financial Assets* (Transfers Project) is a revision of a June 2003 exposure draft, *Qualifying Special-Purpose Entities and Isolation of Transferred Assets*, and would amend FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The proposed Statement seeks to:

- Clearly specify the permitted activities of a qualifying special-purpose entity (QSPE)
- Address practice issues related to which arrangements should be considered and how they should be considered in the legal isolation analysis
- Eliminate the prohibition on a QSPE's ability to hold passive derivative financial instruments that pertain to beneficial interests held by a transferrer
- Revise the methodology used to initially measure at fair value interests related to transferred financial assets held by a transferrer
- Clarify guidance related to when rollovers of beneficial interests are permitted within a QSPE

.65 At its July 26, 2006 meeting, the FASB decided to combine the servicer discretion project (which addressed issues relating to the waiver of due-on-sale, collateral substitution, and foreclosed asset activities) into the Transfers Project. The FASB expects to issue a final Statement, which would amend FASB Statement No. 140, in the second quarter of 2007. See the FASB Web site for complete information.

Proposed FASB Statements, Business Combinations—a replacement of FASB Statement No. 141 *and* Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries—a replacement of ARB No. 51

.66 In these proposed Statements, the FASB plans to revise the existing guidance on the application of the purchase method. Among the main proposals are that:

- 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

.67 Exposure drafts on business combinations—purchase method procedures and noncontrolling interests—were issued on June 30, 2005. Auditors should visit the FASB Web site for expected issuance dates.

Proposed FASB Statement, The Hierarchy of Generally Accepted Accounting Principles

.68 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 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—Nonpublic Companies" section of this Alert) to ensure that each of the documents has a uniform effective date. Readers should be alert for the issuance of a final Statement.

FASB Project on Derivative Disclosures

.69 FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* has been criticized by certain analysts, auditors, investors, and others for lacking transparent disclosures, which would allow a user of the financial statements to assess the overall risk of derivatives on a reporting entity from both a quantitative and qualitative perspective. An exposure draft was issued on December 8, 2006, titled *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133.* The comment deadline is March 2, 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. The proposed disclosures will be effective for both interim and annual reporting periods ending after December 15, 2007, with early application encouraged. At initial adoption, disclosures for earlier periods presented for comparative purposes will be encouraged but not required. Disclosures for earlier periods presented for comparative purposes will be required beginning in the first year after the year of initial adoption. Auditors can monitor the progress of this project on the FASB's Web site.

Proposed FASB Emerging Issues Task Force Issues and FSPs

.70 ***Proposed FASB Emerging Issues Task Force (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.

.71 ***Proposed FASB Staff Positions.*** A number of proposed FSPs are currently in progress. Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/proposed_fsp.shtml for complete information.

Resource Central

.72 The following are various resources that practitioners may find beneficial.

Publications

.73 The Audit Guide *Analytical Procedures* (product no. 012556kk) gives guidance on the effective use of analytical procedures with an emphasis on analytical procedures as substantive tests. This 2006 Guide includes SAS No. 56 concepts and definitions, a questions-and-answers section, an illustrative case study, and a new appendix that includes useful financial ratios.

.74 In the Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (2006) (product no. 012526kk), you will find an overview of derivatives and securities as well as case studies to help you better understand how to audit derivative instruments.

.75 The Audit Guide *Auditing Revenue in Certain Industries* (2006) (product no. 012516kk) assists auditors in fulfilling their professional responsibilities with regard to auditing assertions about revenue. In this edition, you will find:

- Discussions on responsibilities of management, boards of directors, and audit committees for reliable financial reporting
- Summaries on key accounting guidance regarding whether and when revenue should be recognized in accordance with GAAP or GAAS updated for SAS No. 99
- Circumstances and transactions that may signal improper revenue recognition
- Procedures that the auditor may find effective in limiting audit risk arising from improper revenue recognition

.76 The Audit Risk Alert *Compilation and Review—2006/07* (product no. 022307kk) updates CPAs on recent practice issues and professional standards that affect these types of engagements.

.77 The Audit Risk Alert *Independence and Ethics Alert—2006/07* (product no. 022477kk) will inform you of recent developments in the area of independence and ethics for accountants. Specifically, this Alert will help you understand your independence requirements under the AICPA Code of Professional Conduct and certain other rule-making and standard-setting bodies. A compact "plain English" digest of AICPA independence rules is also included. This Alert includes information on guidance on the performance of nonattest services to attest clients, SEC independence rules, PCAOB independence and ethics activities, and Government Accountability Office independence rules.

.78 The *SEC and PCAOB Alert—2006/07* (product no. 022497kk) will prove useful for accountants working in public companies, auditors of public companies, or just the interested accountant who would like to remain current on issues affecting public companies. This Alert provides preparers and auditors with a detailed overview of recent developments at the SEC and PCAOB with respect to financial reporting and auditing matters.

.79 The AICPA *Audit and Accounting Manual* (2006) (product no. 005136kk) is developed exclusively for small- and medium-size CPA practices. This unique manual explains and demonstrates useful techniques and procedures for conducting compilation, review, and audit engagements—from planning, to internal control, to accountants' reports.

.80 The *Accounting Trends & Techniques, 60th Edition* (product no. 009898kk) is the must-have resource for any CPA who frequently creates or uses financial reports. Filled with current reporting techniques and methods used by the nation's top organizations, this 650-page AICPA best-seller will provide the guidance you need to improve your accounting preparation and procedures.

AICPA reSOURCE: Accounting and Auditing Literature

.81 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. If you prefer to have access to the entire library, that is also available. 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

.82 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry. Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.83 AICPA CPExpress (formerly 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 ($319 for nonmembers) for the annual renewal. Divided into one- and two-credit courses that are available 24 hours a day, seven 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

.84 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.

Chief Financial Officer Quarterly Roundtable Series

.85 The Chief Financial Officer (CFO) 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

.86 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 Satisfaction Center

.87 To order AICPA products, receive information about AICPA activities, and find answers to your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.88 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

.89 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.

* * * *

This Audit Risk Alert replaces the general *Audit Risk Alert—2005/06*.

[*The next page is 8071*.]

AAM Section 8015
Compilation and Review Alert—2006/07

CURRENT ACCOUNTING
REPORTING AND PRACTICE ISSUES

NOTICE TO READERS
COMPILATION AND REVIEW ALERT—2006/07

This *Compilation and Review Alert—2006/07* is intended to provide CPAs with an update on recent practice issues and professional standards that affect compilation and review engagements. The document has not been approved, disapproved, or otherwise acted upon by any senior technical committee of the AICPA.

Written by J. Russell Madray, CPA

Edited by Lori L. Pombo, CPA
Technical Manager
Accounting and Auditing Publications

Acknowledgements

The Accounting and Auditing Publications Team would like to thank the members of the Accounting and Review Services Committee and its chair, Tom Ratcliffe, and Michael Glynn, Technical Manager, AICPA Audit and Attest Standards, for their invaluable contributions to this year's Alert. In addition, we would like to thank the following individuals for their help in reviewing this year's Alert:

Ahava Goldman, Technical Manager, AICPA Audit and Attest Standards

Charles Landes, Vice President, AICPA Professional Standards

Sue Lieberum, Senior Technical Manager, AICPA Peer Review Program

Lisa Snyder, Director, AICPA Professional Ethics Division

Our special thanks to J. Russell Madray who developed and wrote this Alert.

How This Alert Will Help You

.01 The *Compilation and Review Alert—2006/07* is a crucial tool, designed to help you as you plan and perform your 2006 and 2007 compilation and review engagements. The 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 of the codification and not the numbered statements, as appropriate. For example, SSARS No. 1 is referred to as AR section 100 of the AICPA *Professional Standards*.

The U.S. Business Environment

.03 In planning your compilation and review engagements, you need to understand the economic conditions facing your client's industry. Economic activities relating to such factors as interest rates, consumer confidence, overall economic expansion or contraction, inflation, and the labor market are likely to have an impact on your client.

.04 The bad news is the U.S. economy has slowed more dramatically than most economists expected, leaving it more vulnerable to a recession. The economy has shifted into a slower gear because of several factors, including the cooler housing market, the toll of once-surging energy prices, and the impact of the Federal Reserve's two-year string of interest rate increases. In fact, growth is getting closer to what some economists describe as the "stall speed," at which an unexpected shock such as a terrorist strike or a hurricane might be enough to trigger a recession. A mathematical model of the economy developed by Federal Reserve economist Jonathan Wright puts the chances of a recession over the next year at about 40 percent.

.05 And with recession risks rising, some Federal Reserve officials are becoming uneasy about the outlook. Although they remain on guard against the dangers of higher inflation, they say they're also paying more attention to the threats to growth. But most economists and Federal Reserve officials still expect the economy to avoid recession, helped by increased exports and business spending. Except for housing, the rest of the economy is healthy and robust.

.06 Unfortunately, one of the biggest wild cards is the magnitude of the housing slowdown. New-home sales in August were 17 percent below a year earlier and the median selling price was down 1.3 percent, the first year-over-year drop since 2003. Existing home sales were the lowest since early 2004, and prices fell for the first time in 11 years. Housing-related industries, including builders, mortgage brokers, and furniture makers, have shed some 40,000 jobs since March, according to Moody's Economy.Com, Inc., in West Chester, Pennsylvania. In the 1990-1991 housing slump, housing-related industries shed 825,000 jobs, or about 35,000 a month.

.07 Consumer spending will also take a hit as falling house prices discourage homeowners from borrowing against equity gains. Home equity withdrawal fell to an annual rate of $497 billion in the second quarter, from $649 billion in the first quarter and $817 billion in the final quarter of 2005, according to calculations supplied by the Federal Reserve. A fall in home prices across the nation would pose a significant threat to consumer spending. And the one-two punch of a slowing housing market and the large announced auto-production cuts by GM, Ford, and Chrysler is really going to slow the economy, according to some economists.

Small Business Confidence

.08 Private companies are a significant element of the U.S. economy. In fact, according to the National Federation of Independent Businesses (NFIB), four of five employing businesses have fewer than 20 people working in them, and only 17,000 of the nation's 4.9 million corporations are registered with the Securities and Exchange Commission (SEC). And, according to the White House, small and young companies create two-thirds of the net new jobs in our economy, and they employ half of all private-sector workers.

.09 In August, Discover Business Card released the results of the inaugural *Discover Small Business Watch*, a new monthly index of economic confidence of the nation's 22 million small businesses with five or fewer employees. The *Discover Small Business Watch* is based upon survey data compiled by Rasmussen Reports, a leading independent public opinion polling company.

.10 Among the key findings, the survey found that small business owners are more optimistic about the current state of the economy when compared to the general population, with 39 percent of small business owners rating the economy as "excellent" or "good," versus the 34 percent of the general population. However, nearly 60 percent of small business owners surveyed believed that economic conditions in the country are getting worse.

.11 In addition, an inaugural survey of more than 600 private business owners in the United States whose companies employ at least 50 people showed decidedly mixed views on the current and future state of the U.S. economy. Compiled by Rasmussen Reports, the *Matrix Founders Index* is a quarterly barometer of attitudes and opinions from those who have founded or acquired their own businesses. In the premier survey, entrepreneurs fairly evenly rated the U.S. economy as excellent (27 percent), good (26 percent), fair (24 percent), and poor (23 percent). They also were split about how well they expect the economy to perform in the near term: 43 percent thought the economy was getting better with 47 percent holding a contrary view. However, 29 percent felt that the United States was currently in a recession.

.12 Overall, the economic outlook is uncertain, which means you should pay close attention to how economic factors such as interest rates, consumer confidence, 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

.13 There have been no SSARS issued since the publication of last year's Alert; however, the Accounting and Review Services Committee (ARSC) is currently working on several projects which will be completed in the near future. They are summarized as follows.

Future SSARS Exposure Draft, *Elimination of Certain References to Statements on Auditing Standards and Incorporation of Appropriate Guidance Into Statements on Standards for Accounting and Review Services*

.14 In many instances, SSARSs 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 is currently developing an exposure draft of a proposed SSARS that will eliminate those references to auditing literature from SSARSs and, if deemed appropriate, guidance similar to that originally referenced will be incorporated into the SSARSs.

.15 Although the ARSC is still considering amendments to be included in the proposed standard, it is expected that it will amend 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* (AICPA, *Professional Standards*, vol. 2). In addition, all affected Interpretations will be conformed or withdrawn. Those affected Interpretations are:

- Interpretation No. 11, "Reporting on Uncertainties," in AR section 9100, *Compilation and Review of Financial Statements: Accounting and Review Services Interpretations of Section 100* (AICPA, *Professional Standards*, vol. 2), by deleting the reference to AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 2), and instead referring to the revised AR section 100 guidance

- Interpretation No. 15, "Differentiating a Financial Statement Presentation From a Trial Balance," in AR section 9100, by deleting the "typical titles" for financial statements and instead referencing the examples of financial statement titles included in AR section 100.04 as revised by the proposed Statement

- Interpretation No. 4, "Discovery of Information After the Date of the Accountant's Report," in AR section 9100, which is expected to be withdrawn

.16 The exposure draft is expected to be issued in the December 2006/January 2007 time frame. A final Statement, if approved, would be effective for compilations and reviews of financial statements for periods ending on or after December 15, 2007. Early application would be permitted.

Future SSARS Exposure Draft, *Omnibus Statement on Standards for Accounting and Review Services—2007*

.17 The ARSC is currently developing a draft Omnibus Statement on Standards for Accounting and Review Services. Although the ARSC is still considering amendments to be included in the proposed standard, it is expected that it will:

- Revise AR sections 100, 200, and 300 to conform to the terminology utilized by other standard setters, including the Auditing Standards Board (ASB) by replacing the term *nonpublic entity* with the term *nonissuer*.
- Clarify the objective of a compilation engagement and expand the definition in AR section 100.
- Revise AR section 100 to incorporate the guidance in Interpretation No. 12, "Reporting on a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles" in AR section 9100 (AICPA, *Professional Standards*, vol. 2), with respect to evaluating the adequacy of disclosure in financial statements prepared in conformity with an other comprehensive basis of accounting (OCBOA) and expand on such guidance.
- Revise AR section 100 to provide guidance with respect to the accountant's consideration of subsequent events in a compilation or review engagement.

.18 The ARSC plans to expose the proposed standard in the December 2006/January 2007 time frame.

ARSC's Consideration of Independence in a Compilation Engagement

.19 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. The purpose of the Discussion Memorandum/Survey was to elicit comments before the ARSC further considered the independence requirements related to compilation engagements. During the seven months that the Discussion Memorandum/Survey was available, the ARSC received over 4,300 responses.

.20 Eighty-two percent of those who responded to the survey were CPAs in public practice; 11 percent were CPAs in industry; 1 percent of the respondents indicated that they were third-party users of compiled financial statements; and 5 percent responded "other." The majority of those who responded "other" were, upon review, identified to be third-party users of compiled financial statements. Of those who responded that they were CPAs in public practice, 84 percent were from firms with ten or fewer partners.

.21 The ARSC identified the most significant issues as follows:

1. Whether the ARSC should amend AR section 100 to state that independence is not required in a compilation engagement.
2. Whether the ARSC should amend AR section 100 to allow the accountant to disclose, in the compilation report, the reasons for the independence impairment.

.22 Accordingly, the ARSC scheduled a public hearing in May 2006 to discuss these issues and the results of the following survey questions.

.23 ***Question:*** *Should the ARSC amend SSARS No. 1 to state that independence is not required in a compilation engagement and accordingly delete the requirement that the accountant disclose when he or she is not independent?*

.24 The survey provided the following responses to this question:

Yes	41.8 percent
No	50.1 percent
Undecided/Need More Information	6.9 percent
Not affected by this issue	1.2 percent

.25 In addition, the ARSC noted that 48 percent of CPAs in public practice; 57 percent of CPAs in industry; 77 percent of third-party users; and 66 percent of "other" respondents answered *no* to the above question.

.26 During the public meeting to discuss the results of the survey, the ARSC considered the above responses. In addition, the ARSC considered the potential for third-party users to be misled as to the accountant's independence if the report was silent as to an independence impairment. The ARSC concluded that since, other than the titles, review and audit reports are silent as to independence since accountants/auditors must be independent to perform those engagements, that a very real possibility exists that third-party users would assume that accountants were independent if the compilation report was silent. The ARSC concluded that it would be inappropriate to revise AR section 100 to state that independence is not required in a compilation engagement and, accordingly, delete the requirement that the accountant disclose when he or she is not independent. The ARSC also discussed the results of the following survey question:

.27 ***Question:*** *If the existing independence requirements with respect to compilation engagements are retained, should the ARSC consider amending SSARS No. 1 to allow the accountant to describe the reason(s) for a lack of independence in the accountant's compilation report?*

.28 The survey provided the following responses to this question.

Yes	57.9 percent
No	32.5 percent
Not Sure/Don't Know	9.6 percent

.29 In addition, the ARSC noted that 56 percent of CPAs in public practice; 67 percent of CPAs in industry; 88 percent of third-party users; and 63 percent of "other" respondents answered *yes* to the above question.

.30 During the public meeting to discuss the results of the survey, the ARSC considered the above responses. The ARSC was especially moved by the response of the third-party users and the "other" respondents. The ARSC determined that more information was needed as to what those users of compiled financial statements would want to see in compilation results. Therefore, the ARSC has reached out to the American Bankers Association in order to facilitate a meeting. That meeting, which is tentatively scheduled for September 2007, will serve as the basis for a broader project on the accountant's compilation report.

Current Practice Issues

Conceptual Framework for AICPA Independence Standards

.31 The Professional Ethics Executive Committee (PEEC) has adopted a "Conceptual Framework for AICPA Independence Standards" (Conceptual Framework) (AICPA, *Professional Standards*, vol. 2, ET sec.

100.01), and a related revision to "Other Considerations" of Interpretation No. 101-1, "Interpretation of Rule 101" (AICPA, *Professional Standards*, vol. 2, ET sec. 101.02) under Rule 101, *Independence*, of the Code of Professional Conduct (the Code). The provisions of the Conceptual Framework for AICPA Independence Standards and the related revision to "Other Considerations" of Interpretation No. 101-1 are effective for all independence decisions made after April 30, 2007. Earlier application is encouraged.

Revision to Interpretation No. 101-1

.32 The PEEC recognizes that it is impossible to enumerate all circumstances in which the appearance of independence might be questioned. Therefore, in the absence of an independence interpretation or ruling under Rule 101 that addresses a particular circumstance, a member should evaluate whether that circumstance would lead a reasonable person aware of all the relevant facts to conclude that there is an unacceptable threat to the member's and the firm's independence. When making that evaluation, members should refer to the risk-based approach described in the Conceptual Framework for AICPA Independence Standards. If the threats to independence are not at an acceptable level, safeguards should be applied to eliminate the threats or reduce them to an acceptable level. In cases in which 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 should be documented.

Conceptual Framework

.33 The Conceptual Framework describes the risk-based approach to analyzing independence matters that is used by the PEEC when it develops independence standards. Under that approach, a member's relationship with a client is evaluated to determine whether it poses an unacceptable risk to the member's independence. Risk is unacceptable if the relationship would compromise (or would be perceived as compromising by an informed third party having knowledge of all relevant information) the member's professional judgment when rendering an attest service to the client. Key to that evaluation is identifying and assessing the extent to which a threat to the member's independence exists and, if it does, whether it would be reasonable to expect that the threat would compromise the member's professional judgment and, if so, whether it can be effectively mitigated or eliminated. Under the risk-based approach, steps are taken to prevent circumstances that threaten independence from compromising the professional judgments required in the performance of an attest engagement.

.34 Professional standards of the AICPA require independence for all attest engagements. The PEEC bases its independence interpretations and rulings under ET section 100 of the AICPA's Code on the concepts in this framework. However, in certain circumstances, the PEEC has determined that it is appropriate to prohibit or restrict certain relationships notwithstanding the fact that the risk may be at an acceptable level. For example, the PEEC has determined that a covered member should not own even an immaterial direct financial interest in an attest client.

.35 Because the Conceptual Framework describes the concepts upon which the AICPA's independence interpretations and rulings are based, it may assist AICPA members and others in understanding those interpretations and rulings. In addition, the Conceptual Framework should be used by members when making decisions on independence matters that are not explicitly addressed by the Code. Under no circumstances, however, may the framework be used to overcome prohibitions or requirements contained in the independence interpretations and rulings.

.36 The risk-based approach entails evaluating the risk that the member would not be independent or would be perceived by a reasonable and informed third party having knowledge of all relevant information as not being independent. That risk must be reduced to an acceptable level to conclude that a member is independent under the concepts in this framework. Risk is at an acceptable level when threats are at an acceptable level, either because of the types of threats and their potential effect, or because safeguards have sufficiently mitigated or eliminated the threats. Threats are at an acceptable level when it is not reasonable to expect that the threat would compromise professional judgment.

.37 The risk-based approach involves the following steps:

a. *Identifying and evaluating threats to independence*—Identify and evaluate threats, both individually and in the aggregate, because threats can have a cumulative effect on a member's independence. If threats are identified but, due to the types of threats and their potential effects, such threats are considered to be at an acceptable level (that is, it is not reasonable to expect that the threats would compromise professional judgment), the consideration of safeguards is not required. If identified threats are not considered to be at an acceptable level, safeguards should be considered as described in the Conceptual Framework.

b. *Determining whether safeguards already eliminate or sufficiently mitigate identified threats and whether threats that have not yet been mitigated can be eliminated or sufficiently mitigated by safeguards*—Different safeguards can mitigate or eliminate different types of threats, and one safeguard can mitigate or eliminate several types of threats simultaneously. When threats are sufficiently mitigated by safeguards, the threats' potential to compromise professional judgment is reduced to an acceptable level. A threat has been sufficiently mitigated by safeguards if, after application of the safeguards, it is not reasonable to expect that the threat would compromise professional judgment.

.38 If no safeguards are available to eliminate an unacceptable threat or reduce it to an acceptable level, independence would be considered impaired.

> **Help Desk**—The Conceptual Framework can be found at www.aicpa.org/about/code/et_100.html and the revised "Other Considerations" section in Interpretation No. 101-1 can be found at www.aicpa.org/about/code/et_101.html#et_101.02.

Preparing Financial Statements for Audit by Another Firm

.39 In today's environment, primarily driven by independence concerns, a client may engage an accountant (or his or her firm) other than the independent auditor, as an advisory accountant to assist management in certain recurring accounting or reporting functions (for example, bookkeeping or assistance in preparing financial statements or notes, performing fair value impairment tests, or assistance in preparing regulatory filings). In this capacity, the advisory accountant may be frequently asked to provide advice on the application of accounting principles or to assist management in formulating its accounting positions prior to discussing such positions with its auditor.

.40 In order to provide guidance to accountants who are engaged as advisory accountants and to help those accountants understand their obligation to consult with the auditor under AU section 625, *Reports on the Application of Accounting Principles,* as amended (AICPA, *Professional Standards*, vol. 1), the ASB issued an interpretation in January 2005.

.41 According to paragraph .08 of Interpretation No. 1, "Requirement to Consult With the Continuing Accountant," in AU section 9625 (AICPA, *Professional Standards*, vol. 1), an important distinction to consider in overcoming the presumptive requirement to consult with the auditor is the nature of the engagement and whether the services are recurring as contrasted to periodic. A recurring engagement may constitute the effective outsourcing of certain controllership or other financial reporting functions that would typically not be indicative of opinion shopping and would typically allow the nonauditor accountant to have complete access to management. If you are engaged in the capacity of an advisory accountant, you nonetheless should be alert to any instances in which the client attempts to use you to "opinion shop." You should establish an understanding with the client that includes a statement that the responsibility for the proper accounting treatment rests with management, who should consult with their auditor, and that the client, along with you, will notify the auditor and members of any governance body (such as audit committee) of the arrangement.

.42 You should document your conclusion that consultation with the auditor was not considered necessary under the circumstances. Additionally, you should comply with the other requirements of AU section 625, including AU section 625.08, which requires you to:

- Obtain an understanding of the form and substance of the transaction(s);
- Review applicable generally accepted accounting principles (GAAP);
- If appropriate, consult with other professionals or experts; and
- If appropriate, perform research or other procedures to ascertain and consider the existence of creditable precedents or analogies.

.43 Another question that often arises in these circumstances is whether the advisory accountant must report on the financial statements that are prepared and submitted to be audited by another firm. According to Interpretation No. 21, "Applicability of SSARS No. 1 When Performing Controllership or Other Management Services" in AR section 9100 (AICPA, *Professional Standards*, vol. 2), if you are in the practice of public accounting and provide an entity (who is not an issuer) with services such as those above (including submitting financial statements), you must follow the performance and communication requirements of AR section 100, including any requirement to disclose a lack of independence. In other words, any financial statements you submit as a result of these services that will be used by a third party (as defined in AR section 100.04), even if they are only submitted to the auditor, should generally be accompanied by an appropriate compilation report.[1]

Proposed SQCS, *A Firm's System of Quality Control*

.44 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 harmonization with International Statement of Quality Control Standard (ISQC) 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 is comprised of members from the ASB, the ARSC, the Peer Review Board and the Center for Public Companies Audit Firms Peer Review Committee.

.45 At its June 2006 meeting, the ASB requested that the task force consider the need to revise existing standards (specifically AU section 161, *The Relationship of Generally Accepted Auditing Standards to Quality Control Standards* [AICPA, *Professional Standards*, vol. 1]) to converge with International Standards on Auditing (ISA) 220, *Quality Control for Audits of Historical Financial Information*. The SQCSs and ISQC No. 1 apply at the firm level, while ISA 220 and AU section 161 apply to the engagement. The task force is also considering whether revisions to the attestation standards and SSARSs (AR section 100.70–.72) are necessary, and if so, their nature and extent.

.46 In July 2006, the ASB issued an exposure draft of a proposed SQCS, *A Firm's System of Quality Control*. The exposure draft introduces a proposed SQCS that will replace all existing SQCSs. This proposed SQCS establishes standards and provides guidance for a CPA firm's responsibilities for its system of quality control for its accounting and auditing practice. It describes elements of quality control and other matters essential to the effective design, implementation, and maintenance of the system. The proposed SQCS also sets forth the meaning of certain terms used in SQCSs issued by the ASB in describing the professional requirements imposed on firms and practitioners-in-charge.

.47 The proposed SQCS deals comprehensively with a firm's quality control practices in the areas of audits, reviews and compilations, and other attestation engagements. It places an unconditional obligation

[1] Interpretation No. 21, "Applicability of SSARS No. 1 When Performing Controllership or Other Management Services," in AR section 9100 (AICPA, *Professional Standards*, vol. 2) provides an option to a report under AR section 100 when an accountant engaged to perform controllership or other management services is in the practice of public accounting and is also an owner or employee of the client.

on a firm to establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and applicable regulatory and legal requirements, and that the reports issued by the firm or engagement partners are appropriate in the circumstances.

.48 The proposed SQCS defines the engagement quality control review and requires firms to establish criteria to determine which engagements are to be subject to an engagement quality control review. It also provides guidance on policies and procedures for performing engagement quality control reviews. An engagement quality control review should include a review of the financial statements or other subject matter information and the report, and, in particular, consideration of whether the report is appropriate. The proposed SQCS states that an engagement quality control review also should include any of the following:

1. A discussion with the practitioner-in-charge
2. A review of selected working papers relating to the significant judgments the engagement team made and the conclusions they reached, or
3. Both discussion and review

.49 The decision to review selected working papers in addition to or instead of discussion with the practitioner-in-charge depends on the complexity of the engagement and the risk that the report might not be appropriate in the circumstances.

.50 In addition, the proposed SQCS:

- Defines the terminology the ASB will use to describe the degrees of responsibility that the requirements in SQCSs impose on firms. There are two categories of requirements:
  1. *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.
  2. *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 firm documents its 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.
- 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:
  1. Leadership responsibilities for quality within the firm ("tone at the top");
  2. Independence, integrity, objectivity, and other legal and ethical requirements;
  3. Acceptance and continuance of client relationships and specific engagements;
  4. Human resources (formerly personnel management);
  5. Engagement performance and engagement documentation; and
  6. Monitoring.
- Recognizes the importance of a quality-oriented internal culture, and requires firms to assign its management responsibilities so that commercial considerations do not override the objectives of the

system of quality control, and to design its policies and procedures addressing personnel performance evaluation, compensation, and promotion 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 opinion, including a requirement that reports must not be issued until the differences of opinion are resolved.
- Requires annual monitoring procedures. Firms are required to assign responsibility for monitoring to a person of appropriate authority, and are required to evaluate deficiencies and communicate recommendations for remedial action.
- 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.

.51 The exposure draft can be obtained at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Exposure+Drafts+of+Proposed+Statements/A_Firms_System_of_Quality_Control.htm. The exposure period ended on September 30, 2006. Letters of comment received on the exposure draft can be viewed at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Exposure+Drafts+of+Proposed+Statements/A+Firms+System+of+Quality+Control. A final standard is expected to be issued in the second quarter of 2007.

Business Risks Associated With Accounting and Review Services

.52 As the underwriter of the AICPA Professional Liability Insurance Program, Continental Casualty Company (CNA) provides professional liability insurance to more than 24,000 CPA firms nationwide. According to CNA, a longstanding problem in defending accountants' malpractice claims has been client disputes regarding scope of services. Oftentimes, claimants allege that their CPA failed to advise them on a specific issue or failed to provide a service that they thought was being provided, and that they suffered damages as a result.

.53 In addition, CNA has noted that in malpractice claims arising from engagements for general accounting or bookkeeping services to small businesses, often a central issue in the claim is the lack of an explicit understanding with the client regarding the scope of services being provided. Many of these claims arise from embezzlement losses suffered by the client. CPAs that issue engagement letters in this practice area often include the disclaimer included in sample engagement letters in the appendixes to SSARS, which reads as follows:

> Our engagement cannot be relied upon to disclose errors, fraud, or illegal acts that may exist. However, we will inform the appropriate level of management of any material errors and of any evidence or information that comes to our attention during the performance of our compilation procedures, that fraud may have occurred. In addition, we will report to you any evidence or information that comes to our attention during the performance of our compilation procedures, regarding illegal acts that may have occurred unless they are clearly inconsequential.

.54 Although such language is helpful, according to CNA, by itself the language does not provide adequate protection to practitioners from such embezzlement-related claims. The reasons for this include the following:

- Claims typically allege that the CPA failed to detect and report to management issues that might indicate embezzlement is occurring, rather than actual evidence of embezzlement. Examples include the untimely posting of receipts, unexplained bank account reconciliation items, repeated payments to vendors that the client hadn't used previously, or unusually high credit card charges.

- Claims also allege that the CPA failed to timely alert the client to obvious internal control weaknesses, such as a lack of segregation of duties, and that, had they done so, the client would have addressed the problem and prevented subsequent embezzlement.

- In addition, claims allege that CPAs failed to detect fraud in engagements that included periodic or regular reconciliation of the client's bank statement against their check register. In these claims, the clients frequently allege that the CPA failed to note that the payee name on one or more of the canceled checks did not match the payee name on the check register, or that the signature on the checks did not match those on file at the client as authorized signatories. In many cases, the CPA did not review the checks either because they considered this to be outside of the scope of their engagement responsibilities or because the checks were not provided with the bank statement. The client simply presumed that the CPA would receive the checks and compare the payees and signatures on the checks to the check register and signatures on file to check for possible fraud.

- Last, claims allege that the CPA had knowledge of internal control weaknesses and indicators of possible fraud or embezzlement by virtue of their ongoing handling of the client's books and records and contacts with the client's employees. This allegation is typically supported by statements pointing out the CPA's multiyear relationship with the client and extensive contacts with the client through ongoing monthly work.

.55 The bottom line is, although engagement letters are very important, you should make it clear to your client that it is management's responsibility to prevent and detect fraud. An effective way to do this is to educate your client as to the importance of internal control in the prevention of fraud. You are then in a position to work with your client in a separate consulting engagement to improve the client's internal control. One advantage is the client's increased awareness of the importance of internal control, which will aid in the design of suitable controls. Controls will result in the reduction of the risk of fraud and errors. In addition, this exercise clarifies management's responsibility to prevent and detect fraud, thereby reducing your legal risk.

Letter Requests From Lenders and Mortgage Brokers

.56 AICPA members have contacted the AICPA to clarify their professional ethical obligations when asked for "comfort letters" by lenders and mortgage brokers. Depending on how practitioners respond to such requests, they may be at risk for failing to comply with AICPA professional standards. In these situations, a number of CPAs may violate professional standards unknowingly; others may cave in to brokers' threats to undermine the CPA-client relationship. CPAs can ethically and effectively address these situations if they are aware of and stick to their professional obligations.

.57 Many CPAs think of a comfort letter as a letter from a CPA to a company involved in a bond offering, an initial public offering (IPO), or a stock placement, that allows the company to assure the underwriter concerning the offering document and the company's financial reports. These letters are discussed in AU section 634, *Letters to Underwriters and Certain Other Requesting Parties* (AICPA, *Professional Standards*, vol. 1).

.58 The comfort letters at issue are similar in intent. These letters are usually associated with stated income loans, which are mortgages that do not require borrowers to document their income. Such loans usually are sought by borrowers whose income sources are difficult to verify or fluctuate from year to year. Self-employed people and individuals with investment income or with sales jobs of varying commissions often apply for stated income loans. Lenders, lacking documentation to support borrowers' income claims, take on the risk that borrowers' claims are inadequate. Because of the higher risk, lenders charge higher interest rates. To gain more comfort in extending loans, some lenders look to the borrowers' CPA for assurance about the stated income amount.

.59 In an effort to minimize their risk, brokers typically ask CPAs to vouch for their clients with a letter supporting clients' claims relating to income and their self-employment. If they arise, these situations can place you at risk in two ways. First, your response must be in compliance with professional standards. If you point out to the broker that reporting on solvency in this situation would be unethical or that a request requiring examining a personal balance sheet and earnings forecast would be expensive, the broker may exert pressure by threatening to suggest that the client change CPAs.

.60 You can protect yourself against the risks associated with these situations, but first you must understand what is and is not permissible. Attestation Interpretation No. 2, "Responding to Requests for Reports on Matters Relating to Solvency" in AT section 9101, *Attest Engagements: Attest Engagements Interpretations of Section 101* (AICPA, *Professional Standards*, vol. 1), provides guidance to the practitioner when he or she receives such requests. Essentially, this Interpretation states that you should not provide any form of assurance relating to matters of solvency, but there are services that you may perform. If a mortgage broker or lender really wants an attest report from you, then you may audit, review, or compile the personal financial statements of the borrower, you may report on pro forma or prospective financial information of the borrower, or you may perform and provide to the client and lender an agreed-upon procedures report, as long as the agreed-upon procedures do not provide any assurance on matters relating to solvency. Brokers tend to ask for as much assurance as they can get without understanding or knowing the cost or consequences. However, once you explain to your client and the broker the cost entailed, they typically back off their request. Instead, the brokers may be satisfied with a simple letter from you acknowledging that the income reported to the broker or lender is the amount that has been reported to the Internal Revenue Service (IRS) on the tax return. Obviously, the client would need to agree to have you send such a letter.

.61 In these situations, you can avoid risk by sticking to your professional responsibilities, following professional standards and not caving in to undue pressure. Also, many insurance providers are aware of this practice and as a result have developed sample letters or templates for CPAs to use in these situations. You should contact your insurance provider and inquire whether they have any additional guidance or sample letters that you could use for these requests.

Current Accounting and Reporting Issues

Handling GAAP Departures

.62 If, in the course of a compilation or review engagement, you become aware of a material departure from GAAP or OCBOA, you have the following three possible courses of action:

- Persuade the client to revise the financial statements (usually the preferred course of action).
- Refer to the material departure in the compilation or review report.
- Withdraw from the engagement (if you believe the client's intent is to mislead financial statement users).

Report Modification Is Adequate

.63 If you decide that the departures can be adequately described in the report, a modified report can be issued. The modification consists of adding a separate paragraph to the report in which the departure is described. In addition, in a compilation report, the accountant adds a sentence at the end of the second paragraph indicating that he or she became aware of a departure from GAAP or OCBOA. In a review report, the accountant revises the third paragraph by adding "with the exception of the matters described in the following paragraphs" prior to the statement that the accountant is not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with GAAP or OCBOA. If known to you, the effect of the departure on the financial statements should be disclosed in the separate paragraph. If the effect of the departure is not known, however, you are not required to determine the effect. When the effect is not known, you must state this fact in the separate paragraph. The following is an example of this additional paragraph:

> Generally accepted accounting principles require that income taxes be accrued. Management has informed us that the Company has not accrued income taxes in the accompanying financial statements, and the effects of this departure from generally accepted accounting principles has not been determined.

Report Modification Is Inadequate

.64 In some circumstances, you may conclude that it would be inadequate to simply add a separate paragraph (or paragraphs) to the report to explain the departure (or departures). If you conclude that the modification to the standard report is not adequate to describe the effects of the departure, AR section 100 states that you should withdraw from the engagement and provide no further services on the financial statements. In addition, you should consider consulting legal counsel and your professional liability carrier.

.65 Generally, you would reach such a conclusion when it appears that the client's intention is to deceive users of the financial statements. Although it is difficult to provide specific guidance for determining when it is inappropriate to issue a report, Interpretation No. 6, "Withdrawal From Compilation or Review Engagement," in AR section 9100 (AICPA, *Professional Standards*, vol. 2) provides the following two illustrations of situations in which the accountant considers whether the client's intent is to deceive users of the financial statements:

1. The client may have entered into a number of leasing arrangements that might be required to be capitalized under Financial Accounting Standards Board (FASB) Statement No. 13, *Accounting for Leases*. The client may not wish to capitalize such leases and may not have determined the effect of this departure from GAAP. However, the client may be willing to disclose in the financial statements information such as the nature of the leased property, the payments required under the leases, and other important terms of the leases. In those circumstances, the accountant is not likely to conclude that the departure was undertaken with the intention of misleading users, even though the effect of the departure is not quantified in the financial statements or the accountant's report.

2. The client may have failed to provide for doubtful accounts and probable sales returns in the face of significant adverse business and economic conditions and may be unwilling to acknowledge that an adjustment should be considered. This might cause the accountant to question whether other information the client provided is incorrect, incomplete, or otherwise unsatisfactory. Also, the accountant's general knowledge of the entity's business and related matters might lead him or her to conclude that this position indicates an intent to mislead users, particularly if the effects of the departure are not determined.

Common Peer Review Findings

Recurring Deficiencies Noted in Compilation and Review Engagements

.66 In 2005, the AICPA Peer Review Program reported approximately 9,500 peer reviews, of which approximately 5,000 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.

Significant Deficiencies

.67 Significant deficiencies include matters that are normally material to understanding the report or financial statements or represent critical SSARS procedure. An engagement with a significant deficiency is normally considered substandard, although careful judgment is required when forming a conclusion. Although this list is not all-inclusive, it does contain the most common, recurring deficiencies. In addition, we have included practical examples and explanations of these deficiencies that you should try to avoid.

Reports, Financial Statement Measurement, Presentation, and Disclosure

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 (i.e., modifying the review report for a lack of independence is inappropriate).
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.
Failure to disclose an OCBOA for financial statements compiled without disclosure, where the basis of accounting is not readily determinable from reading the report	Interpretation No. 12, "Reporting on a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles," in AR section 9100, provides example language that should be added to the end of the first paragraph of the compilation report in these circumstances. For tax-basis financial statements, the wording is as follows; similar wording should be added to compilation reports prepared on the cash/modified-cash basis: The financial statements have been prepared on the accounting basis used by the Company for federal income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles. *Practice Note:* Interpretation No. 12 also contains "model" report wording for review reports issued on OCBOA financial statements.
Failure to disclose, in the accountant's report, a material departure from professional standards (examples include the nonconsolidation of appropriate subsidiaries with a parent company's financial statements; omission of significant income tax provisions in interim financial statements; omission of significant disclosures related to material defined employee	Material departures should be identified in the compilation or review report. For compilation reports, wording should be added to the end of the second paragraph as follows: However, we did become aware of a departure from generally accepted accounting principles that is described in the following paragraph. In review reports, the third paragraph of the review report should be modified as follows:

(continued)

benefit plans; or nonrecognition of significant deferred income)	Based on our review, with the exception of the matter described in the following paragraph, 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. Then a GAAP departure paragraph should be added as the final paragraph in both compilation and review reports.
Inclusion of material balances that are not appropriate for the basis of accounting used	One of the major concerns pertaining to this deficiency relates to compilations/reviews of cash/modified-cash basis financial statements. It is not uncommon to see trade receivables recorded in these financial statements. If the receivables are recognized in the statements, then the "offsetting credit" relates to the fact that revenues are being recognized as they are earned (accrual basis). CPAs are reminded that they may "cross the line" when modifying the cash basis of accounting so that the financial statements essentially are accrual-based financial statements rather than cash/modified-cash basis financial statements. Also, it still is not uncommon to see start-up expenses (i.e., organization costs) capitalized and amortized in GAAP-basis financial statements. CPAs are reminded that, pursuant to the provisions of SOP 98-5, *Reporting on the Costs of Start-Up Activities*, these type costs should be expensed as incurred in GAAP-basis financial statements (although they still should be capitalized and amortized in tax-basis financial statements). Including start-up expenses as an asset in GAAP-basis financial statements is inappropriate. As a final example, it is inappropriate to include a provision for tax in financial statements of a partnership. Since a partnership is a *flow-through* entity in which taxes are paid by the partners, there should be no provision for tax related to the *distribution to partners* so that the partners can cover their pro rata share of the tax liability. *Practice Note*: This listing of practical examples is not inclusive. CPAs are reminded to be very careful not to confuse personal and business financial assets when preparing and reporting on financial statements of a proprietorship.
Failure to include a material amount or balance necessary for the basis of accounting used (examples include the omission of material accruals, failure to provide for material losses or doubtful accounts, or failure to provide for material deferred income taxes)	Essentially, this is an issue of a departure from GAAP or OCBOA, as discussed above. For example, if a provision for tax is not included in the financial statements of a C Corporation or the accrual of compensated absences is omitted from GAAP-basis financial statements. These departures, if material, should result in modification of the compilation or review report to indicate that the departure exists.

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.
Improper accounting of a material transaction (for example, recording a capital lease as an operating lease)	This is another GAAP departure issue. These departures, if material, should result in modification of the compilation or review report to indicate that the departure exists.
Misclassification of a material transaction or balance	You should make sure that items, transactions, and events are classified appropriately in the financial statements.
Failure to segregate the statement of cash flows into the components of operating, investing, and financing activities	It is not uncommon to see amounts misclassified within the three sections. For example, "advances to owners" should be classified as an investing activity, while "advances from owners" should be classified as a financing activity—it is not appropriate to "net" the items.
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 a statement of income and retained earnings when referred to in the report	The compilation or review report should refer to the actual financial statements included in the presentation. CPAs are reminded to modify your report if certain statements are not included in the financial statements. Also, the statement of retained earnings is not a required financial statement.

(continued)

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

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.
Failure to obtain a client management representation letter for a review engagement	A management representation letter is required in all review engagements. These letters are not required in compilation engagements.
Failure to include, in a management-use-only engagement letter, required language for communicating the understanding of the engagement for financial statements that are prepared for management use only, except for the failure to refer to the level of responsibility on supplementary information, which is not a significant deficiency	Refer to AR section 100 for a list of requirements for a management-use-only compilation engagement letter.

.68 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.

Accounting Pronouncements and Guidance Update

.69 Presented below is a list of recently issued accounting pronouncements and other guidance issued since the publication of last year's Alert. For summaries of these pronouncements, or to obtain copies of them, visit the applicable Web site of the issuing body. 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. 155	*Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*
FASB Statement No. 156	*Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140*

FASB Statement No. 157	*Fair Value Measurements*
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)*
FASB Interpretation No. 48	*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).
AICPA Technical Practice Aids 5600.07–5600.17 (November 2005) (Nonauthoritative)	Various lease topics
AICPA Technical Practice Aid 2130.09–2130.35 (December 2005) (Nonauthoritative)	Various topics related to SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*
AICPA Technical Practice Aid 6910.16–6910.20 (January 2006) (Nonauthoritative)	"Nonregistered Investment Partnerships"
AICPA Technical Practice Aid 1400.29–1400.31 and 1500.06 (April 2006) (Nonauthoritative)	Various topics related to FASB Interpretation 46(R), *Consolidation of Variable Interest Entities*
AICPA Technical Practice Aid 2130.36–2130.37 (May 2006) (Nonauthoritative)	"Impact on Cash Flows on a Group of Loans Accounted for as a Pool in Accordance with SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*"
AICPA Technical Practice Aid 1400.32 (June 2006) (Nonauthoritative)	"Parent-Only Financial Statements and Relationship to GAAP"

.70 Some of the standards are summarized below. These summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard.

FASB Statement No. 157, *Fair Value Measurements*

.71 This Statement defines fair value, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, the FASB having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. However, for some entities, the application of this Statement will change current practice.

.72 The changes to current practice resulting from the application of this Statement relate to the definition of fair value, the methods used to measure fair value, and the expanded disclosures about fair value measurements.

.73 This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, 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.

.74 The provisions of this Statement should be applied prospectively as of the beginning of the fiscal year in which this Statement is initially applied, except as follows. The provisions of this Statement should be applied retrospectively to the following financial instruments as of the beginning of the fiscal year in which this Statement is initially applied (a limited form of retrospective application):

1. A position in a financial instrument that trades in an active market held by a broker-dealer or investment company within the scope of the AICPA Audit and Accounting Guides for those industries that was measured at fair value using a blockage factor prior to initial application of this Statement.
2. A financial instrument that was measured at fair value at initial recognition under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, using the transaction price in accordance with 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," prior to initial application of this Statement.
3. A hybrid financial instrument that was measured at fair value at initial recognition under FASB Statement No. 133 using the transaction price in accordance with the guidance in FASB Statement No. 133 (added by FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*) prior to initial application of this Statement.
4. The transition adjustment, measured as the difference between the carrying amounts and the fair values of those financial instruments at the date this Statement is initially applied, should be recognized as a cumulative-effect adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for the fiscal year in which this Statement is initially applied.

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)*

.75 This Statement 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.

.76 This Statement requires an employer that is a business entity and sponsors one or more single-employer defined benefit plans to:

1. 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.

2. 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 Statements No. 87 and No. 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.

3. 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).

4. 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.

.77 This Statement also applies to a not-for-profit organization or other entity that does not report other comprehensive income. This Statement's reporting requirements are tailored for those entities.

.78 This Statement amends FASB Statements No. 87; No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*; No. 106, and No. 132 (revised 2003), *Employers' Disclosures about Pensions and Other Postretirement Benefits*; and other related accounting literature. Upon initial application of this Statement and subsequently, an employer should continue to apply the provisions in FASB Statements No. 87, No. 88, and No. 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.

.79 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 are met:

1. 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.

2. 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.

3. The employer is controlled by an entity covered by items 1 or 2.

.80 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.

.81 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.

.82 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:

1. A brief description of the provisions of this Statement.
2. The date that adoption is required.
3. The date the employer plans to adopt the recognition provisions of this Statement, if earlier.

.83 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 Statements No. 88 or No. 106 is required to be recognized in earnings or changes in unrestricted net assets of that quarter.

.84 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.

FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*

.85 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 a tax position 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.

.86 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.

.87 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

.88 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.

.89 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.

.90 This Interpretation is effective for fiscal years beginning after December 15, 2006. Earlier application of the provisions of this Interpretation is encouraged if the enterprise has not yet issued financial statements, including interim financial statements, in the period this Interpretation is adopted.

Recent AICPA Independence and Ethics Pronouncements

.91 The AICPA *Independence and Ethics Alert—2006/07* (product no. 022477kk) contains a complete update on new independence and ethics pronouncements. Some recent developments pertain to gifts and entertainment, requests for client records, and the Conceptual Framework, which was mentioned earlier in this Alert. The Independence and Ethics Alert can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com. Readers should obtain that Alert to be aware of independence and ethics matters that will affect their practice.

On the Horizon

.92 Practitioners should keep abreast of accounting and reporting developments and upcoming guidance that may affect engagements. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP. The AICPA General *Audit Risk Alert—2006/07* (product no. 022337kk) summarizes some of the more significant outstanding exposure drafts.

.93 Additionally, the following table lists the various standard-setting bodies' Web sites where information regarding outstanding exposure drafts may be obtained. Also see Appendix A, "Additional Web Resources," of this Alert for a more complete list.

Standard-Setting Body	*Web Site*
AICPA Auditing Standards Board (ASB)	www.aicpa.org/members/div/auditstd/drafts.htm
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/members/div/acctstd/index.htm
AICPA Accounting and Review Services Committee (ARSC)	www.aicpa.org/members/div/auditstd/index.htm
Governmental Accounting Standards Board (GASB)	www.gasb.org
Financial Accounting Standards Board (FASB)	www.fasb.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 at www.aicpa.org. The AICPA will notify interested parties by e-mail about new exposure drafts. To have your e-mail address put on the notification list for all AICPA exposure drafts, send your e-mail address to memsat@aicpa.org. Indicate "exposure draft email list" in the subject header field to help process the submissions more efficiently. Include your full name, mailing address and, if known, your membership and subscriber number in the message. The AICPA Web site also has connecting links to the other standard-setting bodies listed above.

SSARS Pipeline

.94 The AICPA ARSC is currently working on the following potential new projects.

Potential Project on Planning and Supervision

.95 Rule of Conduct 201, *General Standards* (AICPA, *Professional Standards*, vol. 2) of the AICPA Code states:

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

.96 Currently, the guidance for planning and supervising with respect to a compilation or review engagement is included in Interpretation No. 5, "Planning and Supervision" (AICPA, *Professional Standards*, vol. 2) in AR section 9100. That Interpretation states that although AU section 311, *Planning and Supervision*, does not govern engagements to compile or review financial statements of a nonpublic entity, an accountant may wish to consider the auditing standards or other reference sources, such as textbooks and articles, when he or she needs additional information on planning and supervision. The ARSC will consider issuing a proposed SSARS that would provide guidance on planning and supervising a compilation or review engagement. The ARSC tentatively plans to expose such a proposed SSARS during the third quarter of 2007.

Potential Project on Use of Terms

.97 In December 2005, the ASB issued SAS No. 102, *Defining Professional Requirements in Statements on Auditing Standards*, and Statement on Standards for Attestation Engagements (SSAE) No. 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements.* Those standards define the terminology the ASB will use to describe the degrees of responsibility that the requirements impose on the auditor or the practitioner. The standards define two categories of professional requirements—"unconditional requirements" (indicated by the words *must* or *is required*) and "presumptively mandatory requirements" (indicated by the word *should*). The ARSC will consider issuing a proposed SSARS that would define the terminology the ARSC will use to describe the degrees of responsibility that the SSARS impose on the accountant. The ARSC tentatively plans to expose such a proposed SSARS during the fourth quarter of 2007.

Potential Recodification of SSARS

.98 The ARSC is considering a reorganization of the Codification of Statements on Standards for Accounting and Review Services. The resulting Codification would be organized as follows:

- SSARSs 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

The ARSC tentatively plans to expose a proposed SSARS during the fourth quarter of 2007.

Potential Reconsideration of SSARS No. 6

.99 In September 1986, the ARSC issued SSARS No. 6, *Reporting on Personal Financial Statements Included in Written Personal Financial Plans* (AICPA, *Professional Standards*, vol. 2, AR sec. 600). AR section 600 provides an exception 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. The ARSC has been deliberating whether the exemption is appropriate. If the ARSC concludes that revisions to AR sec. 600 are appropriate, it is anticipated that such revisions will be exposed for public comment during the third quarter of 2007.

Potential Project on Harmonization With International Standards

.100 The ARSC is aware that the International Audit and Assurance Standards Board (IAASB) has issued International Standard on Review Engagements 2400, *Engagements to Review Financial Statements.* The ARSC plans to review that standard and consider whether the SSARSs should be amended to harmonize with the International Standard. If the ARSC concludes that revisions to SSARSs is appropriate, it is anticipated that such revisions would be exposed for public comment during the fourth quarter of 2007.

Potential Practice Aid for Bookkeeping Engagements

.101 During a September 2006 ARSC meeting, representatives of Continental Casualty Company provided several observations for consideration regarding bookkeeping services:

- Bookkeeping services of varying scope are provided routinely by most sole practitioners and small CPA firms. Approximately 17 percent of all billings reported by CPAs insured in the AICPA Professional Liability Insurance Program arise from this practice area.
- Between 2001 and 2005, approximately 5 percent of all malpractice claims in the AICPA Program arose from bookkeeping engagements.
- AICPA Professional Standards do not specifically address the provision of bookkeeping services. SSARS provides explicit guidance only with respect to the compilation and review of financial statements.

.102 Based on CNA's claim experience, it would appear that practitioners would find useful additional guidance both in performing these services and in establishing an understanding with the client regarding the scope of services provided and the limitations of the CPA's responsibilities to the client in performing services. Accordingly, the ARSC will work with the AICPA's Accounting and Auditing Publications Team to produce a practice aid for bookkeeping engagements.

Accounting Pipeline

Proposed FASB Statements, Business Combinations *and* Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries

.103 In these proposed Statements, the FASB plans to revise the existing guidance on the application of the purchase method. The following are among the main proposals:

1. All acquisitions of businesses will be measured at the fair value of the business acquired

2. Substantially all the assets acquired and liabilities assumed of the acquired business will be recognized and measured at their fair values at the acquisition date

3. Entities that follow U.S. GAAP and international standards will apply substantially the same accounting requirements for their business combinations

.104 Exposure drafts on business combinations—purchase method procedures and noncontrolling interests—were issued on June 30, 2005. Practitioners should visit the FASB Web site for expected issuance dates.

Proposed FASB Statement, The Hierarchy of Generally Accepted Accounting Principles

.105 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 enterprises that are presented in conformity GAAP in the United States. The GAAP hierarchy is currently presented in AICPA 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.

.106 The FASB is responsible for identifying the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental enterprises that are presented in conformity with GAAP. The FASB believes that the GAAP hierarchy should be directed specifically to enterprises because it is the enterprise (not its auditor) that is responsible for selecting accounting principles for financial statements that are presented in conformity with the GAAP hierarchy. 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 Statement, Accounting for Transfers of Financial Assets

.107 The exposure draft *Accounting for Transfers of Financial Assets* (Transfers Project) is a revision of a June 2003 exposure draft, *Qualifying Special-Purpose Entities and Isolation of Transferred Assets*, and would amend FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The proposed Statement seeks to (1) clearly specify the permitted activities of a qualifying special-purpose entity (QSPE), (2) address practice issues related to which arrangements should be considered and how they should be considered in the legal isolation analysis, (3) eliminate the prohibition on a

QSPE's ability to hold passive derivative financial instruments that pertain to beneficial interests held by a transferor, (4) revise the methodology used to initially measure at fair value interests related to transferred financial assets held by a transferor, and (5) clarify guidance related to when rollovers of beneficial interests are permitted within a QSPE. At its July 26, 2006, meeting, the FASB decided to combine the servicer discretion project (which addressed issues relating to the waiver of due-on-sale, collateral substitution, and foreclosed asset activities) into the Transfers Project. The FASB expects to issue a final Statement, which would amend FASB Statement No. 140, in the second quarter of 2007. See the FASB Web site at www.fasb.org for complete information.

Proposed FASB Statement, The Fair Value Option for Financial Assets and Financial Liabilities—Including an Amendment of FASB Statement No. 115

.108 The fair value option project has two phases. First, this proposal represents Phase 1, which addresses the fair value option for certain financial assets and financial liabilities. Second, Phase 2 will consider permitting the fair value option for certain nonfinancial assets and nonfinancial liabilities and some of the financial assets and financial liabilities excluded from the scope of Phase 1.

.109 The proposed Statement would create a fair value option under which an entity may irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and financial liabilities on a contract-by-contract basis, with changes in fair value recognized in earnings as those changes occur. The proposed statement has specific financial presentation requirements to display fair values and those values that are measured using other measurement techniques. The proposed Statement would amend FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, to require that securities reported at fair value in accordance with FASB Statement No. 115 satisfy the specific financial statement presentation requirements. The planned effective date is for years beginning after December 15, 2006. Visit the FASB Web site at www.fasb.org for additional information.

AICPA Resource Central

On the Bookshelf

.110 The following publications deliver valuable guidance and practical assistance as potent 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 and Techniques—2006* (product no. 009898kk)
- Practice Aid *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* (product no. 006701kk)
- *Understanding and Implementing SSARS No. 8* (product no. 006612kk)

Audit and Accounting Manual

.111 The *Audit and Accounting Manual* (as of July 1, 2006) (product no. 005136kk) is a valuable nonauthoritative practice tool designed to provide assistance for audit, review, and compilation engagements. The manual contains numerous practice aids, samples, and illustrations, including audit programs; auditors' reports; checklists; engagement letters; and management representation and confirmation letters, among other items.

AICPA's reSOURCE Online Accounting and Auditing Literature

.112 Get access—any time, anywhere—to the AICPA's latest *Professional Standards*, *Technical Practice Aids*, Audit and Accounting Guides, Audit Risk Alerts, and *Accounting Trends and Techniques*. To subscribe to this essential service for accounting professionals, go to www.cpa2biz.com.

Continuing Professional Education

.113 The AICPA has developed a number of continuing professional education (CPE) courses that might be valuable to CPAs performing compilation and review engagements. Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.114 The AICPA has made significant enhancements to its online CPE library. Because these enhancements dramatically improve the functionality as well as the appearance of the product, the AICPA has also changed the name to CPExpress (formerly *AICPA InfoBytes*). CPExpress contains cutting-edge training and CPE with one- to two-credit courses and 24/7 access. A wide variety of basic, intermediate and advanced level courses are included pertaining to accounting and auditing, consulting services, management, personal development, taxation, and ethics. You can utilize an interactive CPE tracking tool that automatically tracks courses completed and offers the ability to enter and track other CPE courses taken. You can also print CPE certificates on demand, upon completing each course or at any time in the future and return to the same course as many times as you want for ongoing reference after you have earned CPE. To register or learn more, visit www.cpa2biz.com/CS2000/Products/CPA2BIZ/CPExpress.htm.

Member Satisfaction Center

.115 To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Member Satisfaction Center at (888) 777-7077.

AICPA Technical Hotline and Ethics Hotline

.116 Technical questions about GAAP, OCBOA, accounting, auditing, compilation engagements, review engagements, or other technical matters may be addressed to the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research the question and respond with their answer. The Technical Hotline can be reached at (888) 777-7077.

.117 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. The Ethics Hotline can be reached at (888) 777-7077.

Webcasts

.118 When planning your engagements, you can join the many practitioners who have participated in AICPA webcasts. Webcasts are an exceptional way to stay current on today's professional issues. Led by recognized experts, webcasts provide complete briefings on a variety of pertinent practice topics. During a two-hour live webcast, participants have the opportunity to e-mail and ask questions of expert panelists.

.119 When planning your 2006–2007 compilation and review engagements, you need to make sure you, your colleagues, and your staff are aware of any special issues related to upcoming engagements. By viewing the Compilation and Review Risk Alert Webcast, you'll get a complete briefing on current Compilation and Review engagement issues. You will also take away a greater understanding of how to make your 2006-2007 Compilation and Review engagements more effective.

.120 The Compilation and Review Risk Alert Webcast, which was held live on November 21, 2006, is directly relevant to 2006/2007 year-ends. To purchase the archived webcast in CD format, go to: www.cpa2biz.com/CS2000/Products/CPA2BIZ/Webcast/Compilation+and+Review+Risk+Alert+Strategic+Briefing+2006+2007+Webcast.htm. CPE credit is available for participating in this Webcast.

Web Sites[2]

AICPA Online and CPA2biz

.121 AICPA Online, at www.aicpa.org, offers CPAs the unique opportunity to stay abreast of matters relevant to the CPA profession. AICPA Online informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, CPA2Biz at www.cpa2biz.com offers all the latest AICPA products, the Audit Risk Alerts, Audit and Accounting Guides, the professional standards, and CPE courses.

.122 This Alert replaces the *Compilation and Review Alert—2005/06*. The *Compilation and Review Alert* is published annually. As you encounter issues that you believe warrant discussion in next year's Alert, please feel free to share those with us. Any other comments that you have about the Alert would also be appreciated. You may e-mail these comments to lpombo@aicpa.org or write to:

Lori Pombo
AICPA
Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881

[2] See Appendix A, "Additional Web Resources," of this Alert for other helpful Web sites.

.123

Appendix A

Additional Web Resources

Here are some useful Web sites that may provide valuable information to accountants performing compilations and review engagements.

Name of Site	*Content*	*Internet Address*
Accountants World	Online community of independent accountants providing resources and tools	www.accountantsworld.com
Accounting Web	Online community for the accounting profession	www.accountingweb.com
American Institute of CPAs (AICPA)	Summaries of recent auditing and other professional standards as well as other AICPA activities	www.aicpa.org and 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/members/div/acctstd/index.htm
AICPA Accounting and Review Services Committee	Develops and issues review and compilation standards and interpretations	www.aicpa.org/members/div/auditstd/index.htm
CPAnet	Links to other Web sites of interest to CPAs	www.cpanet.com
Economy.com	Source for analysis, data, forecasts, and information on the United States and world economies	www.economy.com
Federal Reserve Bank of New York	Key interest rates	www.ny.frb.org
Financial Accounting Standards Board	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
Governmental Accounting Standards Board	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org
Hoovers Online	Online information on various companies and industries	www.hoovers.com
International Accounting Standards Board	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org
U.S. Tax Code On-Line	A complete text of the U.S. Tax Code	www.fourmilab.ch/ustax/ustax.html
WebCPA	World Wide Web magazine that features up-to-the-minute news for accountants	www.electronicaccountant.com

[*The next page is 8105.*]

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

Acknowledgments

The AICPA wishes to thank the members of the AICPA Health Care Expert Panel and the Chair of that panel, Rick Corcoran, for their assistance and contributions to this Audit Risk Alert.

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.

---

[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).

(continued)

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

.141

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—2006/07

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

NOTICE TO READERS

INSURANCE INDUSTRY DEVELOPMENTS—2006/07

This Audit Risk Alert is intended to provide auditors of insurance company financial statements with an overview of recent economic, technical, and professional developments that may affect the audits 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 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.

Amy M. Eubanks, CPA
Technical Manager
Accounting and Auditing Publications

Acknowledgments

The AICPA staff is grateful to the following individuals for their essential contributions in creating this publication.

Reggie Adamson,
Lincoln Financial Group

Douglas L. Bartlett,
RSM McGladrey, Inc.

Darryl Briley,
KPMG LLP

Donald A. Doran,
PricewaterhouseCoopers LLP

Kathleen N. Enright,
Allstate Insurance Company

Gary France,
Lincoln Financial Group

Kim Kushmerick, AICPA

Richard Lynch,
Ernst & Young LLP

Susan McGrath,
Veris Consulting, LLC

Monica Monson,
Ernst & Young LLP

Holly Ownby,
Ernst & Young LLP

Margaret C. Spencer,
RSM McGladrey, Inc.

M. Patrick Tracy,
RSM McGladrey, Inc.

How This Alert Helps You

.01 This Audit Risk Alert helps you plan and perform your insurance industry audits. The information delivered by this Alert assists you in achieving a more comprehensive 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 your client's financial statements. Moreover, this Alert delivers information about emerging practice issues and information about current accounting, auditing, and regulatory developments.

.02 If you understand what is happening in the insurance industry and 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.

.03 This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2006/07* (product no. 022337kk). 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.

.04 ***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*.

Economic and Industry Developments

.05 AU section 311A, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1), and AU section 311, *Planning and Supervision* (AICPA, *Public Company Accounting Oversight Board [PCAOB] Standards and Related Rules*), provide guidance for auditors regarding the specific procedures that should be considered in planning an audit. These sections state that the auditor should obtain a knowledge of matters that relate to the nature of the entity's business, its organization, and its operating characteristics. The auditor should also consider matters affecting the industry in which the entity operates, including, among other matters, economic conditions as they relate to the specific audit.

.06 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 and help you better assess risks of material misstatement of the financial statements, which will strengthen audit integrity.

The State of the Economy

.07 When planning and performing audit engagements, auditors need to 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 company's financial statements being audited.

.08 A number of factors that could upset economic growth, possibly affecting your client's operations and therefore possibly affecting audit risk, include:

- Rising interest rates during most of the year
- Unstable oil prices
- Dangerously high and rising consumer debt levels

- Inflation concerns
- A softening housing boom in some markets

.09 The U.S. real gross domestic product, which is the broadest measure of economic activity, increased at an annual rate of 5.6 percent during the first quarter of 2006 but slowed to a growth rate of 2.6 percent in the second quarter and 2.0 percent in the third quarter of 2006, according to the Bureau of Economic Analysis. The continued deceleration in growth into the third quarter is due, among other factors, to an acceleration in imports; a larger decrease in residential fixed investment; and decelerations in private inventory investment, personal consumption expenditures for services, and state and local government spending that were partly offset by upturns in equipment and software, personal consumption expenditures for durable goods, and federal government spending.

.10 The unemployment rate remained relatively unchanged during 2006, holding between 4.4 percent and 4.8 percent, and down from rates experienced in the prior year and the lowest since 2001.

.11 After a period of rising rates, the Federal Reserve kept its target for the federal funds rate at 5.25 percent during its last four meetings (August through December 2006). The Federal Reserve stated, "Economic growth has slowed over the course of the year, partly reflecting a substantial cooling of the housing market. Although recent indicators have been mixed, the economy seems likely to expand at a moderate pace on balance over coming quarters." The Federal Reserve cautioned that "readings on core inflation have been elevated and the high level of resource utilization has the potential to sustain inflation pressures. However, inflation pressures seem likely to moderate over time, reflecting reduced impetus from energy prices, contained inflation expectations, and the cumulative effects of monetary policy actions and other factors restraining aggregate demand."

Economic Impact of Hurricanes Katrina and Rita

.12 It has been over a year since Hurricanes Katrina and Rita hit the Gulf Coast region causing catastrophic damage. The natural disasters disrupted the nation's economic growth, caused unprecedented damage, and resulted in significant private insurer losses. According to the Insurance Services Office, Inc. (ISO), Hurricane Katrina alone resulted in estimated insured losses of $40.6 billion. A year later, the United States has experienced a mild hurricane season and the Gulf Coast region continues to rebuild and recover.

Industry Trends and Conditions—Property and Casualty Sector

.13 The U.S. property and casualty insurance industry reported extraordinary performance in the first half of 2006. The industry combined ratio was 92 percent[1] for the first half of 2006, with an expected return on equity of 14.5 percent for the year, according to the Insurance Information Institute (I.I.I.). Insurance companies were affected by record catastrophe losses in 2005; however, reduced hurricane activity during 2006 has contributed to favorable 2006 operating results, resulting in restored levels of policyholder surplus.[2] According to the ISO, the industry consolidated surplus increased by $19.7 billion or 4.6 percent in the first half of 2006, from its year-end 2005 level.

.14 However, the industry continues to face a number of ongoing challenges including but not limited to the following:

- The possibility of above average catastrophe losses due to variable weather conditions
- A continued soft market for rates with the exception of property-related coverages

---

[1] A combined ratio of 92 means that for every dollar of premium income that insurers earned during the first half of 2006, 92 cents exited in the form of claims payments, claims reserves, and expenses. The remaining 8 cents is underwriting profit.

[2] Policyholder surplus is a measure of claims paying capacity or capital.

- 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

.15 Survey data released by The Council of Insurance Agents and Brokers indicates the commercial property and casualty market continued to soften during the third quarter of 2006. 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 5.3 percent during the third quarter of 2006. 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. This survey data released by The Council of Insurance Agents and Brokers reported that one respondent commented insurers are even becoming interested in properties generally considered unattractive, such as car dealers, restaurants, and not-for-profits. In contrast to the overall soft commercial property and casualty market, premium prices have escalated and capacity shrunk for catastrophe-exposed property throughout 2006. Catastrophe-prone property continues to experience historic high premium levels, making it difficult to secure coverage, and deductibles and exclusions continue to rise, specifically in coastal areas.

.16 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.

.17 An auditor can refer to AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1; and for audits conducted in accordance with PCAOB standards: AICPA, *PCAOB Standards and Related Rules*), which states that the auditor's objective when evaluating accounting estimates is to obtain sufficient competent evidential matter 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.

Personal Lines

.18 ***Automobile Insurance.*** The I.I.I. estimates that the average premium expenditure will drop by 0.5 percent in 2007 compared with 2006. Reductions are possibly due to decreasing claim frequency coupled with only modest increases in claim severity throughout 2006. In 2006 as compared with 2005, claim frequency decreased between three percent and five percent, and the average cost per claim, which includes the cost of medical care and property damage, only rose two percent to four percent. The increase in cost per claim is modest despite the ever-increasing costs of medical care, which significantly affects automobile insurance pricing. Other reasons price reductions may occur in 2007 include competitive marketplaces, safer vehicles and roads, aggressive fraud-fighting efforts, and improvements in underwriting technology that can better assess the risk a particular driver represents. 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.

.19 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; and for audits conducted in accordance with PCAOB standards: AICPA, *PCAOB Standards and Related Rules*), describes the objectives and components of internal control and explains how an independent 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.

.20 ***Property Insurance.*** Many insurance companies suffered significant catastrophe losses in 2005. Some affected insurance companies had solvency ratings considered for downgrade and took actions to protect their ratings, including replacing lost capital by issuing debt or equity securities. At the same time, rating agencies' views on how to evaluate catastrophe exposure risk continue to evolve. Rating agencies have also revised their views on capital requirements and the assumptions incorporated in the various exposure models. Insurance companies are taking action to reduce their risk to catastrophes by purchasing reinsurance, which is becoming increasingly expensive as rates harden in response to demand, raising rates. Insurance companies are also trying to reduce their exposure through nonrenewals or changes in coverage or underwriting criteria.

.21 Some of the entities designed to help insurers manage catastrophe risk have levied assessments on companies and insureds. In Florida, Citizens Property Insurance Corporation, the state-run insurer of last resort, became the state's largest home and condominium insurer. This is unsettling because the corporation was established to be an insurer of last resort rather than a major market player. A large number of high-risk clients backed by one state-run insurer depicts a plethora of undesirable clientele; economic insolvency could permeate this particular property market segment if catastrophe strikes again. In response to rising costs, consumer groups are placing increased pressure on politicians and regulators.

.22 Many insurers make flood insurance available to their customers through the National Flood Insurance Program (NFIP) offered by the federal government. The huge volume of claims, driven by the 2005 storms, primarily Hurricane Katrina, was unprecedented and resulted in congressional action to fund NFIP payments. During 2005 and 2006, the U.S. Congress passed several bills increasing the borrowing authority of the NFIP to provide funds for payment of existing claims. Congress is currently conducting a review of payment practices by NFIP service carriers, and some members of Congress have indicated they would not agree to additional increases in borrowing authority unless significant reforms are made to the NFIP. A bill to overhaul the program died in a Senate committee when Congress adjourned in December 2006. Practitioners should remain alert to the status of this issue.

The Impact of the 2005 Hurricane Season on the Property and Casualty Sector

.23 In 2006, insurance companies experienced significant cash outflows as they paid claims generated by the 2005 catastrophes. As noted previously, the ISO estimates that the property and casualty insurance industry will pay out an estimated $40.6 billion on claims related to Hurricane Katrina alone compared with Hurricane Andrew of 1992, which resulted in approximately $21.6 billion in payments. The ISO also estimates that overall insured losses for damage to homes, vehicles, and businesses damaged in 2005 by hurricanes are $57 billion. Readers should be aware that property catastrophe risk exposure is becoming increasingly popular with hedge funds as an alternative for portfolio diversification to enhance returns. Some hedge funds are even establishing their own reinsurance companies. Some audit risks that may be present on audit engagements as a result of the turbulent 2005 hurricane season are presented in the next section for consideration on your engagements.

Potential Audit Risk Area—Claims Expense and Loss Reserves

.24 ***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.

.25 ***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 generally accepted accounting principles (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.

.26 Under GAAP, consideration should be given to the guidance in Financial Accounting Standards Board Statement of Financial Accounting Standards (FASB Statement) No. 5, *Accounting for Contingencies*; FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*; FASB Interpretation No. 14, "Reasonable Estimation of the Amount of a Loss—an interpretation of FASB Statement No. 5;" Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties*; SOP 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises*, as amended by SOP 01-5, *Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification*; 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 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).

.27 Under Statutory Accounting Principles (SAP), Statement of Statutory Accounting Principle (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.

.28 ***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 should evaluate their client's response and adherence to criteria and related internal controls surrounding expenses.

.29 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.

.30 AU section 342 (AICPA, *Professional Standards*, vol. 1; AICPA *PCAOB Standards and Related Rules*) 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*, is an additional source of guidance. Moreover, Interpretation No. 2, "Evaluating Differences in Estimates," in AU section 9312A, *Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312A* (AICPA, *Professional Standards*, vol. 1), and Interpretation No. 2, "Evaluating Differences in Estimates," in AU section 9312, *Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312* (AICPA, *PCAOB Standards and Related Rules*), clarifies guidance for evaluating differences in estimates.

.31 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 independence rules, SEC independence rules, PCAOB independence rules, new National Association of Insurance Commissioners (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 (GAO), state licensing boards, and others.

Potential Audit Risk Area—Reinsurance Recoverables

.32 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. Some reinsurers have had to stop writing new business as a result of the strain on capital caused by losses relating to Hurricane Katrina. Whether you are the auditor of the ceding company or the assuming company, careful attention needs to be paid to the stress Hurricane Katrina has placed on the reinsurance business.

Potential Audit Risk Area—Going-Concern Sensitivities

.33 As discussed previously, insurance companies have faced significant payout of claims during the year due to the 2005 hurricanes. An auditor can evaluate applicable agency ratings; lowered ratings can cause financial hardship for insurers. Moreover, as reinsurance rates rise, it becomes more difficult and costly for insurance companies to reduce their exposure. Many insurance companies have cancelled policies, and in some cases have stopped writing new business in catastrophe-prone areas. As a matter of course, insurance companies lacking geographically diverse clientele are more sensitive to environmental effects (such as hurricanes), which could lead to questions about an entity's going-concern assumption. Finally, lack of product line diversification can increase going-concern risks. It is important to consider your client's lines of business; businesses, home, and automobile policies are largely affected by weather variables.

.34 ***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, as part of every audit, whether there is substantial doubt about the ability of the entity to continue as a going concern for a reasonable period of time, not to exceed one year beyond the financial statement date. A significant consideration in the auditor's evaluation of an insurance companies' 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, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. This new SAS is effective for audits of financial statements for periods beginning on or after December 15, 2006.

Industry Trends and Conditions—Life and Health Sector

.35 Attractive 12-month equity market returns and the demand for benefit guarantees have resulted in a favorable current market for equity-linked annuity and life insurance products offered by life insurers. 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.

.36 Overall, sales of individual life insurance policies have been flat for several years, but universal life products continue to experience double-digit growth, largely on the success of no-lapse guarantee products. The large number of quality life insurers competing for distribution may result in pressure on margins, transfer of certain valuable services to distributors, and the addition of more risky policyholder option features. Also, increased regulatory costs and the need for frequent product innovation are increasing administration costs for insurers.

.37 The U.S. life insurance industry is generally well capitalized, with healthy asset quality. However, certain important elements that may affect an auditor's risk assessment include but are not limited to the following:

- Though improving, historically low investment yields may result in flat to negative profitability of in-force business and slower growth in surplus.
- Lack of available historical experience to be utilized by companies in pricing and reserving for recently issued policyholder financial options continues to affect the level of regulatory scrutiny and availability of reinsurance capacity.
- While many regulators seem to be in favor of a more principles-based approach to reserving for no-lapse guarantees, there has not yet been general agreement on a move to principles-based reserving. There remain large reserving needs for many of these contracts, causing a need to fund the statutory strain. The auditor can refer to AU section 342 (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), which provides guidance on obtaining and evaluating sufficient competent evidential matter 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 approaches included in AU section 342 (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*).
- Hedging programs developed by insurers in recent years to manage exposures to policyholder financial options have not been tested in more volatile markets. Additionally, 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* (AICPA, *Professional Standards*, vol. 1; and for audits conducted in accordance with PCAOB standards: AICPA, *PCAOB Standards and Related Rules*), which provides guidance to auditors in planning and performing auditing procedures for assertions about derivative instruments, hedging activities, and investments in debt and equity securities.

General Market Interest Rates and Interest Spread Compression

.38 Although improving recently, general market interest rates remained relatively low for an extended period of time, which has resulted in a continuing decline in portfolio rates of return. This is an important issue for insurers with fixed interest annuity and life insurance products. For many life insurers, portfolio rates have approached levels needed to support minimum rates guaranteed to policyholders; therefore, some insurers have limited ability to reduce crediting rates in the event of further declines in portfolio yields. Previously, most insurers had been able to adjust crediting rates, and the recent rise in market interest rates has resulted in new money rates not significantly different from portfolio rates. Further moderate increases could improve insurers' profitability, but a significant and sustained increase in new money rates could result in a disintermediation between assets and liabilities and other-than-temporary impairments of invested assets.

.39 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. This may limit their ability to sell the securities. 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.

.40 Statutory accounting does not subject insurers to this impairment model. Rather, impairments related to interest rates or sector spreads are recorded when there is an intent to sell the related security. For additional information on other-than-temporary impairments, see the discussion regarding "Security Valuation Developments" in the "Audit and Accounting Issues and Developments" section of this Alert.

Regulatory and Legislative Issues and Developments

Regulatory Risk—General Governmental

.41 Many industry executives believe, notwithstanding the catastrophe losses incurred by property casualty insurers, that regulatory risk is the biggest challenge faced by insurance companies. Whenever new laws are passed, there is risk of noncompliance due to error or oversight. Auditors need to keep abreast of the developing legislation because changes can affect management's assertions.

.42 Currently, the use of credit-scoring for ratings is still opposed by regulators in certain jurisdictions. Debate continues over regulatory modernization, rate regulation, and a greater role for federal regulation. Additionally, after several failed attempts, Congress may still consider other proposals to establish a trust fund to resolve asbestos injury liabilities. Of the many regulatory issues and developments, some significant issues and developments to consider on your audit engagements are presented in the following paragraphs.

Modernizing Insurance Regulation

.43 While the insurance industry has traditionally been regulated by individual states, many in the industry view the current system of state regulation as overly complex, costly to comply with, and anticompetitive and burdensome in that it slows the process of bringing new products to the marketplace. In response, reform proposals have been introduced to modernize insurance regulation. According to a December 2006 I.I.I. update, reform proposals are currently moving in two directions: (1) a dual federal and state system where insurance companies could choose between the state system and a national regulatory structure or (2) modernization of the current state system. Optional federal charter bills (bills that would give insurers the ability to choose between state and federal regulation similar to the banking industry) were introduced in the House of Representatives and the Senate during the last session. If similar bills, in either of the reform directions, are introduced in the future, they could significantly affect insurance regulation. Auditors should remain alert to the progress of these reform initiatives.

.44 Additionally, the McCarran-Ferguson Act is under renewed scrutiny from a number of sources. The McCarran-Ferguson Act, signed into law in 1945, declared states would continue to regulate insurance and granted insurers a limited exemption from federal antitrust legislation. The exemption in the McCarran-Ferguson Act permits insurers to jointly develop common insurance forms and share loss data to help them price policies. A bill was introduced in early 2006 curtailing the insurance industry's exemptions under the McCarran-Ferguson Act. Auditors should remain alert to the potential for further developments regarding this issue.

Industry Investigations

.45 Over the past several years, there have been investigations of industry practices by the SEC, the U.S. Justice Department, the New York Attorney General, and others focused on industry broker compensation practices, including prohibiting the payment of contingent commissions by insurers to brokers, and, by certain companies, bid-rigging schemes, improper accounting for finite reinsurance transactions, and improper reporting of premiums to avoid assessments. For further information, see the discussion of "Reinsurance Arrangements" in the "Audit and Accounting Issues and Developments" section of this Alert.

Terrorism Risk Insurance Act

.46 Congress passed the Terrorism Risk Insurance Act (TRIA) in November 2002 after the September 11, 2001, terrorist attack. TRIA provided for a program that, in the event of a major terrorist attack, allows the insurance industry and federal government to share losses according to a specific formula. This program allowed development of a terrorism insurance market as insurers' losses are limited. The Terrorism Risk Insurance Extension Act of 2005 provided for an extension for two additional years, expiring at the end of 2007. Whether this legislation will be further extended is uncertain. If TRIA is not renewed, carriers may have a significant increase in retained catastrophe loss exposure from terrorist acts, especially with respect to worker's compensation coverage for which the exposure cannot be excluded. Further details of the Terrorism Risk Insurance Extension Act of 2005 are included in the "Terrorism Insurance Developments" section of this Alert.

Property and Casualty Sector—Assessment Facts and Circumstances

.47 Elevated hurricane activity over several prior seasons has increased assessments levied by state-sponsored residual market insurers, high-risk insurance pools, catastrophe funds, and similar structures (structures). Many states have structures that provide coverage (including reinsurance) in high-risk areas or for high-risk insureds. Certain of these structures operate as insurance companies, reinsurance companies, or both and have the ability to assess insurers[3] operating in their respective state in the event that the structure's fund has insufficient amounts to pay claims.

.48 Auditors may need to determine if their client has identified all of the structures that could result in future assessments and gain an understanding of all structures that could materially affect the client. To gain an understanding, an auditor can either directly contact the structure or access the structures' Web sites to obtain the necessary regulatory information about the plan's operations to assess the reasonableness of the assessments recorded in the financial statements. Some structures to consider are included in the following table.

Structures to Consider	*Web Site*
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

[3] Insurers can directly surcharge their customers to recoup any surcharges made against them by the structures. Specific accounting is discussed later in this section.

Structures to Consider	*Web Site*
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

.49 Changing requirements of structures that affect how such structures are organized or funded increase the risks associated with regulatory compliance, accounting practice, and auditing considerations surrounding management's assertions. A crucial step toward obtaining audit assurance is to be aware of potential pitfalls surrounding assessment facts and circumstances during the planning stages of the audit and thereafter. Some questions to consider are listed in the following paragraphs.

.50 ***Has the client properly identified the type of assessment category (or categories) levied by the regulatory structure?*** SOP 97-3, *Accounting by Insurance and Other Enterprises for Insurance-Related Assessments*, defines four guaranty-fund assessment categories, namely, retrospective-premium-based, prospective-premium-based, prefunded-premium-based, or administrative assessments.[4] Under SAP, SSAP No. 35, *Guaranty Fund and Other Assessments*, does not distinguish between retrospective- and prospective-premium-based assessments and instead treats all premium-based assessments similarly to the retrospective-premium-based assessments described in SOP 97-3. Structures levy assessments based upon specific regulation. For example, Florida Citizens and Louisiana Citizens Property Insurance Corporation both levy retrospective-premium-based assessments. Other structures may levy different types of assessments. Problems in determining the proper assessment type can affect whether an insurer has applied the appropriate accounting and disclosure because the assessment type affects the timing of recorded liabilities and related disclosures. For example, if a structure is limited to annual assessment caps with remainders recovered through future years' assessments, those future assessments may be categorized as either retrospective or prospective for GAAP reporting, depending on the specific structure and state regulations.

.51 ***Has the client maintained compliance with current legislation?*** Lack of compliance can skew management's assertions. For example, under SAP, Interpretation No. 03-01, "Application of SSAP No. 35 to the Florida Hurricane Catastrophe Fund," which provided 2003 guidance specific to the FHCF, has not been updated for 2004 FHCF legislative changes, which now require insurers to act as agents. Insurers now collect assessments from policyholders, rather than being initially liable for the assessment and passing this cost on through additional premiums as was previously the case. Interpretation No. 03-01 is no longer authoritative for assessments levied by the FHCF and is currently being revised by the NAIC. Lack of familiarity with this new legislation could cause an overstatement of liabilities. Paragraph 10 of SSAP No. 35 states that when the reporting entity acts as an agent and (1) the assessment is reflected as a separately identifiable item on the billing to the policyholder and (2) remittance of the assessment by the reporting entity to the state or federal agency is contingent upon collection from the insured, the liability for fees and assessments rests with the policyholder rather than with the reporting entity, and the assessment is not reported in the insurer's statement of operations. Your client's obligation may be to collect and subsequently remit the fee or assessment.

.52 ***Has the client inappropriately applied analogous interpretation of GAAP or SAP?*** In the aforementioned example, the interpretation passed was applicable only to the FHCF. The auditor should be alert that any structure-specific guidance is not inappropriately applied by analogy to other structures.

[4] For additional discussion, see SOP 97-3, *Accounting by Insurance and Other Enterprises for Insurance-Related Assessments*.

.53 ***Has the assessment met all requirements for recognition?*** Management's assertions of completeness and valuation (including related presentation and disclosure) are affected by difficulties surrounding timing and estimation. In accordance with GAAP, in paragraph 10 of SOP 97-3, the following three criteria must be met for your client to recognize liabilities for insurance-related assessments:

1. Has an assessment been imposed or information of a probable assessment levy occurred prior to the issuance of the financial statements (this includes the subsequent events period)?

2. Did the event obligating an entity to pay an imposed or probable assessment occur on or before the date of the financial statements? Note that the term *event* may mean more than one event per paragraph 36 of SOP 97-3. For example, for natural catastrophe retrospective-premium-based assessments, the triggering events are both the occurrence of the catastrophe and the writing of the premium that obligates the entity for the assessment liability.

3. Is the amount of the assessment reasonably estimable?

.54 ***Has the client accounted for SAP and GAAP timing recognition differences that arise due to the type of assessment?*** As mentioned previously, under SAP, SSAP No. 35 rejects some of the guidance in SOP 97-3 and does not distinguish between retrospective- and prospective-premium-based assessments. Instead, all premium-based assessments are accounted for in a manner similar to retrospective-premium-based assessments, as described in SOP 97-3. Note that in certain instances, SAP does parallel FASB Statement No. 5 accounting because paragraph 6 of SSAP No. 35 states that loss-based assessments are presumed probable when the losses on which the assessments are expected to be based are incurred.

.55 ***Has management's methodology for valuing assessment liabilities been consistent from period to period?*** Current practice allows (but does not require) the discounting of aggregate obligations if the amount or timing of payments are "fixed or reliably determinable." Due to increased assessments over the past several years, management's consistency surrounding discounting choices needs to be carefully evaluated. The auditor should also note if all necessary disclosures relating to FASB Statement No. 5, FASB Interpretation No. 14, and SOP 94-6 are present.

.56 ***Has the client properly managed delays in obtaining information used in the estimates?*** In some cases, current-year assessments are based upon prior-year data, and delays may occur obtaining assessment valuation information. Under GAAP, paragraph 3 of FASB Interpretation No. 14 states that when no estimate within a given range is better than another, the liability should be the minimum amount in the range. Under SAP, paragraph 10 of SSAP No. 5, *Liabilities, Contingencies and Impairments of Assets*, states that when the reasonable estimate of the loss is a range, the amount in the range that is considered the best estimate shall be accrued. However, when in management's opinion no amount within management's estimate of the range is a better estimate than any other amounts, the midpoint (mean) of management's estimate in the range shall be accrued. If management determines that the high end of the range cannot be quantified, a range does not exist, and management's best estimate should be accrued.

.57 ***Has the client accounted for assessments not officially levied by applicable structures?*** Paragraph 16 of SOP 97-3 states that an entity need not be formally notified of an assessment by a structure to make a reasonable estimate of its liability. Auditors may need to note if clients have included assessments in the reporting period to avoid unrecorded liabilities. Paragraph 16 continues to state that entities subject to assessments may have to make assumptions about future events, such as when the fund will incur costs and pay claims that will determine the amounts and the timing of assessments. Similarly, under SAP, SSAP No. 35 provides that entities subject to assessments may have to make assumptions about future events, such as when the fund making the assessment will incur costs and pay claims to determine the amounts and the timing of assessments.

.58 ***Has the client waited for board of director (or other authoritative) approval to recognize assessments levied, or not yet levied, by applicable structures?*** Authoritative approval is not the trigger that determines loss as defined in FASB Statement No. 5. Contingent liabilities are recorded when probable and reasonably estimable. Clients need to determine whether an assessment is probable and measurable and then, consistent with the provisions of FASB Statement No. 5, determine if recognition or disclosure is warranted. Similarly, paragraph 4 of SSAP No. 35 requires that a liability should be recognized when (1) information available prior to the issuance of the financial statements indicates that it is probable that a liability has been incurred at the date of the financial statements and (2) the amount of the liability can be reasonably estimated.

.59 ***Has the client accounted for SAP and GAAP timing differences when recognizing and valuing potential future policyholder premium surcharges and premium tax offsets?*** For property and casualty companies, the majority of contracts are of short duration. Under GAAP, paragraph 22 of SOP 97-3 states that assets are recognized for recoveries of amounts based on current laws and projections of future premium collection or policy surcharges from in-force policies (with appropriate valuation allowances established). This does not include expected renewals of short-duration contracts but does include assumptions as to persistency rates for long-duration contracts. In-force policy restriction applied to a short-duration contract product line usually means that asset recognition is limited. However, under SSAP No. 35, an asset may be recognized (gross) for premium tax credits and for policyholder surcharges that will be collected in the future to the extent the asset is probable of realization (with appropriate valuation allowance being recorded).

.60 ***Has the client recognized policyholder surcharges for amounts that are, in substance, pass-through funds?*** Policy surcharges are recognized for in-force policies when appropriate. However, some structures require the insurer to collect policyholder surcharges from insureds for state (and other structure) assessments for future premiums and to remit the surcharge to the state or other regulatory body on behalf of the policyholder. Paragraph 26 of SOP 97-3 clarifies that amounts for receivables and surcharges collected that pass through the insurance entity to the state or other regulatory body should not be recorded as revenues and that amounts due or paid are not expensed. Under SAP, SSAP No. 35 provides that such surcharges shall not be reported in the insurer's statement of operations when both of the following conditions are met:

1. The assessment is reflected as a separately identifiable item on the billing to the policyholder.

2. Remittance of the assessment by the reporting entity to the state or federal agency is contingent upon collection from the insured.

.61 ***Is the transaction related to an assessment or reinsurance?*** Certain structures operate as both assessors and reinsurers. Under GAAP, assessments should be accounted for under SOP 97-3, and reinsurance transactions and certain involuntary pools should be accounted for under FASB Statement No. 113. Under SAP, assessments should be accounted for under SSAP No. 35; reinsurance transactions under SSAP No. 62; and certain involuntary pools under SSAP No. 63, *Underwriting Pools and Associations Including Intercompany Pools*. Insurers ceding business under reinsurance agreements would record ceded premiums for premiums paid to the fund and ceded losses (not assessment liabilities) for recoveries from the fund.

.62 ***Have reinsurance contract variables been properly evaluated?*** As with all insurance contracts, risk transfer criteria need to be analyzed and the asset needs to be evaluated for collectibility from the reinsurance structure. Timely collectibility may be in question if a reinsurance structure's fund is depleted, which may be the case for some structures after recent catastrophes, although ultimate collectibility may not be at risk if the structure of the fund provides for the assessment of all insurers writing business in the affected state until such time as the fund is replenished. The contract should also state how amounts recoverable are calculated. There also should be consideration whether there is an obligation for the ceding company to repay the reinsurance structure if the ceding company does not collect the amount from policyholders through future policy surcharges. For additional information on reinsurance, see the "Reinsurance Arrangements" section of this Alert.

Life and Health Sector—Guarantees and Other Developments

Minimum Guaranteed Death Benefits and No-Lapse Guarantee Mortality Features

.63 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.

.64 The NAIC's 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.

.65 Companies that issue universal life insurance with no-lapse guarantee mortality features are subject to the provisions of SOP 03-1, *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts*, 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.

.66 SOP 03-1 contains guidance for accounting for MGDBs, GMIBs, and no-lapse guarantee features. These features are also addressed in FASB Staff Position (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 AICPA Technical Practice Aid (TPA) section 6300.08, "Definition of an Insurance Benefit Feature." 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

.67 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 off-shore 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.

.68 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 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.

Recent SAP

.69 The NAIC continues to create and clarify statutory accounting guidance for insurance enterprises through its ongoing maintenance process. The most recent NAIC *Accounting Practices and Procedures Manual* (Manual) was published by the NAIC as of March 2006. 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.

.70 The 2006 Manual contains two new SSAPs adopted during 2005 and effective for implementation as of January 1, 2006:

1. SSAP No. 90, *Accounting for the Impairment or Disposal of Real Estate Investments*, replaces paragraphs 9, 10, and 19 of SSAP No. 40, *Real Estate Investments*, and provides statutory accounting guidance concerning when and how to account for an impairment or disposal on a real estate investment or long-lived assets associated with discontinued operations in light of the guidance set forth in FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*.

2. SSAP No. 93, *Accounting for Low Income Housing Tax Credit Property Investments*, requires that investments in Low Income Housing Tax Credit properties be carried at the lower of amortized cost or fair value, a change to the previous requirement of using the equity method of accounting for these types of investments under SSAP No. 48, *Joint Ventures, Partnerships and Limited Liability Companies*.

.71 In 2005, SSAP No. 62 was amended to require additional reinsurance information to be disclosed in new reinsurance interrogatories beginning with the 2005 annual statement. 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 five percent of the prior year surplus, effective for 2007. The current limitation of three 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. It was proposed that the information included in the supplemental schedules to the audited financial statements be limited to reinsurance contracts entered into, renewed, or amended on or after January 1, 1994. During the 2006 Winter NAIC meeting, the SAP Working Group adopted this proposed change to narrow the scope of disclosure 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; therefore, information included in the annual statement interrogatories may be different than disclosures in the audited financial statements, depending on whether the company has any pre-1994 contracts.

.72 As of the date of this writing, the following new SSAPs will become effective in 2007:

1. 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, which introduces the concept of commercial substance in nonmonetary exchanges of similar productive assets. 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. This SSAP should be applied prospectively and is effective for periods beginning after January 1, 2007.

2. 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 Partie*s, requires that terms of transactions between related parties be defined in a written agreement and that the agreement must provide 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 not specifically addressed in a written agreement should be non-admitted. This SSAP was approved as final at the NAIC 2006 Winter meeting. The NAIC SAP Working Group agreed to revise the effective date from January 1, 2007, to December 31, 2007.

.73 Since the adoption of SSAP No. 88, *Investments in Subsidiary, Controlled, and Affiliated Entities, A Replacement of SSAP No. 46*, in 2005, a number of implementation questions have arisen from the industry and regulators. In response to these inquiries, the SAP Working Group is in the process of finalizing an implementation guide that will be adopted as an appendix to SSAP No. 88. This appendix will be in the form of a series of questions and answers and should clarify the intent of the guidance and ensure that insurance companies are properly recording the value of subsidiary, controlled, and affiliated entities.

.74 Additionally, six new interpretations were adopted during 2005 and incorporated into the revised Manual. As of the date of this writing, five new interpretations have been adopted that are effective for 2006. Additionally, several *nonsubstantive* revisions to various SSAPs and changes to the appendices were made during 2005 and 2006 by the NAIC.

Federal Medicare Part D Prescription Drug Programs

.75 The Medicare Prescription Drug Improvement and Modernization Act of 2003 established a new voluntary Medicare Prescription Drug Program (Medicare Part D) for which benefits started on January 1, 2006. The benefit has a $250 deductible for 2006 with $50 annual increases each year after. For 2006, the initial coverage limit is $2,250 with $10 annual increases each year after. The coinsurance percentage associated with initial coverage is 25 percent. Finally, the benefit has an out-of-pocket threshold and an associated secondary coinsurance percentage. After total costs paid by the enrollee (including the deductible and the coinsurance under the initial coverage limit) exceed the out-of-pocket threshold, the enrollee is only responsible for a proportion (namely, the coinsurance percentage) of any further drug costs. For 2006, the out-of-pocket threshold is $3,600 with $50 annual increases each year after. The coinsurance percentage associated with costs above the out-of-pocket threshold is five percent

.76 There are provisions in the regulations that authorize certain types of alternative benefit designs as long as the benefits provided are certified as being actuarially equivalent to the standard design. The regulations also permit a prescription drug plan (PDP) sponsor to offer enhanced alternative coverage, in which at least one key aspect of the benefit design (deductible, cost sharing, or initial coverage limit) is richer than the standard plan. Such additional benefits are referred to as *supplemental benefits* in the regulations. Many companies are expected to develop enhanced alternative coverages that provide insurance benefits for claims above the initial coverage limit, even though the standard out-of-pocket threshold may not have yet been satisfied. The Centers for Medicare & Medicaid Services (CMS) will reimburse PDP sponsors for 80 percent of all claims above the out-of-pocket threshold. To the extent that the PDP sponsor's adjusted allowable risk corridor costs vary in either direction from a target amount, there is risk sharing between the CMS and the PDP sponsor. No sharing occurs if actual costs are within 2.5 percent of the target. A 75 percent and 25 percent sharing occurs for costs between 2.5 percent and 5 percent of the target. Costs in excess of 5 percent of the target are shared 20 percent and 80 percent by the PDP sponsor and CMS, respectively.

Accounting and Auditing Considerations

.77 In this section is a list of several factors that the auditor may need to be aware of when auditing Medicare Part D Programs.

.78 ***Contract classification.*** How should the underlying contract with the beneficiary be classified under FASB Statement No. 60? The underlying contract with the beneficiary in Medicare Part D Programs generally provides health insurance (prescription drug) coverage for periods of one calendar year with premiums adjustable annually.

.79 ***Premiums.*** How should premiums be recognized? Premiums paid by the beneficiary, either directly to the plan sponsor or through withholding from Social Security checks and remitted from Medicare, are composed of up to three components:

1. The base beneficiary premium is a fixed amount that, for the standard benefit plan, is intended on average to represent 25.5 percent of the program costs.

2. The supplemental benefit premium is a fixed amount, applicable only to an enhanced alternative coverage, representing the additional cost of supplemental benefits.

3. The late enrollment fee is a penalty assessed to beneficiaries who enroll outside of the normal enrollment windows, reflecting the possibility of adverse selection.

.80 ***Incurred Claims.*** How should claim costs be accrued? In accordance with FASB Statement No. 60, losses should be accrued as incurred.

.81 ***Risk Sharing.*** How should risk corridor payments be accounted for? Medicare Plan D Programs provide a risk-sharing arrangement whereby actual results for the plan sponsor are compared to the targeted results anticipated in the plan sponsor's bid accepted by Medicare. Threshold limits for payments to or from Medicare will be determined based upon symmetric risk corridors around the target amount as discussed above.

.82 Because of the unique nature of Medicare Part D Programs, there have been two methods utilized in practice for accounting for the risk corridor payments:

1. A retrospective refund arrangement under paragraph 44 of FASB Statement No. 60, based on the experience to date following a model based on FASB Emerging Issues Task Force (EITF) Issue No. 93-14, "Accounting for Multiple-Year Retrospectively Rated Insurance Contracts by Insurance Enterprises and Other Enterprises" (EITF Issue No. 93-14 is based on EITF Issue No. 93-6, "Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises," and identifies the guidance in 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*," related to EITF Issue No. 93-6 as relevant guidance for applying EITF Issue No. 93-14).

2. A retrospective premium adjustment on a retrospectively rated contract in accordance with paragraph 14 of FASB Statement No. 60. This paragraph indicates that if the ultimate premium is reasonably estimable, the estimated ultimate premium shall be recognized as revenue over the period of the contract. Retrospective premiums should be estimated at the beginning of the plan year based upon actuarially determined models, and adjustments should be made based upon revisions to those estimates in each reporting period. Retrospective premium adjustments estimated for the portion of the policy period that has expired shall be considered and immediately recorded as an adjustment to premium. Paragraph 14 of FASB Statement No. 60 also requires that if the ultimate premium cannot

be reasonably estimated, the cost recovery method or deposit method may be used until the ultimate premium can be reasonably estimated.

.83 Either method will yield the same result for an annual period of a calendar-year financial reporting enterprise because the Medicare Part D programs are annual contracts for calendar-year periods. The two methods differ in the determination of a payable or receivable balance at the end of interim reporting periods.

.84 The auditor should consider if a policy decision has been made about which model to follow for allocating the impacts of the risk-sharing provision between interim periods and if the accounting policy has been applied for similar contracts with mandatory experience rating provisions.

.85 ***SAP***. The NAIC Emerging Accounting Issues Working Group adopted Interpretation No. 05-05, "Accounting for Revenues Under Medicare Part D Coverage", at its national meeting in December 2005. This Interpretation provides guidance to life and health insurers on how to present various funds to be received under the Medicare Part D Program. Interpretation No. 05-05 requires the application of existing SAP (SSAP No. 47, *Uninsured Plans*; SSAP No. 66, *Retrospectively Rated Contracts*; and SSAP No. 54, *Individual and Group Accident and Health Contracts*, depending upon the nature of the funds received).

Terrorism Insurance Developments

.86 The market for terrorism risk insurance was severely disrupted by the events of September 11, 2001. Those events resulted in reinsurers choosing to no longer cover terrorism risk or to offer coverage only at very high rates. On November 26, 2002, the president signed TRIA into law. TRIA, which became effective immediately, established a temporary federal program of shared public and private compensation for insured commercial property and casualty losses resulting from acts of terrorism.

.87 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 placed the federal government temporarily in the terrorism risk reinsurance business because the program was written to sunset on December 31, 2005. However, the Terrorism Risk Insurance Extension Act of 2005 (Amendments) was signed into law on December 22, 2005. The Amendments extend the Terrorism Risk Insurance Program (TRIP), established by TRIA, through December 31, 2007. Additionally, the Amendments further limit the lines of business that can participate in the 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.

.88 Under the original program, once an insurer has suffered a loss equal to its deductible, the U.S. Treasury will cover 90 percent of the losses above the deductible. The insurer's deductible increases over the life of the 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 three percent per year. A summary of the major changes as a result of the Amendments is as follows:

- The Amendments increase the insurer deductible for the 2006 program year to 17.5 percent of the prior calendar year direct earned premiums; for the 2007 program year, the deductible increases to 20 percent of the prior calendar year direct earned premiums (the insurer deductible for the 2005 program year was 15 percent of the prior program year's direct earned premium).
- The Amendments increase the industry aggregate retention amount for 2006 and 2007 program years to: the lesser of $25 billion and the aggregate amount of insured losses for all insurers for the 2006

program year, and 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).

- For the 2006 program year, the Amendments establish a program trigger of $50 million in aggregate industry insured losses resulting from certified acts occurring after March 31, 2006. For the 2007 program year, the Amendments establish a program trigger of $100 million in aggregate industry insured losses resulting from certified acts occurring during the 2007 program year.
- Subject to the new 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 2006 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 maintain the annual cap on insured losses at $100 billion for both the 2006 and 2007 program years.

.89 Auditors may need to 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 2006 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 expires after December 31, 2007.

.90 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.

Reminder—Consideration of the Examiners Handbook

.91 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 revision 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.

Internal Control Issues and Developments

Enterprise Risk Management

.92 Enterprise risk management (ERM) continues to be a topic of interest among insurance company management and rating agencies. ERM is an extension of risk-based capital concepts and includes all aspects of business operations that involve risk—insurance risk, investment risk, and operating and financial risk.

In recent years, rating agencies began to encourage insurers to adopt advanced risk management practices and expressed their intent to evaluate the processes and techniques by which companies manage risk exposure as an integral part of their qualitative review of the company's business practices. In October 2005, Standard & Poor's (S&P) announced it would begin specifically analyzing insurers' ERM capabilities and consider those results when assigning ratings. S&P provided evaluation components to be analyzed and refined its ERM quality definitions in June 2006. Since S&P's actions, other rating agencies have commented on their position and views of ERM and how their ratings process already does or will include an assessment of advanced risk management practices. As the implementation of ERM evolves at insurance companies, related rating criteria are likely to change also.

Committee of Sponsoring Organizations of the Treadway Commission Internal Control and ERM Frameworks

.93 In 1992, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) developed a model for evaluating internal controls titled *Internal Control—Integrated Framework* (COSO Framework). More recently, passage of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) and the subsequent establishment of the PCAOB have continued the relevance of the COSO Framework because it broadly serves as the accepted method for management to maintain systems of internal control. In September 2004, COSO issued *Enterprise Risk Management—Integrated Framework*. This framework expands on internal control, providing a more comprehensive focus on the broader subject of ERM. Although it does not replace the COSO Framework (though it does encompass it), organizations can use this ERM framework both to satisfy their internal control needs and to move toward a more complete risk management process. Among other aspects, the auditor may want to be familiar with the framework paradigm, which consists of four objectives (strategic, operations, reporting, and compliance) superimposed over eight components: (1) internal environment, (2) objective setting, (3) event identification, (4) risk assessment, (5) risk response, (6) control activities, (7) information and communication, and (8) monitoring.[5]

New Internal Control Guidance for Smaller Public Companies

.94 As a result of the enactment of Sarbanes-Oxley, public companies and other organizations were prompted to turn their attention to evaluating internal control over financial reporting. Many smaller public companies found they needed assistance in applying the concepts of the COSO Framework, and COSO responded by initiating a project in January 2005 to assist smaller companies in implementing the COSO Framework.

.95 The new guidance, released July 11, 2006, is titled *Internal Control Over Financial Reporting—Guidance for Smaller Public Companies.* The objective of this guidance is to help smaller public companies and their auditors apply the COSO Framework in connection with assessing and reporting on the effectiveness of internal control over financial reporting. This new guidance consists of three volumes:

1. The executive summary volume provides a high-level summary for boards of directors and senior management.

2. The fundamental principles and examples volume includes an overview of internal control over financial reporting in smaller companies; 20 fundamental principles drawn from the COSO framework, along with related attributes (characteristics associated with and supporting a principle) and approaches (describing how smaller companies can apply a principle); and examples of how smaller companies can apply the principles cost-effectively.

[5] Paragraph .25 of AU section 319, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1; and for audits conducted in accordance with PCAOB standards: AICPA, *PCAOB Standards and Related Rules*), requires that, in all audits, the independent accountant obtain an understanding of each of the five components of internal control (the control environment, risk assessment, control activities, information and communication, and monitoring) sufficient to plan the audit.

3. The tools volume contains illustrative tools, including templates, to help management evaluate internal control and determine whether the company has effectively applied the principles. This third volume may provide smaller companies with some additional ideas about how controls can be effectively documented.

.96 Although the guidance was drafted for use by smaller public companies, the principles are equally applicable to large and small nonpublic companies, governmental agencies, and not-for-profit organizations. COSO recognizes that methods for applying the COSO Framework can and should differ for smaller businesses and identified the following themes for specific attention by smaller companies:

- The *control environment* is very important and sets the tone for internal control in a company. In smaller companies, the actions of management and its demonstrated commitment to effective governance and internal control are often more transparent than they are in larger companies.
- In identifying necessary controls, a company should consider the *risks* to reliable financial reporting and then identify controls required to mitigate those risks. Rather than focusing on mandating specific controls, the focus should be on linking those risks to the financial statement assertions and account balances that might be affected.
- *Control activities* require some minimum level of formalization. This is necessary so that everyone understands their responsibilities, how the controls operate, and the importance of the control process.
- *IT* can enable effective internal control. Although IT often has been cited as a source of control risk, small companies can take advantage of IT to promote more effective control.
- *Monitoring* the effectiveness of internal control can take place in many different forms in smaller companies. This includes the ongoing monitoring that may already be in place, including monitoring by executives who have direct and explicit knowledge of the activities of the business. Management often relies on these controls in smaller companies.
- Employees should understand the risks, objectives, and their *personal responsibility for controls*. Even smaller companies can implement effective procedures so that when employees note control problems or deviations from acceptable practices, they can report these findings to the appropriate person before the problems or deviations become significant issues for the company.

.97 A free copy of the executive summary of *Internal Control Over Financial Reporting—Guidance for Smaller Public Companies*, which contains the 20 fundamental principles mentioned previously, can be downloaded from www.coso.org/publications.htm.

COSO Request for Proposal on Monitoring Procedures

.98 On October 17, 2006, COSO issued a request for proposal to develop guidance on the monitoring component of the COSO Framework. The project is scheduled to be completed by the end of 2007. The guidance is expected to describe the objectives of the monitoring component of the internal control framework, provide guidance on how ongoing and separate monitoring can meet the needs of Sarbanes-Oxley compliance, include cost-effective examples of monitoring activities for large and small companies, and provide monitoring tools and techniques to assist companies in their evaluation and assessment. For more information on the request for proposal, please visit www.coso.org.

SEC and PCAOB Update

.99 Auditors may access the *SEC and PCAOB Alert—2006/07* (product no. 022497kk) for more comprehensive coverage of recent developments at 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.

SEC Proposed Guidance on Internal Control Over Financial Reporting

.100 During May 2006, the SEC announced a number of steps it would be taking to improve implementation of the internal control requirements of Section 404 of the Sarbanes-Oxley Act of 2002 (Section 404). These steps included issuing interpretive guidance to assist management and working with the PCAOB to revise and approve pertinent issues within 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*).

.101 Subsequently, on December 13, 2006, the SEC held an open meeting in which it voted to propose for public comment interpretive guidance for management regarding the evaluation of internal control over financial reporting. The guidance was released on December 20, 2006, as proposed rule Release No. 33-8762 and can be accessed at www.sec.gov/rules/proposed/2006/33-8762.pdf. The proposal is clear that companies evaluating internal controls in accordance with this new guidance would satisfy the Sarbanes-Oxley annual evaluation requirement. The proposed guidance intends to assist management in planning and performing its annual evaluation of internal control over financial reporting and reduce unnecessary costs and burdens while still maintaining the benefits of Section 404. The guidance is principle based. The two overarching principles are that:

1. Management should evaluate the design of implemented controls to determine whether they adequately address the risk that a material misstatement in the financial statements would not be prevented or detected in a timely manner.

2. Management should gather and analyze evidence about the operation of its controls based on its assessment of the risk associated with those controls.

.102 The proposed guidance sets forth an approach by which management can perform a top-down, risk-based evaluation of internal control over financial reporting and is designed to be scaleable to allow smaller companies to tailor their evaluations of internal control to fit their size and complexity. Until this point, management has relied extensively on the standards written for auditors in implementing Section 404. The proposed rule also proposed amendments to Rule 2-02(f) of Regulation S-X to require only one opinion on the effectiveness of internal control over financial reporting. The auditor's attestation of management's evaluation required under Section 404(b) of the Sarbanes-Oxley Act would be subsumed within the auditor's opinion on the effectiveness of the company's internal controls. The proposed rule is open for public comment until February 27, 2007.

Further Relief From Section 404 Requirements for Smaller and Newly Public Companies

.103 On December 15, 2006, the SEC adopted an extension of Section 404 compliance dates for nonaccelerated filers. Nonaccelerated filers were scheduled to begin including both management's assessment and an auditor's attestation to management's assessment on the effectiveness of internal control over financial reporting in their annual reports for fiscal years ending on or after July 15, 2007. Nonaccelerated filers will now provide management's report on internal control over financial reporting in its annual reports for fiscal years ending on or after December 15, 2007, and are not required to file the auditor's attestation report until filing an annual report for fiscal years ending on or after December 15, 2008. Management's report included in a nonaccelerated filer's annual report during the filer's first year of compliance with the Section 404(a) requirements will be considered *furnished* rather than filed.

.104 Relief was also provided to newly public companies. A company will not become subject to the internal control over financial reporting requirements until it either has been required to file an annual report for the prior fiscal year with the SEC or had filed an annual report with the SEC for the prior fiscal year. The transition period intends to allow newly public companies to focus on their initial securities offerings and prepare for their first annual report without the additional burden of Section 404 compliance. The SEC press release and final rule (Release No. 33-8760) can be accessed at www.sec.gov/news/press/2006/2006-210.htm. The following table is included in the SEC press release and summarizes the revised compliance dates.

	Accelerated Filer Status[6]	*Revised Compliance Dates and Final Rules Regarding the Internal Control Over Financial Reporting Requirements* — *Management's Report*	*Auditor's Attestation*
U.S. Issuer	Large Accelerated Filer OR Accelerated Filer	Already complying (annual reports for fiscal years ending on or after November 15, 2004)	Already complying (annual reports for fiscal years ending on or after November 15, 2004)
	Nonaccelerated Filer	Annual reports for fiscal years ending on or after December 15, 2007	Annual reports for fiscal years ending on or after December 15, 2008
Foreign Issuer	Large Accelerated Filer	Annual reports for fiscal years ending on or after July 15, 2006	Annual reports for fiscal years ending on or after July 15, 2006
	Accelerated Filer	Annual reports for fiscal years ending on or after July 15, 2006	Annual reports for fiscal years ending on or after July 15, 2007
	Nonaccelerated Filer	Annual reports for fiscal years ending on or after December 15, 2007	Annual reports for fiscal years ending on or after December 15, 2008
U.S. or Foreign Issuer	Newly Public Company	Second Annual Report	Second Annual Report

PCAOB

.105 On December 19, 2006, the PCAOB held an open meeting where it voted unanimously to propose for public comment the following:

- Proposed auditing standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, to supersede the current Auditing Standard No. 2
- Proposed auditing standard, *Considering and Using the Work of Others in an Audit*, to replace current interim standards in AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*) and the direction within Auditing Standard No. 2 relating to using the work of others
- Proposed Independence Rule 3525, *Audit Committee Pre-approval of Services Related to Internal Control Over Financial Reporting*
- Proposed amendments to PCAOB Interim Standards

[6] Effective December 27, 2005, the SEC created a new category of companies called *large accelerated filers* and adjusted the definition of *accelerated filers*. A company is now an accelerated filer if its aggregate worldwide market value of voting and nonvoting common equity held by nonaffiliates is $75 million or more but less than $700 million and, as of the last business day of its most recently completed second fiscal quarter and the company has been subject to the reporting requirements of the Securities Exchange Act of 1934 for at least 12 calendar months, has filed at least one annual report, and is not a small-business issuer. A company is a large accelerated filer if it meets the last three aforementioned requirements and has an aggregate worldwide market value of voting and nonvoting common equity held by nonaffiliates of $700 million or more as of the last business day of the issuer's most recently completed second fiscal quarter. A nonaccelerated filer does not meet aforementioned Exchange Act Rule 12-b-2 requirements for accelerated or large accelerated filers and is therefore not required to file its annual and quarterly reports on an accelerated basis.

.106 The proposed auditing standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, is written to be much shorter and easier to read than Auditing Standard No. 2; however, it does not diminish any of the existing principles in Auditing Standard No. 2. Provisions of the new standard emphasize the importance of risk assessment and direct auditors to focus on the most important controls (controls with the greatest potential to prevent or detect material misstatements). The proposed standard, among other things, removes the requirement to evaluate management's assessment process; clarifies the role of materiality (including interim materiality) in the audit; directs the auditor to tailor the audit for smaller and less complex companies; recalibrates walkthrough requirements; and revises the definitions of significant deficiency, material weakness, and strong indicators of material weakness.

.107 The proposed auditing standard, *Considering and Using the Work of Others in an Audit*, allows the auditor to use the work of others for both the internal control and financial statement audits, eliminating barriers to the integration of the two audits. The proposed standard provides a single framework for using the work of others based on the auditor's evaluation of the combined competence and objectivity of others and the subject matter being tested. The principal evidence provision previously included in Auditing Standard No. 2 is eliminated in this proposed standard.

.108 Auditors can access the complete PCAOB press release, briefing paper, proposed standards, and statements on the PCAOB Web site at www.pcaob.org/Rules/Docket_021/index.aspx. Public comments are due by February 26, 2007.

The NAIC's Sarbanes-Oxley Initiative Update

.109 During the Fall 2006 meeting, the NAIC adopted changes to the Model Audit Rule related to Sarbanes-Oxley, with the majority of those changes being effective for 2010. Beginning in 2003, the NAIC had been reviewing the requirements of Sarbanes-Oxley and formed several subgroups to carefully consider incorporating certain aspects of Sarbanes-Oxley into the Model Audit Rule. Sarbanes-Oxley consists of 11 titles; the key titles of interest to the NAIC have been Titles II, III, and IV. These titles relate to auditor independence (Title II), corporate responsibility (including audit committees) (Title III), and enhanced financial disclosures (Title IV). Enhanced financial disclosures include management's assertion relative to the effectiveness of its internal control over financial reporting and the auditor's attestation report on management's assertion.

.110 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 non-audit 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 year 2010 statutory audits.
- Section 11: Auditors should prepare a written report 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. For more information, see the section of this Alert titled "Reporting Significant Deficiencies and Material Weaknesses in Internal Control to Insurance Regulators."

- 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.

- Section 16: Regarding Management's Report of Internal Control Over Financial Reporting, every insurer is required to file an audited financial report that has annual direct written and assumed premiums 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 the 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.

.111 At the September 2006 meeting, 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. Auditors and preparers may want to be familiar with the Implementation Guide because it is a good supplement to the Model Audit Rule and provides interpretive guidance and clarifications of the terms used. The Implementation Guide will be maintained as a new appendix to the NAIC Manual.

Reporting Significant Deficiencies and Material Weaknesses in Internal Control to Insurance Regulators[7]

.112 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), which supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*. This SAS is effective for audits of financial statements for periods ending on or after December 15, 2006. SAS No. 112 requires the auditor to evaluate identified control deficiencies and determine if they individually or when combined are significant deficiencies or material weaknesses. These terms are defined consistent with PCAOB Auditing Standard No. 2. The term *reportable condition* is no longer used. The SAS also requires that these communications now be in writing. The language definitions of significant deficiencies or material weaknesses in internal control have been referenced to SAS No. 112 in Section 11 of the revised Model Audit Rule; however, the change will not take place until the revisions to the Model Audit Rule are effective in 2010. As a result, the AICPA issued A Statutory Framework for Reporting Significant Deficiencies and Material Weaknesses in Internal Control to Insurance Regulators (Statutory Framework). The Statutory Framework was developed by members of the AICPA NAIC Task Force and AICPA staff and 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 SAS No. 112. For purposes other than satisfying Section 11 of the Model Audit Rule, the auditor also has to consider any additional reporting requirements of SAS No. 112 and SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380A).[8] Even when no significant deficiencies or material weaknesses are identified, several states[9] (Florida, Idaho, Illinois, Maine, New York, North Carolina, Puerto Rico, and

[7] 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 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.

[8] As mentioned previously, SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), supersedes SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380A), and is effective for audits of financial statements for periods beginning on or after December 15, 2006.

[9] For purposes of this framework, the term *states* includes other jurisdictions that are members of the NAIC.

Vermont captive insurers) have a requirement that a letter be filed stating no material weaknesses have been identified.

.113 Section 11 of the 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. While the current Model Audit Rule still specifically references SAS No. 60, auditors must follow SAS No. 112, when effective, 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.[10] The Statutory Framework can be accessed on the AICPA's Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Practice+Aids+and+Tools/.

Year-End Auditing Considerations

.114 For year-end 2006 reporting, the AICPA NAIC Task Force will again undertake efforts to determine whether individual states will again accept reporting of only those significant deficiencies and material weaknesses related to statutory-basis financial reporting of which the auditor becomes aware during the course of the audit that are unremediated as of the balance sheet date as being in compliance with the requirements of Section 11 of the Model Audit Rule. The AICPA NAIC Task Force will continue this effort until the revised Model Audit Rule is effective in 2010. Updated information on the confirmation process will be available from Kim Kushmerick at the AICPA (kkushmerick@aicpa.org).

Audit and Accounting Issues and Developments

Reinsurance Arrangements

.115 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[11] 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.

.116 FASB Statement No. 113 and 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

---

[10] 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 report at the same time the audited financial statements are filed.

[11] Finite or financial reinsurance contracts limit the risk (and rewards) of the underlying business transferred from the ceding company to the reinsurer, often through adjustable features within the reinsurance contract that alter the cash flows between the parties based on the level of losses ceded. Although finite reinsurance may restrict the amount of insurance risk transferred to the assuming company, the contract must still transfer significant insurance risk as defined by FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, and the reinsurer must still be exposed to a reasonable possibility of a significant loss if the contract is to qualify for reinsurance accounting. By transferring less risk to the reinsurer, the insurer receives coverage on potential claims at a lower cost than traditional reinsurance. Due to the highly complex structure of these limited risk agreements, there can be abuses where no risk is transferred (such as a disguised loan), and the auditor should be alert to such agreements.

issued an invitation to comment on "Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting" (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. At its December 6, 2006, meeting, the FASB decided that it would no longer pursue the issue of bifurcation of insurance and reinsurance contracts for financial reporting as part of its discussions relating to its insurance risk transfer project. The FASB decided the risk transfer project should focus on developing enhanced insurance and reinsurance disclosures that highlight any risk-limiting features included in those contracts, and to also work on developing additional language around the current FASB Statement No. 113 guidance to increase the level of risk transfer required for a contract to be accounted for as insurance. 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.

.117 The AICPA Insurance Expert Panel drafted a white paper that was sent to the FASB in November 2003 identifying certain risk transfer issues with respect to the application of risk transfer tests to certain contracts and differing interpretations as to the scope of the FASB Statement No. 113, paragraph 11, exception to the requirement that contracts accounted for as reinsurance expose the reinsurer to a reasonable possibility of significant loss. The white paper outlines issues identified in practice with possible responses, but does not include recommendations. It is available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel_insurance.htm. The AICPA reiterated the issues in the white paper in their comment letter in response to the FASB invitation to comment on "Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting."

.118 EITF Issue No. 93-6, EITF Issue No. 93-14, and EITF Topic No. D-35 represent guidance on required accruals when future rights and obligations under a multiple-year contract change based on loss experience to date.

.119 SOP 98-7, *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk*, should be used to determine the appropriate method of accounting for contracts that do not meet the requirements for reinsurance accounting under FASB Statement No. 113. SOP 98-7 outlines the appropriate accounting for contracts based on whether the contract transfers:

- Only significant timing risk
- Only significant underwriting risk
- Neither significant timing nor underwriting risk
- An indeterminate risk

.120 Other accounting standards continue to have implications for transactions involving reinsurance arrangements. For example, FASB Interpretation No. 46, "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.

.121 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. Auditors may need to assess whether companies have adequate internal controls to identify and analyze complex reinsurance agreements to determine the proper accounting.

Some Additional Auditing Considerations

.122 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; and for audits conducted in accordance with PCAOB standards: AICPA, *PCAOB Standards and Related Rules*) toward these arrangements to identify any of the following:

- Contracts back-dated 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
- *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

.123 Paragraph .02 of AU section 431, *Adequacy of Disclosure in Financial Statements* (AICPA, *Professional Standards*, vol. 1; and for audits conducted in accordance with PCAOB standards: AICPA, *PCAOB Standards and Related Rules*), 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?

New NAIC Reinsurance Disclosure and Filing Requirements

.124 Reinsurance issues have taken center stage at the NAIC as regulators react to 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.

.125 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 five percent of the prior year surplus, effective for 2007. The current limitation of three 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 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. The 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[12]
- 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

.126 For contracts meeting the first three bulleted criteria, management is further required to disclose (1) a summary of the reinsurance contract terms, (2) a brief discussion of management's principal objectives in entering into the agreement, including the economic purpose to be achieved, and (3) the aggregate financial statement impact gross of all such ceded reinsurance contracts on the balance sheet and statement of income.

.127 In addition to the expanded disclosures, the NAIC has adopted a supplemental filing requiring the Chief Executive Officer (CEO) and Chief Financial Officer (CFO) to separately attest to the appropriateness of the accounting procedures applied to the company's ceded reinsurance arrangements. Supplement 20-1, "Reinsurance Attestation Supplement: Attestation of Chief Executive Officer and Chief Financial Officer Regarding Reinsurance Agreements," shall be filed by March 1 and requires the CEO and CFO to make representations related to:

- The existence of any side agreements
- Whether management has documented its risk transfer analysis and such documentation is available for review
- The company's compliance with SSAP No. 62
- Whether appropriate internal controls are in place to monitor reinsurance

SOP 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts*

.128 Issued by the AICPA's Accounting Standards Executive Committee in September 2005, SOP 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts*, provides guidance on accounting by insurance enterprises for deferred acquisition costs on internal replacements of insurance and investment contracts other than those specifically described in FASB Statement No. 97.

.129 SOP 05-1 defines an internal replacement as a modification in product benefits, features, rights, or coverages that occurs by the exchange of a contract for a new contract or by amendment, endorsement, or

---

[12] 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.

rider to a contract, or by the election of a feature or coverage within a contract. Modifications that result from the election by the contract holder of a benefit, feature, right, or coverage that was within the original contract are not internal replacements subject to this guidance as long as all of the conditions listed in paragraph 9 of the SOP are met:

- The election is made in accordance with terms fixed or specified within narrow ranges in the original contract.
- The election of the benefit, feature, right, or coverage is not subject to any underwriting.
- The insurance enterprise cannot decline to provide coverage or adjust the pricing of the benefit, feature, right, or coverage.
- The benefit, feature, right, or coverage had been accounted for since the inception of the contract.

.130 SOP 05-1 introduces the terms *integrated* and *nonintegrated contract features* and specifies that nonintegrated features do not change the base contract and are to be accounted for in a manner similar to a separately issued contract. Integrated features are evaluated in conjunction with the base contract.

.131 Contract modifications that result in a replacement contract that is substantially unchanged from the replaced contract should be accounted for as a continuation of the replaced contract (that is, unamortized deferred acquisition costs and other balances associated with the replaced contract continue to be deferred and amortized or earned in connection with the replacement contract). A contract is substantially unchanged if all of the conditions in paragraph 15 of SOP 05-1 are met:

- The insured event, risk, or period of coverage of the contract has not changed (that is, there are no significant changes in the kind and degree of mortality risk, morbidity risk, or other insurance risk, if any).
- The nature of the investment return (for example whether determined based on formulae specified in the contract, pass through of actual performance, or at the discretion of the insurer), if any, has not changed between the insurance enterprise and the contract holder.
- No additional deposit, premium, or charge relating to the original benefit or coverage, in excess of amounts specified or allowed in the original contract, is required to effect the transaction; or if there is a reduction in the original benefit or coverage, there is a reduction in the deposit, premiums, or charges that is at least equal to the corresponding reduction in benefits or coverage.
- There is no net reduction in the contract holder's account value (or cash surrender value, if any) other than for distributions to the contract holder or designee or charges related to newly purchased benefits or coverages.
- There is no change in the participation or dividend features of the contract, if any.
- There is no change in the amortization method or revenue classification of the contract.

.132 An internal replacement that is determined to result in a replacement contract that is substantially changed from the replaced contract should be accounted for as an extinguishment of the replaced contract. Unamortized deferred acquisition costs, unearned revenue liabilities, and deferred sales inducement assets associated with contracts that have substantially changed should not be deferred in connection with the replaced contract.

.133 Unamortized deferred acquisition costs and the present value of future profits continue to be subject to premium deficiency testing in accordance with the provisions of FASB Statement No. 60.

.134 The notes to the financial statements should describe the accounting policy applied to internal replacements, including whether the company has availed itself of the alternative application guidance outlined in paragraphs 18 and 19 of SOP 05-1 and, if so, for which kinds of internal replacement transactions. SOP 05-1 is effective for internal replacements occurring in fiscal years beginning after December 15, 2006. Retrospective application of SOP 05-1 to previously issued financial statements is not permitted. Initial application of SOP 05-1 should be as of the beginning of an entity's fiscal year. Additionally, disclosure of the effect of the change on retained earnings as of the date of adoption is required. If the financial statements of the year of adoption are presented separately or included in comparative financial statements, the notes to the financial statements should disclose the fact that SOP 05-1 has been adopted and the effective date of adoption, and the nature of any differences in accounting principles or financial statement presentation applicable to the financial statements presented that resulted from adoption of SOP 05-1.

.135 A number of questions have been raised by auditors and insurers regarding the implementation of SOP 05-1. As a result, a task force made up of members of the SOP 05-1 Task Force and the Insurance Expert Panel has been formed to review questions submitted and to determine whether interpretive guidance, in the form of TPAs, is warranted. The FASB held a public roundtable meeting on January 30, 2007, and decided not to delay the effective date of SOP 05-1. Therefore, SOP 05-1 is effective for internal replacements occurring in fiscal years beginning after December 15, 2006.

Security Valuation Developments

.136 Under GAAP, paragraph 16 of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* states that individual securities classified as either available-for-sale or held-to-maturity must be assessed to determine whether a decline in fair value below the amortized cost basis is other than temporary. If such a decline is judged to be other than temporary, the cost basis of the individual security is written down to fair value as the new cost basis, with the amount of the writedown included in earnings (that is, accounted for as a realized loss). The new cost basis should not be changed for subsequent recoveries in fair value.

.137 Additionally, for other-than-temporary impairment analysis conducted in periods beginning after December 15, 2005, FSP FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, nullifies the guidance in paragraphs 10 through 18 of the FASB precursor issuance EITF Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments," carries forward EITF Issue No. 03-1 cost method and disclosure requirements; supersedes EITF Topic No. D-44, "Recognition of Other-Than-Temporary Impairment upon the Planned Sale of a Security Whose Cost Exceeds Fair Value;" and refers to existing other-than-temporary impairment guidance, including Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock,* and SAB No. 59, *Accounting for Noncurrent Marketable Equity Securities*. The FSP also amends FASB Statements No. 115 and No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, and APB Opinion No. 18.

Scope

.138 In short, FSP FAS 115-1 and FAS 124-1 provides guidance on determining (1) when an investment is considered impaired, (2) whether that impairment is other than temporary, and (3) measurement and timing of an impairment loss. The guidance is applicable to debt and equity securities that are within the scope of FASB Statements No. 115 and No. 124 and securities excluded from those Statements and not accounted for under the equity method pursuant to APB Opinion No. 18 (for example, cost-method investments). As indicated in paragraph 127(b) of FASB Statement No. 115, insurance companies are required to report equity securities at fair value, even if they do not meet the scope criteria in paragraph 3 of FASB Statement No. 115. Therefore, the FSP also applies to all equity securities held by insurance companies. Additionally, the outside form of the investment determines the accounting. For example, an investment in mutual fund shares is equity, even if the mutual fund consists mostly of debt securities. Finally, investments that require bifurcation and separate accounting for host instruments under paragraph 12 of FASB Statement No. 133 are included.

Year-End Accounting and Auditing Issues

.139 A significant amount of insurers' investment portfolios are invested in fixed-income investments. Accordingly, insurers are exposed to the potential for a decline in portfolio market value should long-term interest rates rise, leading to unrealized losses and potentially to surplus declines. With the Federal Reserve increasing the federal funds rates throughout 2005 and half of 2006 and energy price increases contributing to inflation worries, many institutional investors, including insurers, believe that long-term rates may be headed higher. All those in the insurance industry will be closely watching the movement of long-term rates in 2007.

.140 Additionally, the interest rate increase is coupled with rising credit quality concerns surrounding certain asset-backed investments. The auditor can evaluate if management has considered the separate or combined effect of these market forces on a potential impairment. The situation could create a more complex auditing environment surrounding security valuation and potential impairment for 2006.

Accounting and Auditing Guidance

.141 FASB Statement No. 115 should continue to be followed along with FSP FAS 115-1 and FAS 124-1. Note that FSP FAS 115-1 and FAS 124-1 provides impairment indicators that should be used in evaluating whether an event or change in circumstances has occurred during the reporting period that may have a significant adverse effect on the fair value of the investment. The auditor can evaluate if management has considered that the definition of *other-than-temporary* does not necessarily mean permanent. The FSP does not provide guidance on making an other-than-temporary assessment. Instead, one must apply other guidance such as in FASB Statement No. 115. Additionally, SEC SAB Topic 5M, *Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities,* states that there are numerous factors to be considered when evaluating for other-than-temporary impairment. Factors include, but are not limited to, the length of time and extent to which the market value has been below cost and the intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value. Another variable is the financial condition and near-term prospects of the issuer, which includes any specific events that may influence the operations of the issuer such as changes in technology that may impair the earnings potential of the investment or the discontinuance of a segment that could affect future earnings potential of the issuer. Other sources of guidance include paragraph 6 of APB Opinion No. 18 and EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets." The FASB special report, *A Guide to Implementation of Statement 115 on Accounting for Certain Investments in Debt and Equity Securities: Questions and Answers*, is also relevant.

.142 FSP FAS 115-1 and FAS 124-1 states that in periods subsequent to the recognition of an other-than-temporary impairment loss for debt securities, an investor must account for the other-than-temporarily impaired debt security as if the debt security had been purchased on the measurement date of the other-than-temporary impairment. That is, the discount or reduced premium recorded for the debt security, based on the new cost basis, would be amortized over the remaining life of the debt security in a prospective manner based on the amount and timing of future estimated cash flows.

.143 When an investor has decided to sell an impaired available-for-sale security and the investor does not expect the fair value of the security to fully recover prior to the expected time of sale, the security is deemed other-than-temporarily impaired in the period in which the decision to sell is made. However, an investor must recognize an impairment loss in the period the decision is made rather than when the actual sale occurs. This incorporates the concept from EITF Topic No. D-44. The aforementioned information does not preclude impairment evaluation of securities that are not planned on being held to recovery. Paragraph 14 of FSP FAS 115-1 and FAS 124-1 states that "an investor shall recognize an impairment loss when the impairment is deemed other than temporary even if a decision to sell has not been made." For further information, see SEC SAB Topic 5M. Finally, FSP FAS 115-1 and FAS 124-1 states that for post-impairment income recognition, income must be recognized on expected, not contractual, cash flows.

.144 Related auditing considerations include evaluation of management's current and former practices regarding FASB Statement No. 115 securities, accounting practice consistency among periods, and rationale for any practice changes in the areas surrounding FSP FAS 115-1 and FAS 124-1. The issue of tainting could occur under certain circumstances; for example, a pattern of selling securities that were intended to hold until recovery, or sales occurring soon after intent to hold decisions. Documentation continues to be paramount with regard to these issues. In December 2005, the ASB issued SAS No. 103, *Audit Documentation*, (AICPA, *Professional Standards*, vol. 1, AU sec. 339). This SAS supersedes SAS No. 96 of the same name and amends paragraphs .01 and .05 of SAS No. 1, section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 530.01 and .05). SAS No. 103 is effective for audits of financial statements for periods ending on or after December 15, 2006, with earlier application permitted. Public issuers can refer to Auditing Standard No. 3, *Audit Documentation* (AICPA, *PCAOB Standards and Related Rules*). Finally, unsubstantiated changes in management practice need to be carefully questioned for appropriateness under the aforementioned GAAP literature listed in this section.

Statutory Accounting

.145 Under SAP, determining whether impairment has occurred on an investment under the NAIC Manual is similar to 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 SSAPs. Differences do arise between GAAP and SAP regarding the timing of an impairment loss for securities subject to EITF Issue No. 99-20. Additionally, under SAP, impairments related to interest rates or sector spreads are recorded when there is an intent to sell the related security.

.146 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. At the Fall 2006 NAIC meeting, the Emerging Accounting Issues Working Group voted to adopt the disclosure requirements of FSP FAS 115-1 and FAS 124-1, effective for 2006. At that time, the Emerging Accounting Issues Working Group exposed an interpretation that incorporates portions of the FSP. During the Winter NAIC meeting, the Emerging Accounting Issues Working Group confirmed its tentative consensus, with modifications, as final. The finalized interpretation, Interpretation No. 06-07, "Definition of Phrase 'Other Than Temporary,'" incorporates portions of FSP FAS 115-1 and 124-1 (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 Interpretation No. 02-07, "Definition of Other Than Temporary."

Quantifying Misstatements

.147 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 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.

.148 Two approaches have commonly been used to quantify such errors. Under one approach, the error is quantified as the amount by which the current year income statement is misstated (the rollover approach). The other common approach quantifies the error as the cumulative amount by which the current year balance sheet is misstated (the 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 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.

.149 The 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.

.150 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 the SAB. 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.

.151 Auditors should be aware if their clients are following appropriate disclosure requirements under GAAP and SAP, respectively, for any adjustments made as a result of SAB No. 108. Additionally, auditors should note the FASB has announced a project to address the process of quantifying misstatements in current year financial statements arising from the carryover or reversal of prior period errors for the purpose of evaluating materiality. At the time of this writing, the FASB is drafting a proposed FSP to address this issue. In response to SAB No. 108, changes may be made to the recently issued Risk Assessment Standards, which are discussed in the next section. Specifically, changes may be made to SAS No. 107, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312).

FASB Statement No. 133 Implementation Guidance

.152 The Derivatives Implementation Group helped the FASB staff answer significant questions that companies face when implementing FASB Statement No. 133.

.153 The FASB staff has issued guidance on numerous FASB Statement No. 133 implementation issues, and this guidance can be obtained from the FASB Web site at www.fasb.org. Following is a listing of the insurance-product-related topics that were addressed, together with a brief discussion of the nature of each issue and the date of FASB clearance. This list is intended to highlight to auditors of insurance companies those areas where the application of FASB Statement No. 133 may be required. In addition to the issues listed below, several other FASB Statement No. 133 implementation issues are applicable to companies operating in all industries; such issues also may be relevant to an audit of an insurance company.

Topic	*Guidance*
A16—Definition of a Derivative: Synthetic Guaranteed Investment Contracts (March 14, 2001)	Synthetic guaranteed investment contracts meet the definition of *derivatives* in accordance with paragraph 6 of FASB Statement No. 133.
B7—Embedded Derivatives: Variable Annuity Products and Policyholder Ownership of Assets (revised September 25, 2000)	Traditional variable annuity products do not contain embedded derivatives that warrant separate accounting under FASB Statement No. 133, even though the insurer, rather than the policyholder, actually owns the assets.
B8—Embedded Derivatives: Identification of the Host Contract in a Nontraditional Variable Annuity Contract (revised September 25, 2000)	Nontraditional variable annuity contracts are distinguished from traditional variable annuity contracts by the fact that investment risk associated with the assets backing the nontraditional variable annuity contracts is shared

	between the issuer and the policyholder. The host contract for a nontraditional variable annuity contract is the traditional variable annuity portion of the contract (that is, without the nontraditional embedded components).
B9—Embedded Derivatives: Clearly and Closely Related Criteria for Market Adjusted Value Prepayment Options (December 6, 2000)	The economic characteristics and risks of the embedded derivative (market-adjusted value prepayment option) in a market value annuity contract are clearly and closely related to the economic characteristics and risks of the host contract and, therefore, need not be bifurcated in accordance with paragraph 12 of FASB Statement No. 133.
B10—Embedded Derivatives: Equity-Indexed Life Insurance Contracts (revised June 16, 2006)	The existence of a death benefit provision does not exclude the entire equity-indexed life insurance contract from being subject to FASB Statement No. 133 for either the issuer or the policyholder because the policyholder can obtain an equity-linked return by exercising the surrender option before death.
B25—Embedded Derivatives: Deferred Variable Annuity Contracts with Payment Alternatives at the End of the Accumulation Period (revised December 19, 2001)	Deferred variable annuity contracts may contain minimum benefit guarantees in either the accumulation or payout phases of the contract. This issue provides derivative accounting guidance for four separate minimum guarantee scenarios.
B26—Embedded Derivatives: Dual-Trigger Property and Casualty Insurance Contracts (March 14, 2001)	A property and casualty contract that provides for the payment of benefits and claims as a result of both an identifiable insurable event and changes in a variable would not contain an embedded derivative instrument that is required to be separately accounted for under FASB Statement No. 133 provided (1) benefits and claims are paid only if an identifiable insurable event occurs (for example, theft or fire), (2) the amount of the payment is limited to the amount of the policyholder's incurred insured loss, and (3) the loss is not virtually certain to occur.
B27—Embedded Derivatives: Dual-Trigger Financial Guarantee Contracts (revised March 26, 2003)	A financial guarantee insurance contract for which payment of a claim is triggered only by the occurrence of the insured's credit losses exceeding a specified level on its loans held (though the amount of the payment is affected by the credit losses in a customized pool of loans by third parties exceeding the same specified level) is an insurance contract that is not subject to FASB Statement No. 133 requirements because it indemnifies the insured for its actual losses incurred above a specified level. A provision limiting claims in the event the insured's credit losses exceed the credit losses in a referenced pool or index of consumer loans represents a type of deductible, rather than an embedded derivative that warrants separate accounting under FASB Statement No. 133.

(continued)

B28—Embedded Derivatives: Foreign Currency Elements of Insurance Contracts (revised March 26, 2003)

Contracts that pay claims in a currency different from the one in which the loss is measured at a predetermined contract exchange rate are not deemed to have an embedded foreign currency derivative.

B29—Embedded Derivatives: Equity-Indexed Annuity Contracts with Embedded Derivatives (revised June 16, 2006)

Equity-indexed annuities that contain *point-to-point* or *ratchet design* features qualify as contracts with embedded equity derivatives that must be bifurcated and reported at fair value in accordance with paragraph 12 of FASB Statement No. 133.

B30—Embedded Derivatives: Application of Statement 97 and Statement 133 to Equity-Indexed Annuity Contracts (revised June 16, 2006)

Equity-indexed annuities contain a debt instrument with an embedded (equity option) derivative. Upon receipt of the consideration for the equity-indexed contract, the issuer is required to allocate a portion of the consideration to the derivative and the remainder to a fixed annuity host contract. Interest credited and changes in the fair value of the derivative should be recognized in earnings. The host contract should be accreted to the minimum account value at the end of the contract using the effective yield method. A minimum liability shall not be recorded if, prior to the maturity of the contract, the aggregate of the host account value and the market value of the derivative is less than the value of the contract on a FASB Statement No. 97 basis (that is, without bifurcating the derivative).

B31—Embedded Derivatives: Accounting for Purchases of Life Insurance (revised March 27, 2006)

FASB Technical Bulletin No. 85-4 prescribes the accounting for life insurance contracts commonly referred to as COLI (corporate-owned life insurance), BOLI (business-owned life insurance), and key-man insurance. This accounting treatment is applicable even though these insurance contracts include derivative-like provisions that would otherwise require separate accounting as derivatives under paragraph 12 of FASB Statement No. 133.

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 (revised June 16, 2006)

An instrument that incorporates credit risk exposures that are either unrelated or only partially related to the creditworthiness of that instrument's obligor has an embedded derivative that is not considered *clearly and closely related* to the economic characteristics and risks of the host contract. B36 affects the accounting for credit-linked notes that incorporate a third party's credit (or default) risk and modified coinsurance arrangements between reinsurers and ceding insurance companies and similar arrangements, which typically include a provision for passing a return that is linked to the performance of investments held by the ceding company to the reinsurer.

The scope of B36 encompasses any receivable or payable where the interest is determined by reference to an actual pool of assets (unless the

	pool were comprised entirely of risk-free debt securities or real estate) or determined by any index other than a *pure* interest rate index.
C1—Scope Exceptions: Exception Related to Physical Variables (February 17, 1999)	If a contract contains a payment provision that requires the issuer to pay to the holder a specified dollar amount based on a financial variable, the contract is subject to the requirements of FASB Statement No. 133 because it would not meet the exclusion in paragraph 10(e)(1) of FASB Statement No. 133.
G4—Cash Flow Hedges: Hedging Voluntary Increases and Interest Credited on an Insurance Contract Liability (revised September 25, 2000)	FASB Statement No. 133 would permit an insurance company to qualify for cash-flow hedge accounting if it is hedging the possibility that it may need to voluntarily increase the interest rate used to credit interest on certain whole life, universal life, repetitive premium variable annuity, and single premium variable annuity contract liabilities. However, to qualify for cash-flow hedge accounting, changes in the hedged interest payments attributable to the hedged risk must be sufficiently correlated with the changes in the cash flows of the hedging derivative.

Reminder—Actuarial Data Integrity

.154 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 claim 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 (e.g., tests of payments on claims paid during the current calendar year).

.155 There may be circumstances in which data deemed significant by the appointed actuary are 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

.156 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.

.157 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; AICPA, *PCAOB Standards and Related Rules*, AU sec. 9339.01–.15, respectively), 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*), supersedes AU section 339 (AICPA, *PCAOB Standards and Related Rules*) for audits of public companies and other issuers.

.158 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 most recent version of the Handbook. Additionally, letters were sent to chief examiners in the states apprising them of the new process.

.159 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

.160 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.

Recent Auditing and Attestation Pronouncements and Related Guidance

.161 Presented in the following table is a list of recent 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/Audit+and+Attest+Standards/. 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.

.162 The PCAOB establishes auditing and attestation standards for audits of public companies. Refer to the PCAOB Web site at www.pcaob.org for information about its activities. You may also review the *SEC and PCAOB Alert—2006/07* (product no. 022497kk), 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. 102, *Defining Professional Requirements in Statements on Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 120) Statement on Standards for Attestation Engagements (SSAE) No. 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 20) Issue Date: December 2005 (Not applicable to audits conducted in accordance with PCAOB standards)	These standards established two categories of professional requirements that are identified by specific terms. The words *must* or *is* required are used to indicate an unconditional requirement. The word *should* is used to indicate a presumptively mandatory requirement. The words *may, might, could,* and *should consider* represent actions that auditors have a professional obligation to consider. The provisions of SAS No. 102 and SSAE No. 13 were effective upon issuance. It is the ASB's intention to make conforming changes to AICPA literature over the next several years to remove any language that would imply a professional requirement where none exists.
SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339) Issue Date: December 2005 (Not applicable to audits conducted in accordance with PCAOB standards)	SAS No. 103 supersedes SAS No. 96, *Audit Documentation*, and amends SAS No. 1, section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 530). This standard is 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. See the "SAS No. 103, Audit Documentation" section in this Alert.
SASs No. 104 through No. 111, the Risk Assessment Standards Issue Date: March 2006 (Not applicable to audits conducted in accordance with PCAOB standards)	See the "AICPA Risk Assessment Standards" section 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 (Not applicable to audits conducted in accordance with PCAOB standards)	SAS No. 112 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. 113, *Omnibus Statement on Auditing Standards—2006* (AICPA, *Professional Standards*, vol. 1, AU secs. 150, 316, 328, 333, 341, 341A, 342, and 560) Issue Date: November 2006 (Not applicable to audits conducted in accordance with PCAOB standards)	This standard: • Revises the terminology used in the 10 standards of SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150), 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. 35 and .46) 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 *completion of field work* with the term *date of the auditor's report*; and • 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. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380) Issue Date: December 2006 (Not applicable to audits conducted in accordance with PCAOB standards)	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.
SSAE No. 14, *SSAE Hierarchy* (AICPA, *Professional Standards*, vol. 1, AT sec. 50) Issue Date: November 2006 (Not applicable to audits conducted in accordance with PCAOB standards)	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 attest 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).

AICPA TPA section 8100.01–.02 (Nonauthoritative)	The title of section TIS 8100.01 is "Determining the Effective Date of a New Statement on Auditing Standards for Audits of a Single Financial Statement,," and the title of TIS section 8100.02 is "Determining the Effective Date of a New Statement on Auditing Standards for Audits of Interim Periods."
PCAOB Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist* Issue Date: February 2006 (Applicable to audits conducted in accordance with PCAOB standards only)	This standard applies if auditors report on the elimination of a material weakness in a company's internal control over financial reporting. The standard establishes a voluntary engagement that would be performed at the election of the company.
PCAOB Conforming Amendment to AT 101.04*f*, *Attest Engagements, Conforming Amendment to PCAOB Auditing and Related Professional Practice Standards Resulting from the Adoption of the Auditing Standard No. 4* Issue Date: February 2006 (Applicable to audits conducted in accordance with PCAOB standards only)	The conforming amendment states that Auditing Standard No. 4 must be used for reporting on whether a material weakness continues to exist for any purpose other than a company's internal use.
PCAOB Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees Issue Date: April 2006 (Applicable to audits conducted in accordance with PCAOB standards only)	The rules include general rules with respect to ethics and independence, restrict certain types of tax services a registered public accounting firm may provide to its audit clients, and prohibit contingent fee arrangements for any services a registered public accounting firm provides to its audit clients in order to maintain its independence.
PCAOB Report on the Initial Implementation of 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*, PCAOB Staff Guidance section 300) Issue Date: November 2005 (Applicable to audits conducted in accordance with PCAOB standards only)	This report reaffirmed and amplified previous guidance issued by the PCAOB in May 2005. The report focuses on reasons the PCAOB found audits performed were not always as efficient and effective as Auditing Standard No. 2 intended. The report also explains certain aspects of Auditing Standard No. 2 such as the terms *more than remote* and *strong indicators*.

(continued)

PCAOB Overview of Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist* Issue Date: April 2006 (Applicable to audits conducted in accordance with PCAOB standards only)	This overview provides additional information on the provisions of Auditing Standard No. 4.
PCAOB Staff Questions and Answers, *Adjustments to Prior-Period Financial Statements Audited by a Predecessor Auditor* Issue Date: June 2006 (Applicable to audits conducted in accordance with PCAOB standards only)	The guidance explains that if prior period financial statements that require adjustments were audited by a predecessor auditor, either the successor auditor or the predecessor auditor may audit the adjustments as long as the auditor is independent and registered with the PCAOB. The guidance continues to address questions regarding when the predecessor auditor audits the prior period financial statement adjustments, when the successor auditor audits the prior period financial statement adjustments, and when the successor auditor has not yet completed an audit of the current period financial statements.
PCAOB Staff Audit Practice Alert No. 1, *Matters Relating to Timing and Accounting for Options Grants* Issue Date: July 2006 (Applicable to audits conducted in accordance with PCAOB standards only)	This issuance was prompted by recent reports and disclosures about issuer practices related to the granting of stock options, including the *backdating* of such grants. The guidance identifies existing standards that could bear on auditors' work and applies them to the issues that have been raised regarding companies' stock option granting practices. It does not establish new requirements.
PCAOB Staff Questions and Answers, *Auditing the Fair Value of Share Options Granted to Employees* Issue Date: October 2006 (Applicable to audits conducted in accordance with PCAOB standards only)	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.

SAS No. 103, *Audit Documentation*

.163 In December 2005, the ASB issued SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339). This SAS supersedes SAS No. 96 of the same name. 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.

.164 The SAS also amends paragraphs .01 and .05 of AU section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1), as amended. The amendment 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 on the financial statements. As defined in the footnote to paragraph .01, sufficient appropriate audit evidence includes, among other things, evidence that the audit documentation has been reviewed and that the company's financial statements, including disclosures, have been prepared and that management has asserted that they have taken responsibility for them. Consider how this guidance affects the process followed on your engagements (including the review of audit documentation and financial statements, obtaining management's representations, and analyzing subsequent events) and how this affects the date of the audit report.

AICPA Risk Assessment Standards

.165 In March 2006, the AICPA ASB issued eight SASs that provide extensive guidance concerning the auditor's assessment of the risks of material misstatement in a financial statement audit, and the design and performance of audit procedures whose nature, timing, and extent are responsive to the assessed risks. Additionally, the SASs establish standards and provide guidance on planning and supervision, the nature of audit evidence, and evaluating whether the audit evidence obtained affords a reasonable basis for an opinion regarding the financial statements under audit. 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")*	This statement amends SAS No. 1, *Due Professional Care in the Performance of Work* (AU sec. 230).
SAS No. 105, *Amendment to Statement on Auditing Standards No. 95,* Generally Accepted Auditing Standards	This statement amends SAS No. 95, Generally Accepted Auditing Standards (AU sec. 150).
SAS No. 106, *Audit Evidence*	This statement supersedes SAS No. 31, *Evidential Matter* (AU sec. 326A).
SAS No. 107, *Audit Risk and Materiality in Conducting an Audit*	This statement supersedes SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AU sec. 312A).
SAS No. 108, *Planning and Supervision*	This statement supersedes SAS No. 1, *Appointment of the Independent Auditor* (AU sec. 310); and supersedes SAS No. 22, *Planning and Supervision* (AU sec. 311A).
SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*	This statement supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AU sec. 319).
SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*	This statement supersedes SAS No. 45, *Substantive Tests Prior to the Balance-Sheet Date* (AU sec. 313); and together with SAS No. 109, supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AU sec. 319).
SAS No. 111, *Amendment to Statement on Auditing Standards No. 39*, Audit Sampling	This statement amends SAS No. 39, *Audit Sampling* (AU sec. 350).

Key Provisions of the New Standards

.166 The SASs emphasize the link between understanding the entity, assessing risks, and the design of further audit procedures. The SASs introduce the concept of risk assessment procedures, which are deemed necessary to provide a basis for assessing the risk of material misstatement. Risk assessment procedures, along with further audit procedures, which consist of tests of controls and substantive tests, provide the audit evidence to support the auditor's opinion of the financial statements. According to the SASs, the auditor should perform risk assessment procedures to gather information and gain an understanding of the entity and its environment, including its internal controls. These procedures include inquiries, analytical procedures, and inspection and observation. Assessed risks and the basis for those assessments should be documented; therefore, auditors may no longer default to maximum control risk for an entity's risk assessment without documenting the basis for that assessment. The SASs also require auditors to consider and document how the risk assessment at the financial statement level affects individual financial statement assertions, so that auditors may tailor the nature, timing, and extent of their audit procedures to be responsive to their risk assessment. It is anticipated that generic audit programs will not be appropriate for all audit engagements because risks vary among entities.

Effective Date and Implementation

.167 The SASs are effective for audits of financial statements for periods beginning on or after December 15, 2006; earlier application is permitted. In most cases, implementation of the SASs will result in an overall increased work effort by the audit team, particularly in the year of implementation. It is also anticipated that to implement the SASs appropriately, many firms will have to make significant revisions to their audit methodologies and train their personnel accordingly. 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.

New Companion Audit Guide

.168 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 will help 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.

Recent Independence and Ethics Pronouncements

.169 The AICPA *Independence and Ethics Alert—2006/2007* (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.

.170 The AICPA general *Audit Risk Alert—2006/07* (product no. 022337kk) and other AICPA industry-specific Alerts contain summaries of recent pronouncements not included here. To obtain copies of other AICPA Alerts, contact AICPA Service Center Operations at (888) 777-7077 or go online at www.cpa2biz.com.

Recent Accounting Pronouncements and Related Guidance

.171 Presented in this section is a list of recent accounting pronouncements and related 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*.

Recent Accounting Pronouncements and Related Guidance	
FASB Statement No. 155	*Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*
FASB Statement No. 156	*Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140*
FASB Statement No. 157	*Fair Value Measurements*
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)*
FASB Interpretation No. 48	*Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*
FSP FTB 85-4-1	*Accounting for Life Settlement Contracts by Third-Party Investors*
EITF Issue No. 06-4	"Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements"
EITF Issue No. 06-5	"Accounting for Purchases of Life Insurance—Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4"
FASB EITF Issues	Go to www.fasb.org/eitf/agenda.shtml for a complete list of EITF Issues.
FSPs	Go to www.fasb.org/fasb_staff_positions for a complete list of FSPs.
AICPA Practice Guide (Nonauthoritative)	"Practice Guide on Accounting for Uncertain Tax Positions Under FIN 48"
AICPA TPA section 6910.21–.24 (Nonauthoritative)	These TPA sections discuss various investment company topics.
AICPA TPA section 5700.01 (Nonauthoritative)	"Income Tax Accounting for Contributions to Certain Nonprofit Scholarship Funding Organizations"
AICPA TPA section 2210.28 (Nonauthoritative)	"Accounting for Certain Liquidated Damages"
AICPA TPA section 1400.32 (Nonauthoritative)	"Parent-Only Financial Statements and Relationship to GAAP"
AICPA TPA section 2130.09–.37 (Nonauthoritative)	These TPA sections discuss various topics on the application of SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*.

(continued)

AICPA TPA section 1400.29–.31 and 1500.06 (Nonauthoritative)	These TPA sections discuss various topics regarding FASB Interpretation No. 46(R) on variable interest entities.
AICPA TPA section 6910.16–.20 (Nonauthoritative)	These TPA sections discuss nonregistered investment partnerships topics.
AICPA TPA section 5600.07–.17 (Nonauthoritative)	These TPA sections discuss various lease topics.
COSO Internal Control Over Financial Reporting—Guidance for Smaller Public Companies	The guidance provides a set of 20 basic principles representing the fundamental concepts associated with and drawn directly from the five components of internal control described in the COSO Internal Control Framework.

.172 Of the pronouncements and other guidance listed in the previous table, those having particular significance to the insurance industry are briefly explained here. The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. The AICPA general *Audit Risk Alert—2006/07* and other AICPA industry-specific Alerts also contain summaries of recent pronouncements not discussed here. To obtain copies of AICPA literature, call the AICPA Service Center Operations at (888) 777-7077 or go online at www.cpa2biz.com.

FASB Statement No. 157, *Fair Value Measurements*

.173 In September 2006, the FASB issued FASB Statement No. 157 to provide enhanced guidance for using fair value to measure assets and liabilities. 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 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.

FSP FTB 85-4-1, *Accounting for Life Settlement Contracts by Third-Party Investors*

.174 This FSP provides initial and subsequent measurement guidance and financial statement presentation and disclosure guidance for investments by third-party investors in life settlement contracts. As noted in paragraph 5 of the FSP, an investor may elect to account for its investment in life settlement contracts using either the investment method or the fair value method. This FSP also amends certain provisions of FASB Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance*, and FASB Statement No. 133.

.175 The guidance in this FSP shall be applied to fiscal years beginning after June 15, 2006. An investor shall apply the guidance prospectively for all new life settlement contracts. At the date of adoption, an investor shall make a one-time irrevocable election to account for its currently held life settlement contracts on an instrument-by-instrument basis using either the fair value method or the investment method and recognize a cumulative-effect adjustment to beginning retained earnings.

EITF Issue No. 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements"

.176 This EITF issue addresses how an employer should account for the deferred compensation or postretirement benefit aspects of split-dollar life insurance arrangements. The EITF issue pertains to entities with endorsement split-dollar life insurance arrangements that provide the employee with a specified benefit that is not limited to the employee's active service period (that is, it extends into postretirement). The structure of a split-dollar life insurance arrangement can be complex and varied. In a typical endorsement split-dollar arrangement, the employer owns the policy and all rights of ownership, including the right to terminate the policy at any time. As a benefit of employment, the institution endorses over to the employee (the employee designates a beneficiary) a portion of the specified benefit.

.177 The EITF concluded that the specified benefit associated with the endorsement split-dollar life insurance arrangement has not been settled upon entering into such an arrangement and as a result, the employer should recognize a liability for future benefits based on the substantive agreement with the employee. Therefore, the use of an investment product to fund a deferred compensation arrangement does not prevent the need to accrue the obligation presented by the deferred compensation arrangement; note that a liability for the benefit obligation has not been settled through the purchase of an endorsement-type policy. The consensus in this EITF issue is effective for fiscal years beginning after December 15, 2007, with earlier application permitted.

EITF Issue No. 06-5, "Accounting for Purchases of Life Insurance—Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4"

.178 EITF Issue No. 06-5, "Accounting for Purchases of Life Insurance—Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4," concluded on three issues. First, when determining the amount that can be realized in an insurance contract, the policyholder should consider any additional amounts, beyond the cash surrender value, included in the contractual terms of the policy. Second, the amount that can be realized under the insurance contract should be determined based on the assumed surrender value at the individual policy or certificate level, unless all policies (or certificates) are required to be surrendered as a group. Any amounts that are recoverable by the policyholder at the discretion of the insurance company should be excluded from the amount that could be realized. Third, in measuring the cash surrender value, the task force concluded when it is appropriate to discount the cash surrender value. This EITF issue is effective for fiscal years beginning after December 15, 2006. Earlier application is permitted as of the beginning of a fiscal year for periods in which interim or annual financial statements have not yet been issued.

On the Horizon

.179 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. Read the AICPA general *Audit Risk Alert—2006/07* for a more complete list of ongoing auditing and accounting projects. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS.

.180 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/
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/
Financial Accounting Standards Board (FASB)	www.fasb.org
National Association of Insurance Commissioners (NAIC)	www.naic.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—Nonpublic Companies

Proposed Amendment to SAS No. 69, The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles, for Nongovernmental Entities*

.181 The ASB has 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 FASB proposed Statement, which can be obtained at www.fasb.org.

Proposed SSAE Regarding Reporting on an Entity's Internal Control Over Financial Reporting

.182 In January 2006, the ASB issued a revised exposure draft of a proposed 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 earlier, in December 2006, the PCAOB exposed for public comment a proposed auditing standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* to supersede the current Auditing Standard No. 2. Because the forthcoming changes to Auditing Standard No. 2 will be relevant to the revision of AT section 501, the ASB has decided to defer to issuance of final revised AT section 501 until the PCAOB issues their amendments and the ASB has time to consider them.

Auditing Pipeline—Public Companies

.183 Guidance issued by the PCAOB is included in the section of this Alert titled "Recent Auditing and Attestation Pronouncements and Related Guidance." Readers may also refer to the "SEC and PCAOB Update" section of this Alert for a brief overview of some significant ongoing SEC and PCAOB projects. For more information regarding recent developments at both the SEC and PCAOB, readers may refer to the *SEC and PCAOB Alert—2006/07* (product no. 022497kk), mentioned previously.

Accounting Pipeline

.184 Presented below are accounting pronouncements currently in the exposure 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 below.

FASB Risk Transfer Project

.185 As mentioned in the "Reinsurance Arrangements" section of this Alert, the FASB issued an invitation to comment on "Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting" in May 2006 with a comment period that ended in August 2006. The purpose of the invitation to comment was to gather input from buyers and sellers of insurance and reinsurance contracts and the users of their financial statements about the possible bifurcation of those contracts. The FASB was seeking to gather information about whether bifurcation of certain contracts and accounting for the financing element as a deposit would improve financial reporting by providing users of financial statements with better information about the economic substance of insurance arrangements.

.186 At its December 6, 2006, meeting, the FASB decided that it would no longer pursue the issue of bifurcation of insurance and reinsurance contracts for financial reporting as part of its discussions relating to its insurance risk transfer project. The FASB decided the risk transfer project should focus on developing enhanced insurance and reinsurance disclosures that highlights any risk-limiting features included in those contracts, and to also work on developing additional language around the current FASB Statement No. 113 guidance to increase the level of risk transfer required for a contract to be accounted for as insurance. 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.

FASB Project on Derivative Disclosures

.187 FASB Statement No. 133 has been criticized by certain analysts, auditors, investors, and others for lacking transparent disclosures, allowing a user of the financial statements to assess the overall risk of derivatives on a reporting entity from both a quantitative and qualitative perspective. An exposure draft was issued on December 8, 2006, titled, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*. The comment deadline is March 2, 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. The proposed disclosures will be effective for both interim and annual reporting periods ending after December 15, 2007, with early application encouraged. At initial adoption, disclosures for earlier periods presented for comparative purposes will be encouraged but not required. Disclosures for earlier periods presented for comparative purposes will be required beginning in the first year after the year of initial adoption. Auditors can monitor the progress of this project on the FASB's Web site.

FASB Business Combination Projects—Insurance Overview

.188 On June 30, 2005, the FASB, jointly with the International Accounting Standards Board (IASB), issued for comment two exposure drafts: proposed Statements of Financial Accounting Standards, *Business Combinations—a Replacement of FASB Statement No. 141*, and *Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries—a replacement of ARB No. 51*. The FASB's target date for issuing the final standards is mid-2007. The FASB and IASB will review the target effective dates of the Statements near the end of deliberations.

.189 In these proposed Statements, the FASB plans to revise the existing guidance on the application of the purchase method. The following are among the main proposals:

1. Business combinations would be measured and recognized as of the acquisition date at the fair value of the acquiree. This would apply to step acquisitions and partial acquisitions (those in which less than 100 percent of the equity interests in the acquiree are acquired at the acquisition date).

2. The assets acquired and liabilities assumed would be measured and recognized at their fair values as of the acquisition date, with limited exceptions.

3. A new definition of a business would amend the definition provided in International Financial Reporting Standard (IFRS) 3, *Business Combinations*, and nullify the definitions provided in EITF Issue No. 98-3, "Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business," and FASB Interpretation No. 46.

4. In a step acquisition, the acquirer would remeasure its preacquisition noncontrolling equity investments to fair value at the acquisition date and would recognize any gain or loss in income.

5. If the acquisition date fair value of the acquirer's interest in the acquiree exceeds the fair value of the consideration transferred for that interest, the excess would first be recognized as a reduction of any goodwill until goodwill is reduced to zero then any remaining excess would be recognized in income.

6. Any measurement period adjustments to the provisional values recognized for the assets acquired and liabilities assumed would be recognized as if the accounting for the business combination had been completed at the acquisition date. Therefore, comparative information for prior periods would be adjusted.

.190 ***Short-Duration Contracts***. The business combinations exposure draft states that short-duration insurance contract claim liabilities assumed in a business combination should be measured at fair value at the date of acquisition. Paragraph A49 of the business combinations exposure draft explains that FASB Statement No. 60, as amended by paragraph D13 of the exposure draft, requires an expanded presentation that splits the fair value of acquired insurance contracts into two components:

1. A liability measured in accordance with the insurer's accounting policies for short-duration insurance contracts that it issues.

2. An intangible asset, representing the fair value of the contractual rights and obligations acquired, to the extent that the liability does not reflect that fair value. This intangible asset is excluded from the scope of FASB Statement No. 142, *Goodwill and Other Intangible Assets*, and FASB Statement No. 144. After the business combination, the acquirer is required to measure that intangible asset on a basis consistent with the measurement of the related insurance liability.

.191 The business combinations exposure draft also provides guidance for "Day 2" accounting in paragraph 36. After initial recognition, contingencies shall be accounted for as follows:

a. A contingency that would be accounted for in accordance with FASB Statement No. 5 if it were acquired or incurred in an event other than a business combination shall continue to be measured at fair value with any changes in fair value recognized in income in each reporting period.

b. All other contingencies shall be accounted for in accordance with GAAP. For example:

1. A contingency that is a financial instrument shall be accounted for in accordance with applicable financial instrument guidance.
2. A contingency that is an asset or liability arising from an insurance contract shall be accounted for in accordance with FASB Statement No. 60, as amended (including the intangible asset, if any, recognized for the difference between the amounts recognized on the acquisition date at fair value and the amounts that would be recognized in accordance with FASB Statement No. 60).

FASB Fair Value Option Project

.192 In the FASB's fair value project, it is considering whether to permit entities a one-time election to report certain financial instruments (and perhaps similar nonfinancial instruments) at fair value with the changes in fair value included in earnings. The fair value option project has been divided into two phases. This proposal, issued January 25, 2006 and titled *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115,* represents phase one of the project. The exposure draft's comment period ended April 10, 2006. Phase one addresses the fair value option for certain financial assets and financial liabilities. Phase two will consider permitting the fair value option for certain nonfinancial assets and nonfinancial liabilities and some of the financial assets and financial liabilities excluded from the scope of phase one.

.193 The proposed Statement would create a fair value option under which an entity may irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and financial liabilities on a contract-by-contract basis, with changes in fair value recognized in earnings as those changes occur. The proposed Statement has specific financial presentation requirements to display fair values and those values that are measured using other measurement techniques. The proposed Statement would amend FASB Statement No. 115 to require that securities reported at fair value in accordance with FASB Statement No. 115 satisfy the specific financial statement presentation requirements.

.194 The exposure draft noted that insurance and reinsurance contracts that are financial instruments, as discussed in FASB Statements No. 60, No. 97, and No. 113, would be included in the scope of the fair value option project. Questions have been submitted to the FASB asking which insurance and reinsurance contracts would be considered financial instruments, and recommending that the final guidance clearly state the criteria to be used in determining which insurance and reinsurance contracts should be designated as financial instruments to avoid significant inconsistency in application of this Statement. During the FASB's redeliberations which began in August 2006, the FASB tentatively decided that insurance and reinsurance contracts that meet the definition of a financial instrument will remain in the scope of phase one, and the scope of phase one will be expanded beyond insurance and reinsurance contracts that are financial instruments to also include insurance contracts that do not prohibit settlement of the insurer's obligation by payment to a third-party provider of goods or services rather than by payment to the insured or other claimant.

.195 The FASB tentatively projects a final Statement for phase one will be issued during the first quarter of 2007. FASB activity on phase two will begin after a final Statement has been issued for phase one. Visit the FASB Web site at www.fasb.org/project/index.shtml for additional information.

FASB Financial Guarantee Insurance Project

.196 The objective of this project is to provide guidance with respect to the timing of claim liability recognition, premium recognition (including accounting for installment premiums), and the related amortization of deferred policy acquisition costs, specifically for financial guarantee contracts issued by insurance companies that are not accounted for as derivative contracts under FASB Statement No. 133. A financial guarantee contract guarantees the holder of a financial obligation the full and timely payment of principal and interest when due and is typically issued in conjunction with municipal bond offerings and certain structured finance transactions. The goal is to reduce diversity in accounting by financial guarantee insurers, thereby enabling users to better understand and more readily compare the insurers' financial statements. An exposure document is expected to be issued by the FASB in the first quarter of 2007.

IASB and FASB Modified Joint Project on Accounting for Insurance Contracts

.197 The IASB and the FASB have agreed to approach a project on accounting for insurance contracts using the modified joint approach. The IASB will issue for public comment a discussion paper containing its tentative decisions on the accounting for insurance contracts. The FASB plans to seek input from its constituents on the IASB's preliminary views by issuing an invitation to comment containing the IASB discussion paper. The feedback received on that invitation to comment will be used by the FASB in deciding whether to add to its agenda a joint project with the IASB to develop a comprehensive standard on accounting for insurance contracts. The IASB expects to issue its discussion paper in the first quarter of 2007; the FASB also expects to issue its invitation to comment during the first quarter 2007.

FASB Exposure Draft, Accounting for Transfers of Financial Assets

.198 The exposure draft *Accounting for Transfers of Financial Assets* is a revision of a June 2003 exposure draft, *Qualifying Special-Purpose Entities and Isolation of Transferred Assets*, and would amend FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125*. The proposed Statement seeks to:

1. Clearly specify the permitted activities of a qualifying special-purpose entity (QSPE).
2. Address practice issues related to which arrangements should be considered and how they should be considered in the legal isolation analysis.
3. Eliminate the prohibition on a QSPE's ability to hold passive derivative financial instruments that pertain to beneficial interests held by a transferor.
4. Revise the methodology used to initially measure at fair value interests related to transferred financial assets held by a transferor.
5. Clarify guidance related to when rollovers of beneficial interests are permitted within a QSPE.

.199 At its October 18, 2006 meeting, the FASB continued redeliberations on the exposure draft and discussed whether and how to amend the isolation guidance in FASB Statement No. 140. The FASB decided to amend the isolation criteria in paragraph 9(a) of FASB Statement No. 140 for consolidated financial statements that include a transferor by requiring that the legal analysis treat all of the involvements in the transferred financial assets by any entity that is included in the consolidated financial statements being presented as if those involvements were made by the transferor. In order for a parent entity of a transferor to meet the isolation requirement, an isolation analysis must conclude that the transferred financial assets would be beyond the reach of all of the entities (and their creditors) included in the financial statements being presented, using the assumption that all of the involvements of the entities were made by the transferor. The FASB expects to issue a final Statement, which would amend FASB Statement No. 140, in the second quarter of 2007. See the FASB Web site for complete information.

Proposed FASB Statement, The Hierarchy of Generally Accepted Accounting Principles

.200 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 AU section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles (AICPA, *Professional Standards*, vol. 1). 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 the "Auditing Pipeline—Nonpublic Companies" section of this Alert) to ensure that each of the documents has a uniform effective date. Readers should be alert for the issuance of a final Statement.

.201 At the August 2006 meeting, the FASB discussed certain GAAP hierarchy issues that were raised by constituents subsequent to redeliberations on the FASB exposure draft *The Hierarchy of Generally Accepted Accounting Principles.* The FASB decided that:

- The grandfathering provisions related to EITF Issues and SOPs in SAS No. 69 should not be included in the final Statement.
- EITF D-Topics will be explicitly included in category (c) of the GAAP hierarchy. Additionally, a footnote will be added that states that SEC observer comments are accounting principles for SEC registrants.
- A near-final version of the proposed Statement, including all of the FASB's decisions made during redeliberations, will be posted to the Web site.

.202 Again, 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.

Derivatives TPA

.203 The Convertible Debt, Convertible Preferred Shares, Warrants, and Other Equity-Related Financial Instruments Task Force and AICPA staff have issued a working draft of the TPA titled "Convertible Debt, Convertible Preferred Shares, Warrants, and Other Equity-Related Financial Instruments." This TPA is nonauthoritative, is a working draft, and reflects existing authoritative literature as of December 1, 2006. It can be accessed at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/Working+Draft+of+Convertible+Debt+Convertible+Preferred+Shares+Warrants+and+Other+Equi.htm.

Proposed FASB EITFs and FSPs

.204 ***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.

.205 ***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/proposed_fsp.shtml for complete information.

Resource Central

.206 The following are various resources that practitioners engaged in the insurance industry may find beneficial.

Publications

.207 The following publications deliver valuable guidance and practical assistance as potent tools to be used on your engagements.

- Audit and Accounting Guide *Life and Health Insurance Entities*. This Guide summarizes applicable practices and delivers "how-to" advice for handling almost every type of financial statement. It describes relevant matters, conditions, and procedures unique to the insurance industry and illustrates treatments of financial statements and reports to caution auditors and accountants about unusual problems.

- Audit and Accounting Guide *Property and Liability Insurance Companies*. This Guide summarizes applicable practices and delivers "how-to" advice for handling almost every type of financial statement. It describes relevant matters, conditions, and procedures unique to the insurance industry and illustrates treatments of financial statements and reports to caution auditors and accountants about unusual problems.

- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit*. This Guide will assist practitioners in applying the auditing standards related to the assessment of risk in an audit of financial statements. This Guide provides both authoritative and nonauthoritative guidance on applying the audit risk standards and addresses. The Guide also provides guidance on, among other things:

  — Key concepts underlying the auditor's risk assessment process

  — Understanding the client, its environments, and its internal control

  — Linking risk assessment and the design of further audit procedures

  — Performing further audit procedures

  — Evaluating audit findings, audit evidence, and internal control deficiencies

  In addition, the Guide offers many useful appendixes and an in-depth illustrative case study. Plus, the existing Audit Guide titled *Consideration of Internal Control in a Financial Statement Audit* has been incorporated into this new Guide.

- Audit Guide *Analytical Procedures*. You will receive guidance on the effective use of analytical procedures with an emphasis on analytical procedures as substantive tests. This 2006 Guide includes AU section 329 (AICPA, *Professional Standards*, vol. 1) concepts and definitions, a questions-and-answers section, an illustrative case study, and a new appendix that includes useful financial ratios.

- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*. In this Guide, you will find an overview of derivatives and securities in addition to case studies to help you better understand how to audit derivative instruments.

- Audit Guide *Auditing Revenue in Certain Industries*. This Guide assists auditors in fulfilling their professional responsibilities with regard to auditing assertions about revenue. In this edition, you will find:

  — Discussions on responsibilities of management, boards of directors, and audit committees for reliable financial reporting

  — Summaries on key accounting guidance regarding whether and when revenue should be recognized in accordance with GAAP

  — Circumstances and transactions that may signal improper revenue recognition

  — Procedures that the auditor may find effective in limiting audit risk arising from improper revenue recognition

- General *Audit Risk Alert—2006/07* (product no. 022337kk). 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.

- *Compilation and Review Alert—2006/07* (product no. 022307kk). This Alert updates CPAs on recent practice issues and professional standards that affect these types of engagements.

- *Independence and Ethics Alert—2006/07* (product no. 022477kk). This Alert will inform you of recent developments in the area of independence and ethics for accountants. Specifically, this Alert will help you understand your independence requirements under the AICPA Code of Professional Conduct and certain other rule-making and standard-setting bodies. A compact "plain English" digest of AICPA independence rules is also included. This alert includes information on guidance on the performance of nonattest services to attest clients, SEC independence rules, PCAOB independence and ethics activities, and GAO independence rules.

- *SEC and PCAOB Alert—2006/07* (product no. 022497kk). This Alert will prove useful for accountants working in public companies, auditors of public companies, or just the interested accountant who would like to remain current on issues affecting public companies. This Alert provides preparers and auditors with a detailed overview of recent developments at the SEC and PCAOB with respect to financial reporting and auditing matters.

- Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk). This Alert summarizes the eight risk assessment standards, highlights significant new requirements found in the standards, and helps you understand the many new requirements, including the following:

  — Auditors are to gather a sufficient understanding of the client and its environment, including its internal control, to allow for the better development of a tailored audit approach.

  — Auditors are to have an adequate basis of his or her audit approach, eliminating the default to a maximum control risk assessment.

  This easy-to-read Alert gives you the right amount of information you will need to gain an understanding of the standards to begin incorporating the standards into your audit programs.

- AICPA Audit and Accounting Practice Aid *Illustrative Disclosures on Derivative Loan Commitments* (product no. 006642kk). SEC SAB No. 105, *Application of Accounting Principles to Loan Commitments*, emphasizes that registrants should disclose their accounting policy for derivative loan commitments in accordance with APB Opinion No. 22. This Practice Aid provides illustrative disclosures under SEC Regulation S-K, Item 303; SEC Regulation S-K, Item 305; APB Opinion No. 22; FASB Statement No. 133; and FASB Statement No. 107.

- *Checklists and Illustrative Financial Statements for Life and Health Insurance Entities* (product no. 008956kk). This practice aid is invaluable to anyone who prepares financial statements and reports for life and health insurance companies. These disclosure checklists have been designed to help you prepare financial statements and assist you in determining the adequacy of disclosures in the financial statements you are auditing.

- *Checklists and Illustrative Financial Statements for Property and Liability Insurance Entities* (product no. 008966kk). This practice aid is invaluable to anyone who prepares financial statements and reports for property and liability insurance companies. These disclosure checklists have been designed to help you prepare financial statements and assist you in determining the adequacy of disclosures in the financial statements you're auditing.

- *Audit and Accounting Manual* (product no. 005136kk) is developed exclusively for small- and medium-size CPA practices. This unique manual explains and demonstrates useful techniques and procedures for conducting compilation, review, and audit engagements—from planning to internal control to accountants' reports.

- *Accounting Trends & Techniques, 60th Edition* (product no. 009898kk). This is the must-have resource for any CPA who frequently creates or uses financial reports. Filled with current reporting techniques and methods used by the nation's top organizations, this 650-page AICPA bestseller will provide the guidance you need to improve your accounting preparation and procedures.

AICPA reSOURCE: Accounting and Auditing Literature

.208 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

.209 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. Visit www.cpa2biz.com for a complete list of CPE courses.

- *AICPA's Annual Accounting and Auditing Update Workshop* (2006 Edition) (product no. 736182kk [text] or 187190 [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. 736773kk [text] or 186754 [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.

Online CPE

.210 AICPA CPExpress (formerly 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 ($319 for nonmembers) for the annual renewal. 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. To register or learn more, visit www.cpa2biz.com.

Webcasts

.211 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

.212 The CFO 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

.213 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 Satisfaction Center

.214 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

.215 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

.216 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.

* * * *

.217 This Audit Risk Alert replaces *Insurance Industry Developments—2005/06*.

.218 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 aeubanks@aicpa.org or write to:

Amy M. Eubanks, CPA
AICPA
The Palladian
220 Leigh Farm Road
Durham, NC 27707-8110

.219

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

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
National Association of Insurance Commissioners (NAIC)	Information on regulation of the insurance industry	www.naic.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 8139*.]

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

Acknowledgements

The AICPA staff is grateful to the following individuals for their essential contributions in creating this publication.

Wynne E. Baker
Kraft CPAs, PLLC

Sydney K. Garmong
Crowe Chizek and Company, LLC

Dennis Hild
Crowe Chizek and Company, LLC

Richard Juntilla
Wells Fargo & Company

Anne H. Ross
J.W. Hunt and Company, LLP

Barry Cohen,
Mauldin & Jenkins, LLC

Lawrence R. Gee
Countrywide Financial Corporation

Joy Jean
Wolf and Company, P.C.

Myrna Parker
AICPA, Inc.

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.

[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.

---

[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.

(continued)

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.

(continued)

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.

[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.

* * * *

.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

.248

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

[*The next page is 8161*.]

AAM Section 8060

Employee Benefit Plans Industry Developments—2007

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

NOTICE TO READERS
EMPLOYEE BENEFIT PLANS INDUSTRY DEVELOPMENTS—2007

This Audit Risk Alert, prepared by the AICPA staff, is intended to provide auditors of financial statements of employee benefit plans with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform.

This publication is an *Other Auditing Publication* as defined in 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. This publication was reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Linda C. Delahanty
Technical Manager
Audit and Attest Standards

Acknowledgments

The AICPA staff wishes to thank the members of the AICPA Employee Benefit Plans Expert Panel; the AICPA Employee Benefit Plans Audit Guide Revision Task Force; and the Office of the Chief Accountant (OCA), Employee Benefits Security Administration (EBSA) of the U.S. Department of Labor (DOL) for their contributions to this Alert.

2006–2007 Employee Benefit Plans Expert Panel

Marilee P. Lau, *Chair*
Robert Cote
Cindy Finestone
Robert Lavenberg
Lynne McMennamin
Kevin Murphy
Alan Ross
Deborah Smith
Kristin Tveit
Michele Weldon
Alice Wunderlich

How This Alert Helps You

.01 This Alert helps you plan and perform your employee benefit plan audits. It provides information on current industry developments and emerging practice issues as well as current auditing, accounting, and regulatory developments affecting employee benefit plans. The knowledge delivered by this Alert assists you in achieving a more robust understanding of the business, economic, and regulatory environment in which your clients operate.

.02 ***References to Professional Standards.*** When referring to the professional standards, this Alert may cite 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*.

> **Help Desk—**See the AICPA publication *Audit Risk Alert—2006/07* (product no. 022337kk) for general guidance. For a thorough discussion of recent developments and key issues in the area of independence and ethics, see the AICPA Audit Risk Alert *Independence and Ethics Alert—2006/07* (product no. 022477kk). For a thorough discussion of recent Securities and Exchange Commission (SEC) and Public Company Accounting Oversight Board (PCAOB) developments, see the AICPA Audit Risk Alert *SEC and PCAOB Alert—2006/07* (product no. 022497kk). These Alerts can be obtained by calling the AICPA at (888) 777-7077 or by going online at www.cpa2biz.com. It is important to point out that for Employee Retirement Income Security Act of 1974 (ERISA) engagements, the DOL has separate independence standards that may be more restrictive than those of the AICPA. See paragraph A.88 in Appendix A of the AICPA Audit and Accounting Guide *Employee Benefit Plans*, with conforming changes as of March 1, 2007 (EBP Guide) (product no. 012597kk), for a listing of the DOL's independence standards.

Hot Topics

Pension Protection Act of 2006

.03 On August 17, 2006, President Bush signed into law the Pension Protection Act of 2006 (PPA), which is the most comprehensive pension reform legislation since ERISA was enacted in 1974. The PPA, which comprises approximately 400 pages, will lead many companies to change the way their plans are designed and administered, amend plan documents, increase plan funding, and make additional plan disclosures in regulatory filings and to plan participants.

Audit Considerations as a Result of the PPA

.04 Plan sponsors and administrators will need to understand the effects of the new law on their plans and to seek professional advice and assistance in implementing the new requirements. Plan auditors will also need to understand the effects of the new law and consider modifications to the audit approach. Certain changes are effective now or in 2007, but most changes are effective for plan years that begin in 2008 or later.

.05 The PPA is extensive, and certain provisions will affect the plan audit. The AICPA Employee Benefit Plan Audit Quality Center has prepared a summary analysis of key provisions of the PPA, which is available online at www.ebpaqc.aicpa.org. Notable provisions of the PPA that will require auditor attention as the audit is planned and performed include the following:

- Effective in 2007, all employer contributions to a defined-contribution (DC) plan must vest no slower than the schedule that currently applies to matching contributions (the 3-year cliff or 6-year graded schedule). The new vesting rules apply only to contributions made in plan years beginning on or after January 1, 2007, but can also be applied to past contributions.
- It permanently extends a number of employee benefit provisions that were part of the 2001 Economic Growth and Tax Relief Reconciliation Act that had been set to expire in 2010, including increased contribution limits, faster vesting, catch-up contributions, and Roth contributions.
- It provides miscellaneous rules addressing administration of plans including new benefit statement requirements. Quarterly benefit statements must be provided to participants who have the right to direct investments in a plan, and annually to those who do not.

- It provides new annuity rules for defined benefit pension plans and money purchase pension plans effective beginning in 2008. Participants must be offered a new *qualified optional survivor annuity*.
- It revises rollover and plan distribution rules.
- There are new rules encouraging automatic enrollment in 401(k) plans.
- In 2008, safe harbor automatic enrollment is allowed.
- It revises the rules that govern employer funding of defined benefit pension plans that will require the auditor to gain an understanding of the impact of the changes when reviewing the actuarial valuation. The PPA revised many rules surrounding defined benefit plans.
- It provides for new rules related to funding, withdrawal liability, and disclosures for multiemployer plans.
- It created a new plan design, DB(k), to become effective beginning in 2010.
- Plans will be required to be amended to conform to the PPA by the end of the 2009 plan year. Collectively bargained plans have until the end of the 2011 plan year.
- It includes new DOL Safe Harbor guidelines to be issued to provide Section 404(c) protection to plan sponsors for participants who fail to make an affirmative election if the contributions are invested in a default investment option.
- It provides for a new prohibited transaction exemption (PTE) for investment advice from a fiduciary advisor to DC plan participants under an *eligible investment advice arrangement*. It also establishes a new independent audit requirement for DC plans with eligible investment advice arrangements with respect to compliance with applicable requirements for such arrangements. Be alert to the issuance of guidance from the DOL on how this requirement is to be fulfilled.
- Beginning in 2007, it provides for more diversification rights of investments in publicly traded employer securities to participants in a DC plan.

.06 The above highlights serve only as a brief summary of provisions of the PPA that will affect the plan auditor. The auditor will need to be familiar with the PPA to address certain changes in his or her audit approach. While many of the changes are effective for plan years beginning in 2008, auditors should learn more about the immediate impact on the plans they audit and gain an understanding of the intention of management to effectively and efficiently plan and prepare for future audits.

Financial Accounting Standards Board Staff Position AAG INV-1 and SOP 94-4-1

.07 In December 2005, the Financial Accounting Standards Board (FASB) issued 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*.[1]

[1] The financial statement presentation and disclosure guidance in paragraphs 8–11 of Financial Accounting Standards Board (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*, is effective for financial statements for plan years ending after December 15, 2006. The revised definition of fully benefit responsive in paragraph 7 of the FSP shall be effective for all investment contracts as of the last day of the annual period ending after December 15, 2006. Earlier application is permitted for fiscal years in which annual financial statements have not been issued. If comparative financial statements are presented, the guidance in that FSP shall be applied retroactively to all prior periods presented. If an investment contract is considered fully benefit responsive under the revised definition as of the last day of the annual period ending after December 15, 2006, that contract shall be considered fully benefit responsive for all periods presented, provided that contract would have been considered fully benefit responsive in accordance with the then-existing provisions of this Statement of Position (SOP).

.08 This FSP provides (1) a definition of fully benefit-responsive investment contracts and (2) guidance with respect to the financial statement presentation and disclosure of fully benefit-responsive investment contracts.

.09 This FSP amends the guidance in AICPA Statement of Position (SOP) 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans*, with respect to the definition of fully benefit responsive and the presentation and disclosure of fully benefit-responsive investment contracts; SOP 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans;* and paragraph 10(h) of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, to effectively remove the scope exception provided for fully benefit-responsive investment contracts reported at contract value in accordance with SOP 94-4. Appendix B of the FSP shows the amendments to SOP 94-4, SOP 92-6, and FASB Statement No. 133.

Financial Statement Presentation and Disclosure Requirements

.10 Defined-benefit health and welfare benefit plans should report investment contracts at fair value. Defined-contribution 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 defined-contribution plan attributable to fully benefit-responsive investment contracts. An investment contract is considered fully benefit responsive for purposes of this SOP if certain criteria are met for that contract, analyzed on an individual basis. See paragraph 3.19 of the EBP Guide for such criteria.

.11 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.

.12 Defined-contribution 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 where 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 this Statement 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.

   Help Desk—See Appendix D of this Alert for Technical Practice Aids (TPAs) that provide guidance on implementing this FSP and for illustrative financial statements. The complete FSP can be viewed on the FASB Web site at www.fasb.org.

Related Auditing Issues

.13 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 must have sufficient information to evaluate and independently challenge the valuation. Plan sponsors may need to work with the various service providers (for example, trustee or custodian, investment advisor, or recordkeeper) surrounding the investment contracts to determine which service provider will assist in the mechanics of the valuation. Auditors should 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.

.14 For full-scope audits of plans with investments in investment contracts, auditors should gain an understanding of the valuation methodology during planning through discussion with clients and service providers and review of valuation documentation. The auditor should review and test 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: A Practice Aid for Auditors.*

Related TPAs

.15 The AICPA has issued three TPAs to provide additional guidance when implementing FSP AAG INV-1 and SOP 94-4-1. See Appendix D of this Alert to view the TPAs.

Risk Assessment Standards

.16 In March 2006, the AICPA's Auditing Standards Board (ASB) issued 8 SASs. SASs No. 104–No. 111 were issued together and are known as the *risk assessment standards,* applying to audits conducted in accordance with Generally Accepted Auditing Standards (GAAS). While the new risk assessment standards 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 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. They are effective for audits of financial statements for periods beginning on or after December 15, 2006, with earlier application permitted. A table listing the 8 SASs and their effects on existing standards follows.

Statement on Auditing Standard	***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")	This Statement amends SAS No. 1, *Due Professional Care in the Performance of Work* (AU section 230).
SAS No. 105, *Amendment to Statement on Auditing Standards No. 95,* Generally Accepted Auditing Standards	This Statement amends SAS No. 95, *Generally Accepted Auditing Standards* (AU section 150).
SAS No. 106, *Audit Evidence*	This Statement supersedes SAS No. 31, *Evidential Matter* (AU section 326A).
SAS No. 107, *Audit Risk and Materiality in Conducting an Audit*	This Statement supersedes SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AU section 312A).
SAS No. 108, *Planning and Supervision*	This Statement supersedes SAS No. 1, *Appointment of the Independent Auditor* (AU section 310), and supersedes SAS No. 22, *Planning and Supervision* (AU section 311).
SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*	This Statement supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AU section 319).
SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*	This Statement supersedes SAS No. 45, *Substantive Tests Prior to the Balance Sheet Date* (AU section 313), and, together with SAS No. 109, supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AU section 319).
SAS No. 111, *Amendment to Statement on Auditing Standards No. 39, Audit Sampling*	This Statement amends SAS No. 39, Audit Sampling (AU section 350).

Some Important Highlights of the New Risk Assessment Standards

.17 Whether due to errors or fraud, the new risk assessment standards require the auditor to understand and respond to risks of material misstatements. That understanding should identify risks to your 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. While 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 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 you have previously done. Implementation of the SASs will most likely result in significant changes to your firm's audit methodologies and the training of your personnel. Therefore, it is recommended that you 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 Assessments* (product number 022526kk) at www.cpa2biz.com.

New Companion Audit Guide

.18 In December 2006, the AICPA issued an Audit Guide titled *Assessing and Responding to Audit Risk in a Financial Statement Audit* (product no. 012456kk). This Guide helps practitioners 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.

Employee Benefit Plan Considerations

.19 The following paragraphs offer a brief description of the fundamental audit concepts described in the AICPA Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement* and examples of how these concepts may be applied in your audits of employee benefit plans.

.20 ***Reasonable assurance.*** GAAS requires the auditor to "obtain reasonable assurance about whether the financial statements are free from material misstatement." SAS No. 104 clarifies that reasonable assurance is a high but not absolute level of assurance. For example, the auditor may obtain reasonable assurance in an employee benefit plan audit by gathering evidence that:

- Hard to value investments such as real estate, limited partnerships, and private placement equities are valued at fair market value.
- The completeness objective has been achieved with respect to employer contributions.
- Pensions and annuities paid and benefits paid have been accurately calculated and have been properly shown on the plan's financial statements.
- The benefit obligations determined by the plan's actuary appear reasonable and significant changes are understood by the auditor.
- Expenses paid by the plan are reasonable and necessary.

.21 ***Audit risk and the risk of material misstatement.*** The auditor must consider audit risk and must determine a materiality level for the financial statements taken as a whole. Audit risk is the risk that the financial statements are materially misstated and the auditor fails to detect such a misstatement or appropriately modify the audit opinion. The auditor should perform the audit to reduce audit risk to a low level. The auditor should assess the risk of material misstatement (in other words, the combined assessment of inherent and control risks) as a basis for further audit procedures. In an employee benefit plan, the following should be considered:

- An overall materiality level for the plan should be determined. The determination of what is material to the users is a matter of professional judgment.
- The impact of current developments in the financial markets as they relate to the valuation of plan investments.

- Whether the risk of material misstatement would be high for areas such as: investments, contributions, and benefits paid.

.22 ***Materiality and tolerable misstatement.*** Audit materiality represents the maximum amount that the auditor believes the financial statements could be misstated and still fairly present the plan's net assets available for benefits and the changes in net assets available for benefits. Tolerable misstatement is the maximum known error within the financial statements that you are willing to accept. The following areas are typically the most material areas in a benefit plan's financial statements:

- Investments (and cash in a health and welfare plan)
- Benefits paid (in a health and welfare plan)
- Pensions and annuities paid (in a pension plan)
- Contributions

.23 Care should be taken by the auditor in determining the maximum level of tolerable error in these areas. Other balances in an employee benefit plan (for example, cash in a pension plan) are not normally material to a plan's financial statements; therefore, errors might be significant in relation to the account balance but still would be below the tolerable error established for that account. Whereas an error in cash that is below tolerable misstatement may not cause the auditor to modify the auditor's opinion, the auditor should consider the inherent risk within the class of transactions as a qualitative factor that could affect materiality considerations.

.24 ***Financial statement assertions.*** Assertions are management's implicit or explicit representations regarding the recognition, measurement, presentation, and disclosure of information in the financial statements. Assertions fall into three categories: (1) classes of transactions, (2) account balances, and (3) presentation and disclosure. Certain significant risks at the assertion level for an employee benefit plan include the following:

- Investments exist, are valued at fair value, and are shown properly by investment type in the statement of net assets available for benefits and are properly disclosed.
- Claims for pensions and other benefit payments have been properly approved or denied and, if approved, have been paid in accordance with the plan document.
- Employer contribution income is properly recognized and is complete with respect to any accruals, including amounts due at the end of the period, a valuation for amounts deemed uncollectible, and the present value of any employer withdrawal liability (for multiemployer plans).
- Participant data used to calculate plan benefit obligation are complete.
- Transactions with parties in interest have been properly shown in the plan's financial statements.
- Plan expenses have been recorded in the proper amount, in the proper accounting period and in accordance with the plan document.

.25 ***Internal control.*** Internal control is a process designed to provide reasonable assurance about the achievement of the plan's objectives. These objectives fall into three categories: financial reporting, operations, and compliance with laws and regulations. The five interrelated components of internal control are the control environment, risk assessment, information and communication systems, control activities, and monitoring. Specific controls that an employee benefit auditor may test include:

- Assessing whether plan's management has controls in place to maintain compliance with applicable rules and regulations (for example, DOL, Pension Benefit Guaranty Corporation (PBGC), IRS, or PCAOB)

- Ensuring that the plan has a system for paying and denying pensions or health claims
- Ensuring that all investment income has been received and recorded appropriately
- Ensuring that the plan actuary has utilized the appropriate data in calculating the present value of plan obligations
- Assessing whether plan personnel have the capability to prepare the plan's financial statements
- Ensuring that employer and employee contributions are complete and accurate
- Ensuring that securities lending activity has been appropriately accounted for

.26 The auditor's understanding of internal control involves determining whether and how specific controls may prevent or detect and correct material misstatements.

.27 ***Information technology.*** A client's use of information technology (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 operating units or business functions. In an employee benefit plan audit, the auditor may decide to test whether:

- The client's IT system is being properly utilized to determine participant data (for example, payroll and employee information) and pension and health benefit payments
- A database system is being properly utilized to check for duplicate payments, improper utilization, and other payments made in the health care payment system
- Pension credits earned are being properly accounted for and utilized in calculating the payment of benefits
- Passwords are utilized by the plan and appropriate restrictions exist to prevent or detect fraud
- The IT system is accurately allocating shared expenses between plans that share facilities and other expenses

.28 ***Audit evidence.*** Audit evidence is all the information the auditor uses to arrive at the conclusions that support the opinion on the audit. Audit evidence is cumulative in nature. Audit evidence must be sufficient and appropriate. Sufficient and appropriate audit evidence in an employee benefit plan audit as part of the overall risk assessment would include, but would not be limited to:

- Reading the minutes of meetings of plan trustees and designing audit steps based on the actions taken during those meetings
- Interviewing the plan's administrator regarding internal controls
- Conducting SAS No. 99 interviews with nonaccounting personnel
- Obtaining a Type II SAS No. 70 letter from the service provider who processes plan activity
- For full scope audits, obtaining confirmation of securities held by the plan's investment custodian, and testing investment valuations on the plan's investments
- Testing the trustees' and plan employees' expense reimbursement forms

Help Desk—The AICPA has developed and published an Audit Guide titled *Assessing and Responding to Audit Risk in a Financial Statement Audit* (product no. 012456kk) to aid in implementing the new risk assessment standards. This Guide can be purchased by contacting the AICPA CPA2BIZ Service Center at 888-777-7077 or online at www.cpa2biz.com.

Limited-Scope Certifications

.29 Under DOL regulations, certain assets held by a bank, trust company, or similar institution or by a regulated insurance company and related investment information do not have to be audited provided the institution certifies the information. All noninvestment activity of the plan, such as participant allocations, contributions, benefit payments, and expenses, are subject to audit. Paragraphs 7.65, 7.66, and 13.26 in the EBP Guide provide guidance for limited-scope audit procedures and reporting.

.30 The Form 5500 instructions state that current value means fair market value where available. Otherwise, current value means the fair value as determined in good faith under the terms of the plan by a trustee or a named fiduciary assuming an orderly liquidation at the time of the determination. Refer to ERISA Section 3(26). Plan management should instruct the institutions certifying investment information for purposes of limited-scope audits to certify as to the current value of investments at the date of the plan's year end and to exclude any investments that are not valued at fair value as of the plan's year end.

.31 It is the plan administrator's responsibility to prepare the financial statements and footnote disclosures in accordance with GAAP. The AICPA Audit Issues Task Force is currently discussing certain revisions to paragraphs 7.65 and 7.66 of the EBP Guide to help clarify guidance. Be alert for the issuance of additional guidance.

Alternative Investments

.32 Alternative investments are investments for which a readily determinable fair value does not exist (that is, investments that are not listed on national exchanges or over-the-counter markets, or for which quoted market prices are not available from sources such as financial publications, the exchanges, or the National Association of Securities Dealers Automated Quotations System [NASDAQ]). 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* (product no. 012625kk), such as:

- Hedge funds
- Private equity funds
- Real estate funds
- Venture capital funds
- Commodity funds
- Offshore fund vehicles
- Funds of funds
- Bank common and collective trust funds

.33 Collectively, these types of investment funds are referred to herein as *alternative investments.* Alternative investments may be structured as limited partnerships, limited liability corporations, trusts, or corporations. Investors in alternative investments include pension plans. Many invest a small percentage of their total investments, while others invest a substantial percentage of their total investments in these vehicles. In addition, the underlying investments of the alternative investments can range from marketable securities to complex or illiquid investments. Alternative investments can present challenges with respect to obtaining sufficient appropriate audit evidence in support of the existence and valuation assertions because of the lack of a readily determinable fair value for these investments and the limited investment information generally provided by fund managers.

.34 When auditing alternative investments, it is important to understand the client's process related to valuation. This includes, but is not limited to, determining the nature of the underlying investments, understanding how often plan management interacts with fund manager(s) of such investments, the availability of audited financial statements for such investments, and Type II SAS 70 reports on the determination of unit values of such investments. Obtaining a confirmation from the trustee, custodian, or investment manager that contains fair values does not constitute valuation testing. For further guidance, refer to Interpretation No. 1 of AU section 328, "Auditing Interests in Trusts Held by a Third-Party Trustee and Reported at Fair Value."

.35 Additional guidance can also be found in the AICPA Practice Aid titled *Alternative Investments—Audit Considerations: A Practice Aid for Auditors*. This Practice Aid addresses challenges associated with auditing investments for which a readily determinable fair value does not exist.

.36 Auditors need to determine that they have obtained sufficient and competent audit evidence to support the existence and valuation assertions related to alternative investments. In the event that such evidence is not obtained, consideration of modifications to the audit opinion may be required.

AICPA Resources and Projects

The AICPA Employee Benefit Plan Audit Quality Center

.37 The AICPA Employee Benefit Plan Audit Quality Center (the Center) is a firm-based, voluntary membership Center created in March 2003 with the goal of promoting quality employee benefit plan audits. Center member firms demonstrate their commitment to ERISA audit quality by joining the Center and agreeing to adhere to its membership requirements. The Center now has over 1,300 members in all 50 states, the District of Columbia, the U.S. Virgin Islands, and Puerto Rico.

.38 Recent reviews performed by the DOL's EBSA have shown a difference in the quality of ERISA audits performed by Center member firms compared with those performed by nonmember firms. To help members meet the challenges of performing quality audits in the employee benefit plan area, the Center:

- Monitors activities of standard setters, the DOL, stakeholder groups, and others and communicates this information to its members via periodic E-Alerts
- Develops valuable tools and resources—such as audit preparedness and planning checklists and schedules, auditor guidelines for preparing proposals, "Topix" primers, and more—that are sent to members and developed and archived on the Center's Web site
- Sponsors "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
- Provides an online member forum for sharing ideas, best practices, and questions with other members
- Develops information for auditors to share with plan stakeholders regarding issues of importance to plan auditors, such as the importance of plan sponsors and trustees monitoring their TPAs
- Serves as a single voice for Center members to the DOL

.39 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.

Guide Overhaul Project

Description and Background

.40 The EBP Guide was last issued in 1991. The Guide has not been revised or amended, other than for conforming changes, since then. Since 1991, significant changes have occurred in the types of retirement plans offered by employers, the way plans are administered, and the types of plan investments. Many of these changes have resulted in accounting issues that are not contemplated in the existing Guide. In 2004, a task force began work on a project to revise the EBP Guide.

Tentative Conclusions

.41 Some of the tentative conclusions reached by AcSEC in discussing the accounting issues for the EBP Guide are listed in the following sections. The tentative conclusions are subject to change as AcSEC continues to deliberate the accounting issues and are not considered guidance. Visit the AICPA Web site for updates on this AcSEC project at www.aicpa.org.

.42 ***Accounting for contributions receivable for defined benefit pension plans.*** Minimum contributions required should be accrued, and any excess amounts would be considered a Type II subsequent event unless there were evidence of a formal commitment as of the balance sheet date. When the issue is drafted for the EBP Guide, it should be expanded to discuss all of the factors listed in paragraph 10 of FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans,* with emphasis placed on the formal commitment.

.43 ***Accounting for contributions receivable for DC pension plans.*** Additional guidance should be included in the Guide discussing factors that should be reviewed in determining whether contributions should be recorded due to an obligation resulting from a formal commitment under paragraph 10 of FASB Statement No. 35. Additional information about the relationship between employees and employer as compared to defined benefit plans should also be included.

.44 ***Accounting for contributions receivable for defined benefit health and welfare benefit plans.*** A receivable from the employer should be accrued equal to the liability for employees' claims recorded prior to plan's year end. A receivable from the employer should be accrued equal to the liability for incurred but not reported (IBNR) employee claims if, as of the date of the financial statements, there is a legal or contractual requirement for the employer to fund this amount.

.45 ***Employee deferral and related matching contributions for DC plans.*** It would be rare that this amount would be significant; therefore, this issue will not be included in the Guide.

.46 ***Accounting for excess employee contributions.*** Excess employee contributions should be recorded as a liability in the year in which they were contributed to the plan (in accordance with paragraph 3.31 of the EBP Guide) with the corresponding debit side of the entry being netted against contributions received. Additionally, disclosure thereof should be presented in the notes to the financial statements.

.47 ***Presentation of investment income from commingled investment funds.*** The Guide should express two views. One is that dividends and distributions should be considered investment income and shown separately from changes in fair value. The second is that dividends should only be considered investment income and shown separately from changes in fair value.

.48 ***Disclosures for limited partnerships and similar investments.*** Additional disclosures should be made relating to limited partnerships and similar investments. The Guide should clarify that these disclosures apply to certain types of investments that are hard to value or not liquid (alternative investments). If the information for the disclosures cannot be obtained or is prohibited from being disclosed, that should be disclosed as well. AcSEC also noted that the task force should look at the disclosures required by the FASB Fair Value project.

.49 ***Current developments and plans.*** AcSEC will continue its discussions of issues at a future meeting.

Audit Issues

Recent Auditing Pronouncements

.50 Presented in the following section is a list of auditing and attestation pronouncements and related guidance issued since the publication of last year's Alert. For information on auditing and attestation standards and related guidance issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm. For audits of issuers, such as Form 11-K audits, see the section "Form 11-K Audits" of this Alert. As a reminder, AICPA auditing and attest standards are applicable only to audits and attestation engagements of nonissuers.

.51 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,* which is issued by the AICPA's Auditing Standards team and is available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Opinion/.

Recent Auditing and Attestation Pronouncements and Related Guidance	
SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (May 2006)	The new 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. See Appendix B of this Alert for further guidance.
SAS No. 113, *Omnibus Statement on Auditing Standards—2006* (November 2006)	This SAS amends SAS No. 95, *Generally Accepted Auditing Standards*; SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*; SAS No. 101, *Auditing Fair Value Measurements and Disclosures*; SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*; SAS No. 57, *Auditing Accounting Estimates*; "Subsequent Events" of SAS No. 1, *Codification of Auditing Standards and Procedures;* and SAS No. 85, *Management Representations*. The amendments in paragraphs 1–5 of this SAS are effective for audits of financial statements for periods beginning on or after December 15, 2006. Earlier application is permitted. The amendments in paragraphs 7–14 of this SAS are effective for audits of financial statements for periods ending on or after December 15, 2006. Earlier application is permitted.
SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (December 2006)	The new standard supersedes SAS No. 61, *Communication With Audit Committees*. It establishes and provides guidance on the auditor's communication with those charged with governance in relation to an audit of financial statements. Although this Statement applies regardless of an entity's governance structure or size, particular considerations apply where all of those charged with governance are involved in managing an entity. It is effective for periods beginning on or after December 15, 2006.

(continued)

AICPA TPA sections 8100.01–.02 (Nonauthoritative)	"Determining the Effective Date of a New Statement on Auditing Standards for Audits of a Single Financial Statement" and "Determining the Effective Date of a New Statement of Auditing Standards for Audits of Interim Periods."

.52 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.

SAS No. 103, *Audit Documentation*

.53 Paragraphs 5.17–5.24 of the EBP Guide provide the background of SAS No. 103, *Audit Documentation*. In documenting the nature, timing, and extent of audit procedures performed, SAS No. 103 requires that the auditor record:

- Who performed the work and the date such work was completed
- Who reviewed specific audit documentation and the date of such review

.54 This documentation can be performed manually or electronically depending on the nature of the workpapers.

.55 In addition, SAS No. 103 requires that identifying characteristics of the specific items tested be documented. This includes the following:

- For a detail test of participants, this includes their name and employer number. Care should be given when using the entire social security number of a participant due to privacy and confidentiality issues.
- For a procedure requiring selection or review of all items over a specific amount from a given population, the auditor should record the scope of the procedures and identify the population (for example, all distributions over $XX from the benefit payment register).
- For a procedure requiring inquiries of specific plan or entity personnel (for example, fraud and illegal act inquiries), the auditor should record the dates of the inquiries, the names and job designations of the plan or entity personnel, and the inquiry made.
- For a procedure requiring systematic sampling from a population of documents, the auditor should identify the documents selected by recording their source, the starting point and the sampling interval.

Dating of the Auditor's Report

.56 SAS No. 103 also provides guidance regarding the dating of an audit report. Paragraph 23 of SAS No. 103 states that the auditor's report should not be dated earlier than the date on which the auditor has obtained sufficient appropriate evidence to support the opinion. Sufficient appropriate evidence includes that the audit documentation has been reviewed; that all testing procedures have been completed; and that the plan's financial statements, including disclosures, have been prepared and management has asserted that it has taken responsibility for them. The timing of the review of the Form 5500 may affect the dating of the audit report. If the Form 5500 has not been prepared prior to release of the financial statements, the auditor should consider obtaining a draft of the Form 5500 to prevent differences from arising after the report has been issued. If differences arise additional procedures may have to be performed and the report possibly reissued for reconciling items.

.57 The auditor's responsibility with regard to the Form 5500 is outlined in AU section 550, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards,* vol. 1), as amended. In accordance with AU section 550, the auditor's responsibility for the information does not extend beyond the financial information identified in his or her report, and the auditor has no obligations to perform any procedures to corroborate other information contained in the document. However, the auditor should read the information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements. If the auditor concludes that there is a material inconsistency, he or she should determine whether the financial statements, his or her report, or both require revision. If he or she concludes that they do not require revision, he or she should request the client to revise the other information contained in the Form 5500.

.58 The final assembly of the audit file should be completed within 60 days following the report release date. Statutes, regulations, or the audit firm's quality control policies may specify a shorter period of time in which this process should be completed. SAS No. 103 also provides guidance in the event that changes to documentation after the assembly of the audit work papers is required.

SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit*

.59 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. See Appendix B of this Alert for further guidance specific to employee benefit plans.

SAS No. 114, *The Auditor's Communication With Those Charged With Governance*

.60 SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), replaces SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380A), as amended. The new SAS requires the auditor to conduct two-way communication with those charged with governance about certain significant matters related to the audit. It also establishes standards and provides guidance on (1) which matters should be communicated, (2) to whom they should be communicated, and (3) the form and timing of the communication. SAS No. 114 is applicable for audits of the financial statements of all nonissuers and is effective for audits of financial statements for periods beginning on or after December 15, 2006.

> **Help Desk—**The requirement for the auditor to communicate with those charged with governance are included in other SASs. SAS No. 114 does not change the requirements in those standards, including the requirements in SAS No. 112 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 Appendix A of SAS No. 114 for a complete list of requirements included in other SASs.

Auditing Plan Fees and Expenses

.61 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 12.10 and 12.11 of the EBP Guide. Typically, plan expenses are below materiality levels in a benefit plan audit and, therefore, are not subject to significant detailed testing. Often, auditors gain assurance over expense balances using other audit procedures such as substantive analytics. Irrespective of the materiality level, auditors need to gain an understanding of the expenses that are allowed to be paid by the plan according to the plan document.

.62 Auditors should be especially aware of fees paid by one plan on behalf of another plan resulting from errors or inappropriate allocations. In addition, auditors should be aware of fees paid by the plan for certain services (actuarial fees) that may relate to services provided to the plan sponsor. Expenses paid by the plan that are not allowed by the plan document or excessive fees, no matter how immaterial, may be deemed a prohibited transaction requiring further testing and disclosure as described in paragraph 11.13 of the EBP Guide.

.63 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.

Separately Managed Accounts

.64 Some plans have accounts at a trust company, insurance company, or similar institution consisting of individual plan assets that are managed by an investment manager specifically for the plan. Often, these separately managed accounts are mistaken for pooled investment vehicles (for example, insurance company pooled separate accounts [PSAs], mutual funds, or common collective trusts). A review of the underlying investment agreement with the investment manager or discussions with the service providers will typically reveal whether the investment is a pooled or separately managed vehicle. Individual assets of a separately managed account are held in the name of the plan and should be audited in a manner similar to other individual investments held directly by the plan. The auditing objectives and procedures described in paragraphs 7.15 and 7.16 of the EBP Guide apply to individual assets and activity for a separately managed account. Such individual investments are also subject to the reporting requirements in paragraphs 2.14, 3.22, or 4.39 of the EBP Guide. In addition, these investments would be considered individual investments for purposes of reporting on Form 5500, Schedule H, line 4i—*Schedule of Assets (Held at End of Year)* and line 4j—*Schedule of Reportable Transactions.*

Unitized Trusts

.65 In certain instances, the recordkeeper of a separately managed account will maintain a net asset value per unit or *unitization* for the account. Purchases and sales of the account on behalf of the plan sponsor will be transacted at that net asset value per unit. For plan auditors to test the value of the purchases and sale transactions, the auditor will need to be comfortable with the price (net asset value per unit) at which the transactions were executed. The auditor should gain an understanding of the process to calculate the net asset value per unit through review of pertinent investment agreements, discussion with the service provider, or review of service provider's SAS No. 70 report. The auditor should then determine the level of testing required to gain comfort over the unit values. The accumulation of the net asset value per unit may be covered by the SAS No. 70 report, which may be used to reduce the scope of substantive testing.

.66 Unitization is also typically used when employer stock or guaranteed investment contracts are offered as an investment option in DC plans. A cash or money market component is added to the investment for liquidity purposes, and the transaction activity is unitized.

Unaudited PSA Accounts

.67 Pooled separate accounts (PSAs) are very common benefit plan investments and are similar to mutual funds except that they are issued by insurance companies and are not publicly traded like mutual funds. Usually PSAs have audited financial statements; however, for certain insurance companies, audited PSA financial statements are not available, and, therefore, the valuation and investment activity is not tested.

.68 Where there are no audited PSA financial statements, paragraphs 7.52 and 7.16 in the EBP Guide states that the auditor should obtain a copy of the service auditor's report (SAS No. 70 report) if available, but the Guide does not discuss how to perform the substantive testing.

.69 While the best and ultimate solution may be for plan sponsors to require insurance companies to provide audited financial statements on the funds in which their plans invest, there are currently situations where plans have most of their investments in unaudited PSAs.

.70 When a PSA does not have audited financial statements, the auditor may consider the following:

1. Confirm existence of the underlying investments of the PSA on a security-by-security basis.
2. Test valuation of the underlying investments in the PSA.
3. Gain an understanding of the process to calculate the net asset value per unit.
4. Determine the level of testing required to gain comfort over the unit values.

.71 For transaction information during the year, consider performing the following:

1. Obtain, review and assess the insurance company PSA SAS No. 70 report, if available. See Chapter 6 of the EBP Guide for further guidance on the use of SAS No. 70 reports.
2. Test investment activity (such as, purchases and sales).
3. Test investment income through analytics or detailed testing.
4. If no SAS No. 70 report is available, consider expanding testing procedures.

Investments Reported as 103-12 Entities as Required by the DOL

.72 Many limited partnerships, hedge funds, and other pooled funds such as group trusts elect to file with the DOL as a 103-12 entity. DOL regulation 29 CFR 2520.103-12 provides an alternative method of reporting for plans that invest in an entity, other than a master trust investment account, common/collective trust (CCT), or PSA, whose underlying assets include *plan assets* (within the meaning of DOL regulation 29 CFR 2510.2-101) of two or more plans that are not members of a related group of employee benefit plans. Making this determination can be complicated and may necessitate legal or other specialized industry consultation. Generally, a 103-12 entity will operate based on its legal structure (according to its operating agreements) in the form of a financial services product such as a trust or a limited partnership. Typically, audited financial statements are required by the entity's operating agreement and are prepared in accordance with GAAP in a format following industry standards consistent with the entity's operations. For example, a 103-12 entity that operates as a limited partnership would prepare financial statements in accordance with GAAP for limited partnerships. See paragraph A.56 of the EBP Guide for guidance on the filing requirements for 103-12 entities.

.73 To determine the auditing procedures for a plan's investment in a 103-12 entity, the auditor needs to understand the legal structure (for example, limited partnership or trust) and follow the auditing procedures as described in paragraphs 7.60 (limited partnerships) or 7.20–7.22 (CCTs) in the EBP Guide.

Self-Directed Investments

.74 Plan sponsors of participant-directed DC plans continue to allow participants to expand their control over investment decisions through self-directed investments, which are sometimes referred to as self-directed brokerage accounts. These features allow participants to select any investment they choose without oversight from the plan administrator or investment committee. Self-directed investments are different from participant-directed investment fund options. Participant-directed investment fund options allow the participant to select from among various available alternatives and to periodically change that selection. The alternatives are usually fund vehicles, such as registered investment companies (that is, mutual funds), commingled funds of banks, or insurance company PSAs providing varying kinds of investments (for example, equity funds and fixed income funds). Paragraphs 7.61–7.63 of the EBP Guide provide additional guidance on self-directed features. Also, see paragraphs 7.59 and 7.60 of the EBP Guide if the self-directed assets consist of alternative investments such as limited partnerships, hedge funds, or private equity funds.

Help Desk—Auditors should note that when a SAS No. 70 report is available, it often does not cover the self-directed investments. In addition, auditors should obtain a reconciliation of the self-directed investment balances according to the trustee or custodian to the amount recorded in the financial statements.

Help Desk—The Form 5500 Schedule H, line 4i—*Schedule of Assets Held (At End of Year)* allows one line item reporting for self-directed assets except for investments in hard-to-value assets such as limited partnerships, joint ventures, and real estate. See Form 5500 Schedule H instructions for further detail.

Auditing Health and Welfare Plans

.75 Health and welfare 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.

.76 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 should 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 check is presented for payment, or when 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 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

.77 When answering these questions, the auditor should 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 are integral to developing the audit approach and the sampling methodology.

.78 This section is intended to describe certain areas unique to health and welfare benefit plans, including suggested audit procedures[2] such as:

1. HIPAA privacy concerns
2. Health and welfare claims and potential problems
3. Contracts with benefit service providers
4. Rebates receivable
5. Accumulated eligibility credits
6. Actuarial data and census information
7. Stop-loss coverage
8. Premium stabilization reserves
9. COBRA
10. Health savings accounts and health reimbursement arrangements

1. HIPAA Privacy Concerns

.79 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.

.80 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

.81 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). If asked to sign such confidentiality, indemnification, or business associates agreements, auditors need to take special care in reviewing these agreements. Often, the auditor may not agree with certain language in the agreement, resulting in delays in the audit until mutually agreeable language is determined. Many of the representations are very broad. The agreements generally require that the auditor hold the claim processor harmless from any actual or threatened action arising from the release of information without limitation of liability. In addition, the agreements may require the auditor to hold the client harmless as well. This last indemnification will most likely contradict provisions in the engagement letter between the auditor and the client. Before entering into any confidentiality agreements, the agreement should be reviewed by the auditor's legal counsel. Auditors need to keep in mind that the testing of claims by a third-party administrator could be delayed as a result of the request to sign such an agreement and should plan the timing of the audit accordingly. If the auditor is unable to obtain access to records as a result of not signing a confidentiality agreement or a third-party administrator's refusal to provide access under any circumstances, a scope limitation could result.

---

[2] Some of the audit procedures noted may be more extensive than what is required by generally accepted auditing standards (GAAS).

Audit Documentation

.82 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
- Reporting to the sponsor any misuse of PHI by the accounting firm

.83 AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), (SAS No. 103) provides guidance to auditors on documentation requirements. See paragraphs 5.17–5.24 of the EBP Guide for guidance.

.84 *De-identified* health information is not subject to HIPAA. To be considered de-identified under HIPAA, information in work papers should 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 four digits)
- Telephone and fax numbers
- E-mail addresses
- Medical record numbers
- Health plan beneficiary numbers
- Account numbers

2. Health and Welfare Claims and Potential Problems

.85 The auditor should have a basic understanding of the terms of the plan and have the skill and knowledge to test that claims are being properly adjudicated. 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. The auditor should be aware, however, of the typical problems that a health and welfare plan might experience when processing claims. The auditor should be aware of any processing problems that the plan is experiencing with claims and should discuss what the plan is doing to correct these issues with the plan administrator. See Appendix G of this Alert for claims testing information. Potential problems may 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

.86 When testing health and welfare claims, some errors typically found include:

- ***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.
- ***Other errors.*** These may occur in the diagnosis code, the Current Procedural Terminology or Healthcare Common Procedure Coding System code,[3] or in the information in the claims form.

3. Contracts With Benefit Service Providers

.87 For any contracts the plan has with a benefit service provider, the reconciliation of the amounts due to or from the benefit service provider should be examined to determine if the amounts are appropriate. Any amounts due from the benefit provider should be classified as a receivable in the statement of net assets, and amounts due to the provider would normally be shown in the financial statements with the other benefit obligations of the plan.

4. Rebates Receivable

.88 If there are rebates receivable from a service provider, those rebates should be examined to determine if the correct amount for the appropriate periods of time has been reflected in the proper period. In addition, the auditor should 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. Finally, the auditor should consider the propriety of the rebate. For example, if the payment vehicle for the claims receiving the rebate was the Voluntary Employees' Beneficiary Association (VEBA) trust account, receipt of the rebate by the plan sponsor and deposit of such rebate into a nontrust account may not be appropriate.

5. Accumulated Eligibility Credits

.89 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 should determine whether the plan provides for accumulated eligibility credits and should determine 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*.

---

[3] 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).

6. Actuarial Data and Census Information

.90 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 should 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.

7. Stop-Loss Coverage

.91 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.

.92 The auditor should gain an understanding of the stop-loss coverage that a plan has and should test that claims have been properly filed against the policy within the period specified by the policy.

8. Premium Stabilization Reserves

.93 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 should be considered when evaluating the existence of the asset.

9. COBRA

.94 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 FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits*, FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, or both, are satisfied.

.95 In many cases, the collection of COBRA contributions and payment of COBRA benefits are performed by third-party administrators. The administration of these benefits should 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 IBNR should include COBRA participants.

Notices for COBRA Continuation Health Care Coverage

.96 The DOL has published final rules clarifying the requirements for notices under COBRA for employees, employers, and plan administrators. The rules provide guidance and model notices for workers and family members to continue their group health care coverage. 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.

10. Health Savings Accounts and Health Reimbursement Arrangements

.97 Individuals enrolled in certain high-deductible health plans can establish 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[4] health expenses, 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).

.98 When HSAs or 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. 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 the EBP Guide for further information about HSAs and HRAs.

Eligible Compensation and Payroll Data

Eligible Compensation

.99 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 should address the determination of eligible compensation for individual employees and comparison of the definition of eligible compensation used in the calculation to the plan document. 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 is necessary.

.100 The auditor should examine the definition of compensation used to determine whether the method used is allowable within the Internal Revenue Code (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.

---

[4] This refers to qualified health expenses as defined under Internal Revenue Code section 213(d).

Payroll Data

.101 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. While testing of the payroll area may have been performed in conjunction with the corporate audit, all of the assertions surrounding payroll relevant to the plan audit may or may not have been tested. The plan auditor needs to understand which assertions surrounding payroll were tested during the corporate audit to determine the scope of payroll testing required for the plan audit.

.102 For example, payroll testing performed for a corporate audit may include only high-level analytics with limited documentation of the control environment or performance of substantive procedures 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 have a SAS No. 70 type 1 report, which provides a description of procedures and controls but does not have a SAS No. 70 type 2 report, which also includes testing of the procedures and controls and can be used to reduce the scope of substantive testing. There are some payroll service providers that have a SAS No. 70 type 2 report. However, the SAS No. 70 type 2 reports often have extensive user controls that must be present at the plan sponsor and be tested by the plan auditor to rely on the SAS No. 70 type 2 report. Paragraph 10.05 of the EBP Guide describes procedures the auditor should consider to test payroll in conjunction with the plan audit. Also see Appendix H of this Alert for guidance on payroll auditing.

.103 In certain circumstances, the plan sponsor may issue an integrated Rule 404 report under 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), that includes tests of controls surrounding the payroll area. The report should be reviewed carefully by the plan auditor to determine its usefulness in reducing the scope of testing for the plan audit. Plan auditors should be aware that while they may be able to rely on key controls tested by the corporate auditor to reduce the scope of payroll testing for the plan audit, key controls tested by management may not be used to reduce the scope of the payroll testing for the plan audit.

.104 If the plan sponsor has an internal audit department that has performed work on payroll data that is relevant to the audit, and if it is efficient 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 the plan audit.

Actuarial Reports for Defined Benefit Plans

.105 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. Based on recent economic trends, the range of discount rates used is 7 percent to 8.5 percent for 2006 calendar year-end plans. When this approach is used, the rate selected will generally be the same as that used for funding purposes. The plan auditors should 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. Care should be taken to determine if the proper amount is disclosed in the benefit plan's financial statements.

.106 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.

.107 The most significant demographic assumptions used to determine the actuarial present value of accumulated plan benefits include mortality rates, turnover, retirement, marriage statistics, and form of payment or type of benefit elections. With the increase in life expectancies, the mortality assumption should be improving. Certain mortality tables used by actuaries include the 1983 GAM table, 1994 GAM, UP 1994, and RP-2000 tables. The 1983 GAM table is a required table for certain of the calculations to determine minimum funding requirements under ERISA through 2006. 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 1983 GAM table will be used frequently for 2006 audits. Beginning in 2007, the new table that will be required for minimum funding purposes will be based on the RP-2000 table.

.108 Because older mortality tables such as 1983 GAM are becoming outdated and will no longer be used for ERISA purposes after 2006, auditors should 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.

.109 Regardless of the assumption used, each assumption must be individually reasonable. Plan administrators should review actual plan experience with assumptions used periodically to determine if any changes should be made. The following should also be considered as plan auditors review actuarial valuations:

- Trends and nature of benefit distributions (for example, lump sum versus annuity) should be considered. A plan that predominantly pays lump sum benefits will have a higher cost 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 will be undervalued.
- Whether there has been a shift in the plan population over time should be considered. This could warrant a different assumption for turnover or retirement if, for example, participants are retiring much earlier or later than assumed.
- Whether there have been recent plan mergers or acquisitions should be considered. In the case of a plan merger, all assumptions should 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 should be considered. Changes in plan benefits available may affect anticipated turnover and retirement patterns. These assumptions should be reviewed if the plan is amended to change benefits.
- Whether consistent gains and losses are generated each year should be considered. If yes, this may indicate that assumptions are not reasonable based on actual experience.
- When reviewing an actuarial report, consideration should be given to:
  - *a.* Consistency of benefits accumulated each year (auditors should expect changes if there has been a plan merger, acquisition, or significant plan provision change)
  - *b.* 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)

c. The asset value on the financial statements should match the asset value shown in the actuarial report

d. Inclusion of impact of a change in plan provisions and impact of merger, spin-off, or acquisition

.110 It is also important to note that the assumption of salary increases is not relevant for FASB Statement No. 35 because FASB Statement No. 35 is based on the disclosure of the actuarial present value of accumulated plan benefits, which does not take into account future salary increases.

The Use of Beginning-of-Year Benefit Information Date

.111 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 the EBP Guide.

.112 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, 2006, and December 31, 2005, the actuarial valuation will be as of January 1, 2006. 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, 2005 (one day earlier). Typically, this will not cause a material misstatement unless there was a plan amendment that took place on January 1, 2006. In that case, the effect of the amendment must be removed. As shown in the EBP Guide, when beginning-of-year benefit information is used, two statements of net assets and two 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 the EBP Guide.

Medicare Prescription Drug, Improvement, and Modernization Act

.113 The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 provides for subsidies payable from the government to an employer or a health care plan that provides drug benefits that are at least actuarially equivalent to the Medicare Part D benefits. Depending upon the type of plan, the benefit obligations should either reflect or not reflect the effect of these subsidies.

.114 For a single employer plan, the subsidies are generally payable to the employer and not to the plan. As a result, the employer's obligation is reduced, but the plan's obligation has not been reduced. In determining the employer's obligations according to FASB Statement No. 106 for the employer's financial statements, the benefit obligation is reduced to reflect the effect of the subsidy. Because the plan's obligation is not reduced, it is not appropriate for the plan to show the same FASB Statement No. 106 obligation that was reported by the employer. In these circumstances, two valuations are required. One valuation is needed for the employer's reporting under FASB Statement No. 106, and a second valuation (without removing the effect of the subsidy) is required to report the plan's obligations. Auditors need to be sure that the second valuation is being used for the plan's financial statements and that the plan is not reporting the same obligation as the employer.

.115 For a multiemployer plan, the subsidies are due to the plan. Therefore, the obligations reported by the multiemployer plan should reflect the effect of the Medicare subsidy. Unlike the single employer plan, there is no FASB Statement No. 106 reporting required for employers participating in the multiemployer plan. Therefore, there is only one valuation required for multiemployer plans, and that valuation should reflect the reduced obligation that reflects the Medicare subsidy.

Allocation Testing for DC Plans

.116 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. Each type of participant account activity during the year (for example, contributions, income allocations, expense allocations, and forfeiture allocations) should be taken into consideration in the determination of auditing procedures. In a limited-scope audit, the allocation of investment income to individual accounts is not certified by the trustee or custodian and should be tested by the auditor, taking into consideration reliance on a SAS No. 70 type 2 report, if available. See Chapter 10 of the EBP Guide for further discussion of auditing participant data.

Missing Participant Data

.117 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.

.118 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. Auditors should take special care in determining if there are any missing participant data prior to accepting a new benefit plan engagement.

.119 Auditors should recommend that a plan sponsor consult with legal counsel and consider contacting the DOL prior to attaching a qualifier or disclaimer of opinion relating to a Form 5500 filing for a benefit plan.

Analytical Procedures as Substantive Tests

.120 For all audits of financial statements in accordance with GAAS, analytical procedures should be applied to some extent for the purposes of assisting the auditor in planning the nature, timing, and extent of other auditing procedures and as an overall review of the financial information in the final review stage of the audit. In some cases, however, analytical procedures can be more effective or efficient than tests of details for achieving particular substantive testing objectives. Analytical procedures may be used as substantive tests to obtain evidential matter about particular assertions related to account balances or classes of transactions. See Appendix F of this Alert for further guidance on the use of analytical procedures in employee benefit plan audits.

On the Horizon—Auditing

.121 Auditors should keep abreast of auditing developments and upcoming guidance that may affect their engagements. Presented in the following section is brief information about some ongoing projects that have particular significance to employee benefit plans or that may result in very significant changes. Read the AICPA general *Audit Risk Alert—2006/07* (product no. 022337kk) for a more complete list of ongoing auditing and accounting projects. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS.

.122 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 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/edo/index.htm
Financial Accounting Standards Board (FASB)	www.fasb.org/draft/index.shtml
Public Company Accounting Oversight Board (PCAOB)	www.pcaobus.org or www.pcaob.com
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/members/div/ethics/index.htm
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 your membership and subscriber number in the message. The AICPA Web site also has links to the other standard-setting bodies listed in the previous table.

Auditing Pipeline—Nonpublic Companies

Proposed Amendment to SAS No. 69, The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles*

.123 The ASB has 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 titled *The Hierarchy of Generally Accepted Accounting Principles*. The FASB proposal moves responsibility for the GAAP hierarchy for nongovernmental entities from the auditing literature to the accounting literature. The proposed SAS deletes 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). 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.

Proposed Statement on Standards for Attestation Engagements Regarding Reporting on an Entity's Internal Control Over Financial Reporting

.124 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 Standards: 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). In May 2006, the PCAOB announced plans to amend certain aspects of PCAOB Auditing Standard No. 2 to improve its implementation. Because the forthcoming changes to the PCAOB standard will be relevant to the revision of AT section 501, the ASB has decided to defer the issuance of a final AT standard until the PCAOB issues their amendments and the ASB has time to consider them.

Auditing Pipeline—Public Companies

.125 For pending projects for both the PCAOB and the SEC, readers may refer to the *SEC and PCAOB Alert—2006/07* (product no. 022497kk), mentioned previously.

AICPA Peer Review Developments—Recurring Deficiencies Found in Employee Benefit Plan Audits

.126 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:

- Inadequate testing of participant data
- Inadequate testing of investments, particularly when held by outside parties
- Inadequate disclosures related to participant-directed investment programs
- Failure to understand testing requirements on a limited-scope engagement
- Inadequate consideration of prohibited transactions
- Incomplete description of the plan and its provisions
- Inadequate or missing disclosures related to investments
- Failure to properly report on a DOL limited-scope audit
- Improper use of limited-scope exemption because the financial institution did not qualify for such an exemption
- 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

.127 The EBP Guide provides guidance concerning areas of noted deficiencies.

Form 11-K Audits

Form 8-K Requirements for Form 11-K Filers

.128 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 Exchange Act 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. While 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. 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 "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

.129 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.

.130 An employee benefit plan may be an affiliate of a registrant as its plan sponsor. The SEC's independence rules related to pre-approval surround services provided to the issuer and the issuer's subsidiaries but not 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 pre-approve 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 pre-approval 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 pre-approved 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 pre-approval requirements. Registrants and their auditors are reminded that the financial statements included in a Form 11-K must be audited by an independent auditor that 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

.131 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. 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 ERISA file the plan financial statements within 180 days after the plan's fiscal year end.

Applicable Audit Standards

.132 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 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

.133 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 GAAS for DOL filings. The PCAOB and SEC staff believes 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*), does not allow a reference to GAAS, hence a "dual" standard report is not appropriate and will not be accepted by the SEC.

.134 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) 942-2960. See the EBP Guide, paragraph 13.19, for an example of an opinion for an 11-K audit.

PCAOB Standards and Conforming Amendments

.135 As a result of the Sarbanes-Oxley Act of 2002, both U.S. and non-U.S. public accounting firms wishing to prepare or issue reports, or to play a substantial role in the preparation or issuance of such reports, on U.S. public companies must be registered with the PCAOB and comply with the standards and rules of the PCAOB. The PCAOB's standards and rules apply to registered public accounting firms and their associated persons in connection with their audits of the financial statements of issuers, as defined in Section 2(a)(7) of the Sarbanes-Oxley Act, and those firms' auditing and related attestation practices. 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. The PCAOB does not intend to suggest that registered public accounting firms and their associated persons must comply with the PCAOB's standards and rules in auditing nonissuers. Auditors who fall within the PCAOB's scope should understand and follow the standards, rules, and other requirements of the PCAOB. All PCAOB standards and rules must be approved by the SEC before taking effect.

PCAOB Auditing Standard No. 4

.136 Since the publication of last year's Alert, the PCAOB has issued PCAOB Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist* (AICPA, *PCAOB Standards and Related Rules*). This standard applies if auditors report on the elimination of a material weakness in a company's internal control over financial reporting. The standard establishes a voluntary engagement that would be performed at the election of the company.

> **Help Desk—**For information on auditing standards and related guidance issued subsequent to the writing of this Alert, please refer to the PCAOB Web site at www.pcaobus.org (audits of issuers only).

Accounting Issues

Recent Accounting Pronouncements

.137 Presented in the following table 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*.

Recent Accounting Pronouncements and Related Guidance	
FASB Statement No. 157 (September 2006)	*Fair Value Measurements*
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)* 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. However, an employer without publicly traded equity securities is required to disclose certain 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.
FASB Statement No. 159 (February 2007)	*The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115* This Statement is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007, provided the entity also elects to apply the provisions of FASB Statement No. 157, *Fair Value Measurements*.
FASB Interpretation No. 48 (June 2006)	*Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109* This Interpretation is effective for fiscal years beginning after December 15, 2006. Earlier application of the provisions of this Interpretation is encouraged if the enterprise has not yet issued financial statements, including interim financial statements, in the period this Interpretation is adopted.
FASB Emerging Issues Task Force (EITF) Issues (Various dates)	Go to www.fasb.org/eitf/ for a complete list of EITF Issues.
FSPs (Various dates)	Go to www.fasb.org/fasb_staff_positions/ for a complete list of FSPs.

FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*

.138 FASB Interpretation No. 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 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

.139 This Interpretation is effective for fiscal years beginning after December 15, 2006. Earlier application of the provisions of this Interpretation is encouraged if the enterprise has not yet issued financial statements, including interim financial statements, in the period this Interpretation is adopted.

FASB Statement No. 157, *Fair Value Measurements*

.140 FASB Statement No. 157, *Fair Value Measurements,* defines fair value, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements because the FASB previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. However, for some entities, the application of this Statement will change current practice.

.141 This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, 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.

FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*

.142 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.

.143 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.

.144 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.

.145 However, an employer without publicly traded equity securities is required to disclose certain 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.

Help Desk—FASB Statement No. 158 will result in testing of investment amounts at the plan sponsor. Such testing by the plan sponsor audit team would not preclude the plan auditor from performing a limited-scope audit of the plan.

.146 When the auditor audits both the plan sponsor and the plan, coordination of investment testing with the plan sponsor audit team may be useful. If the plan auditor does not audit the plan sponsor, consideration should be given to inquiring of the client if any issues arose during the audit of the plan sponsor when auditing investments.

Securities Lending Transactions

.147 Under FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, plans that engage in securities lending should present the assets received in return for the securities, as well as the exchanged securities, on the statement of net assets available for benefits. The plan should also recognize its obligation to return the collateral in the statement of net assets available for benefits. The exchanged securities, as well as the assets received for them (if an investment), should be reported on the ERISA-required supplemental schedule of assets (held at end of year) with the appropriate disclosures.

.148 For securities lending arrangements within a master trust, footnote disclosure of the master trust investments should include the collateral pledged as well as an offsetting liability for the return of the collateral. Because plan investments in a master trust are recorded as a single line item on the plan's statements of net assets, securities lending in the master trust would not be reflected on the face of the plan's financial statements. Often, auditors are unaware that the plan has entered into these transactions because the trustee or custodian nets the collateral assets against the collateral liabilities and because the only indication is the existence of "other income" on the statements. Auditors should ask the plan sponsor and service providers about the existence of a securities lending arrangement and review plan documents to determine the proper auditing procedures. It is important to note that the terms of security lending agreements vary; therefore, it is recommended that auditors obtain a copy and review the security lending agreements to gain an understanding of the security lending arrangements entered into by the plan sponsor.

.149 Securities loaned under a securities lending program at the end of the year should be reported on the Form 5500 Schedule H, line 4i—*Schedule of Assets (Held at End of Year)*. If the transferee has the right by custom or contract to sell or repledge the security loaned, a notation should be made in column (c) of the plan's Form 5500 Schedule H, line 4i—*Schedule of Assets (Held at End of Year)* showing there is a restriction on transferability of the loaned securities. If the transferee does not have the right by custom or contract to sell or repledge the security loaned, no such notation is required on the plan's Form 5500 Schedule H, line 4i—*Schedule of Assets (Held at End of Year).*

On the Horizon—Accounting

.150 Auditors 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 employee benefit plans or that may result in very significant changes. Read the AICPA general *Audit Risk Alert—2006/07* (product no. 022337kk) for a more complete list of ongoing auditing and accounting projects. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS.

.151 Refer to the table in the section "On the Horizon—Auditing" in this Alert for a listing of various standard-setting bodies' Web sites where information may be obtained on outstanding exposure drafts, including downloading exposure drafts. Many more accounting and auditing projects exist in addition to those discussed there. Readers should refer to information provided by the various standard-setting bodies for further information.

Accounting Pipeline

.152 Presented in the following list are accounting pronouncements currently in the exposure process.

Proposed FASB Statement, *The Hierarchy of Generally Accepted Accounting Principles*

.153 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—Nonpublic Companies" section) to ensure that each of the documents has a uniform effective date. Readers should be alert for the issuance of a final Statement.

FASB Project on Derivative Disclosures

.154 FASB Statement No. 133 has been criticized by certain analysts, auditors, investors, and others for lacking transparent disclosures, which would allow a user of the financial statements to assess the overall risk of derivatives on a reporting entity from both a quantitative and qualitative perspective. An exposure draft was issued on December 8, 2006, titled *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*. The comment deadline is March 2, 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. The proposed disclosures will be effective for both interim and annual reporting periods ending after December 15, 2007, with early application encouraged. At initial adoption, disclosures for earlier periods presented for comparative purposes will be encouraged but not required. Disclosures for earlier periods presented for comparative purposes will be required beginning in the first year after the year of initial adoption. Auditors can monitor the progress of this project on the FASB Web site.

Proposed FASB EITFs and FSPs

.155 ***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.

.156 ***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.

Regulatory Developments

2006 Form 5500 Series

.157 The DOL, IRS, and the PBGC have released the 2006 Form 5500 return/reports, schedules, and instructions to be used by employee benefit plans for plan year 2006 filings. The IRS has also released the

Form 5500-EZ return and instructions to be used by certain one-participant retirement plans for plan year 2006 filings.

.158 The modifications to the Form 5500 for plan year 2006 are described under "Changes to Note" in the 2006 instructions. Modifications to the Form 5500 Annual Report for 2006 include the following.

> ***Form 5500.*** (1) The lines 6 and 7 instructions on counting participants and beneficiaries in welfare benefit plans have been expanded to include the definition of when an individual is no longer a participant or beneficiary. (2) The instructions covering small and large pension plans, under the Pension Benefit Plan Filing Requirements, have been clarified for attaching the pages of Schedule SSA to Form 5500. Filers should attach only one page 1. Filers can attach more than one page 2 as necessary.
>
> ***Schedule B.*** (1) The instructions for lines 1d(2)(a), 1d(2)(c), and 6a have been modified because the PPA changed the interest rate to be used in calculating a plan's current liability for the 2006 plan year. (2) The PPA provides funding relief for certain defined benefit plans (other than multiemployer plans) maintained by a commercial passenger airline or by an employer whose principal business is providing catering services to a passenger airline. Special instructions have been added for this provision, allowing eligible plans to be funded using an alternative funding schedule based on a 17-year amortization of unfunded liabilities.
>
> ***Schedules H and I.*** The TIPs in the instructions for lines 4a and 4d of Schedules H and I have been updated to refer to the revised Voluntary Fiduciary Correction Program (VFCP), which was published in the Federal Register on April 19, 2006. The TIPs also explain that applicants that satisfy both the VFCP requirements and the condition of PTE 2002-51 are relieved from the obligation to file the Form 5330 with the IRS.
>
> ***Schedule P.*** The IRS no longer requires the filing of Schedule P, *Annual Return of Fiduciary of Employee Benefit Trust.*

.159 Modifications to the Form 5500-EZ Annual Report for 2006 include the following:

- The IRS has eliminated the filing requirement for the Schedule P, *Annual Return of Fiduciary of Employee Benefit Trust.*
- Instructions have been added for new line 10i for funding (see IRC section 412).

> **Help Desk**—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. 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.

2006 Form M-1 for Multiple Employer Welfare Arrangements

.160 On December 7, 2006, the DOL published the 2006 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.

.161 MEWAs are arrangements that offer medical benefits to the employees of two or more employers or to their beneficiaries. The annual filing date for the 2006 Form M-1 is March 1, 2007. In addition, administrators can request an automatic 60-day extension to May 1, 2007. The 2006 form is virtually identical to the previous year's form.

.162 The online filing system is available on the DOL'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 can be printed for the filer's records. The Web site includes a user manual, Frequently Asked Questions, 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 may be obtained by calling EBSA's toll free number at (866) 444-EBSA (3272) or visiting the Web site at www.dol.gov/ebsa and clicking on "Forms/Doc Requests."

Correspondence From EFAST or the DOL OCA

.163 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, KS, and the DOL's 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

.164 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.

.165 Once completed, the Form 5500 is filed with the DOL's EFAST processing center in Lawrence, KS. 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 deficiencies or discrepancies are identified after subjecting Form 5500 filings to these multiagency edit tests, the EFAST system generates a letter addressed to the plan administrator that identifies the problem(s) and provides 30 days 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 post 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

.166 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 reviews the Form 5500 filings and requests 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.

.167 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 where 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.

.168 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 agency action, and the plan administrator forfeits all appeal rights.

.169 After the DOL reviews the Statement of Reasonable Cause, the agency 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

.170 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 regarding any unresolved filing issues.

.171 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

.172 The EBSA continues its enhanced programs aimed at assessing and improving the quality of employee benefit plan audits. According to the EBSA, 48 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 whom perform 5 audits or fewer. The EBSA utilizes both top-down and bottom-up strategies in selecting and evaluating ERISA audits.

.173 First, the EBSA conducts periodic inspections of firms with substantial ERISA audit practices. The EBSA staff meets with firm management, reviews firm policies and procedures that relate to employee benefit plan audits, and conducts onsite reviews of a sample of ERISA audit engagements. This top-down approach will provide the EBSA with 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.

.174 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.

.175 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.

.176 Finally, the EBSA has expanded its enforcement efforts dealing with fiduciary breaches to include determining whether plan auditors may be considered as *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 in concealing the violation.
- The plan auditor failed to act when required to do so by applicable professional standards.

DOL Fiduciary Education Initiatives

.177 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.

.178 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. Also included are the following DOL-issued publications:

Meeting Your Fiduciary Responsibilities. To meet their responsibilities as plan sponsors, employers need to understand some basic rules, specifically ERISA. ERISA sets standards of conduct for those who manage an employee benefit plan and its assets (called fiduciaries). This publication provides an overview of the basic fiduciary responsibilities applicable to retirement plans under the law.

Understanding Retirement Plan Fees and Expenses. This booklet will help retirement plan sponsors better understand and evaluate their plan's fees and expenses. While the focus is on fees and expenses involved with 401(k) plans, many of the principles discussed in the booklet will also have application to all types of retirement plans.

401(k) Plan Fee Disclosure Tool. This is a form that provides employers with a handy way to make cost-effective decisions and compare the investment fees and administrative costs of competing providers of plan services.

Selecting an Auditor for Your Employee Benefit Plan. Federal law requires employee benefit plans with 100 or more participants to have an audit as part of their obligation to file the Form 5500. This booklet will assist plan administrators in selecting an auditor and reviewing the audit work and report.

Selecting and Monitoring Pension Consultants—Tips for Plan Fiduciaries. ERISA requires that fiduciaries of employee benefit plans administer and manage their plans prudently and in the interest of the plan's participants and beneficiaries. In carrying out these responsibilities, plan fiduciaries often rely heavily on pension consultants and other professionals for help. To encourage the disclosure and review of more and better information about potential conflicts of interest, the DOL and the SEC have developed a set of questions to assist plan fiduciaries in evaluating the objectivity of the recommendations provided, or to be provided, by a pension consultant.

Tips for Selecting and Monitoring Service Providers for Your Employee Benefit Plan. Business owners are responsible for ensuring that their 401(k) plans comply with federal law and rely on other professionals to assist them with their plan duties. Selecting a service provider is one of the most important responsibilities of a plan sponsor. The EBSA has prepared this set of tips to assist business owners in carrying out these responsibilities.

Reporting and Disclosure Guide for Employee Benefit Plans. This Guide is intended to be used as a quick reference tool for certain basic reporting and disclosure requirements under ERISA.

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

.179 The Delinquent Filer Voluntary Compliance (DFVC) Program 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.

Change in Mailing Address

.180 In April 2006, the DOL announced new addresses to be used for the DFVC Program. The new addresses are provided in the following table. Mail submitted to the former address will be returned, unopened, to the sender.

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

.181 Eligibility in the DFVC Program continues to be limited to plan administrators with filing obligations under Title I of ERISA who comply with the provisions of the program and who have not been notified in writing by the DOL of a failure to file a timely annual report under Title I of ERISA. Form 5500-EZ filers and Form 5500 filers for plans without employees (as described in 29 CFR 2510.3-3(b) and (c)) are not eligible to participate in the DFVC Program because such plans are not subject to Title I.

Program Criteria

.182 Participation in the DFVC Program is a two-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 DFVC Program the required documentation and applicable penalty amount. The plan administrator is personally liable for the applicable penalty amount, and, therefore, amounts paid under the DFVC Program shall not be paid from the assets of an employee benefit plan.

Penalty Structure

.183 ***Per day penalty.*** The basic penalty under the program is $10 per day for delinquent filings.

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.

Per plan cap. This cap is designed to encourage reporting compliance by plan administrators who have failed to file an annual report for a plan for multiple years. The per plan cap limits the penalty to $1,500 for a small plan and $4,000 for a large plan regardless of the number of late annual reports filed for the plan at the same time. There is no "per administrator" or "per sponsor" cap. If the same party is the administrator or sponsor of several plans required to file annual reports under Title I of ERISA, the maximum applicable penalty amounts would apply for each plan.

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. However, it is not available if, as of the date the plan files under the DFVC Program, there is a delinquent annual report for a plan year during which the plan was a large plan.

"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

.184 Although the DFVC Program 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 where the conditions of the DFVC Program have been satisfied.

> **Help Desk—**Questions about the DFVC Program should be directed to EBSA by calling (202) 693-8360. For additional information about the Form 5500 Series, visit the EFAST Internet site at www.efast.dol.gov or call the EBSA Help Desk toll-free at (866) 463-3278.

VFCP

.185 The 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.

.186 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
- Relief from civil penalties for transactions involving health and welfare plans

.187 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.

.188 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.

> **Help Desk—**For more information about the VFCP Program, 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

> **Help Desk—**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.

.189 In addition to handling technical telephone inquiries, the EBSA is involved in numerous outreach efforts designed to provide information to practitioners to help their clients comply with ERISA's reporting and disclosure requirements. The agency's outreach efforts continue to focus on plan audit quality, the current Form 5500, the EFAST Processing System, and other agency-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/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

.190 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. The latest date that pension plans can be segregated is the 15th business day of the month following the month in which the participant contributions are withheld or received by the employer. The latest date that welfare plans can be segregated is 90 days from the date on which such amounts are withheld or received by the employer.

Reporting of Late Remittances

.191 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.

.192 Information on all delinquent participant contributions should be reported on line 4a of either Schedule H or Schedule I 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.

.193 Beginning with the 2003 Form 5500, information on delinquent participant contributions is no longer required to also be reported on line 4d of Schedule G. 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 PTE 2002-51 have been satisfied) may be reported on a separate supplemental schedule to be attached to the Form 5500 and reported on by the Independent Qualified Public Accountant (IQPA).

.194 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, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1), 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 the EBP Guide for further discussion of prohibited transactions.

.195 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 Prohibited Transaction Exemption (PTE) 2002-51, should expect the following:

- To receive a "no action" letter issued by the DOL that provides for no imposition of Section 502(l) penalties
- To receive relief from the excise tax provisions of the IRC
- To 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)
- To not be 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

.196 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

.197 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.

.198 In Advisory Opinion 2002-2A, the DOL concluded that, while 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 the purpose of determining when such repayments become assets of the plan. Specifically, the Advisory Opinion concluded that participant loan repayments paid to or withheld by an employer for purposes of transmittal to the plan become plan assets as of the earliest date on which such repayments can reasonably be segregated from the employer's general assets.

.199 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.

.200 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.

DOL Final Rule on Electronic Filing of the Form 5500 and Proposed Changes to the 2008 Form 5500

.201 On July 21, 2006, the EBSA published in the Federal Register a final regulation requiring plans to file Form 5500 annual reports electronically, beginning with 2008 plan year filings due in 2009. Simultaneously, the EBSA, along with the IRS and the PBGC, proposed changes to the forms that will be processed under the new electronic system.

.202 The wholly electronic filing system will be streamlined, cost effective, and more efficient for plans. It will also increase the accuracy of information used by the public and the government. Under the final rule, the electronic filing requirement will be effective for plan years starting on or after January 1, 2008. This will give plans and service providers time to adapt to the new electronic system and any changes to the Form 5500.

.203 Among the proposed revisions to the Form 5500 are (1) creation of a new short form for small plans whose assets are held in easy-to-value investments with regulated financial institutions, (2) increased transparency of plan-related fees and expenses, (3) improved information on the funding of defined benefit plans, and (4) realignment of the reporting rules of 403(b) plans (subject to Title I) to be compatible with those of 401(k) plans. The new system will also customize the information required to be filed to the type of plan involved in each filing.

> **Help Desk—**The text of the final rule and the proposed changes to the Form 5500 are available on the EBSA Web site at www.dol.gov/ebsa.

DOL Proposes PPA Revisions to the Form 5500 Annual Report for 2008

.204 On December 8, 2006, the EBSA, IRS, and PBGC announced proposed supplemental revisions to the 2008 Form 5500.

.205 The proposed revisions implement amendments to ERISA's annual reporting and pension funding requirements and the IRC enacted them as part of the PPA. The proposal supplements a more general revision of the 2008 Form 5500 proposed by the agencies in July 2006. The supplemental proposal would replace the Schedule B, *Actuarial Information*, filed by defined benefit pension plans with separate actuarial schedules for multiemployer plans and single-employer plans.

.206 The supplemental proposal would also add questions to the Schedule R, *Retirement Plan Information*, to collect new information on defined benefit pension plans required under the PPA.

.207 Finally, the supplemental proposal would establish the Form 5500-SF, which was part of the agencies' July 2006 proposal, as the simplified report required by PPA for plans with fewer than 25 participants.

.208 These proposed revisions would be effective for 2008 plan year filings.

DOL Abandoned Individual Account Plan Final Regulations and Class Exemption

.209 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

.210 The regulations establish standards for determining when a plan is abandoned, simplify 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

.211 A plan will generally 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

.212 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 (bank, trust company, mutual fund family, or insurance company).

Termination and Winding-Up Process

.213 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
- Filing a summary terminal report

.214 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

.215 The regulations establish a fiduciary safe harbor for the investment of rollover distributions from terminated plans to IRAs for missing participants.

Fiduciary Liability and Annual Reporting Relief

.216 QTAs that follow the regulation will be considered to have satisfied the prudence requirements of ERISA with respect to winding-up activities.

.217 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. The QTA must complete and file a summary terminal report at the end of the winding-up process.

Class Exemption

.218 The exemption would cover transactions where the QTA selects and pays itself for the following:

- Services rendered prior to becoming a QTA
- Services in connection with terminating and winding up an abandoned plan
- Distributions from abandoned plans to IRAs or other accounts maintained by the QTA resulting from a participant's failure to provide direction

Administration

.219 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

.220 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

.221 The EBSA has initiated a new enforcement project, the Consultant Advisor Program (CAP), that 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 agency 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 CAP will also seek to identify potential criminal violations such as kickbacks or fraud.

Independence Request for Information

.222 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.

.223 The DOL comment period for the RFI closed on December 11, 2006, and the DOL has received 27 comments to date. The DOL continues to evaluate the comments to identify common themes, and the project remains an important DOL initiative.

EBSA's Proposed Rule on Default Investment Alternatives for Participant-Directed Plans

.224 On September 27, 2006, the DOL published a proposed rule in the Federal Register to make it easier for fiduciaries of 401(k) plans and other participant-directed defined-contribution plans to adopt automatic enrollment design features. The proposed rule is the first major regulation resulting from the PPA signed into law by President Bush on August 17, 2006.

.225 The proposal implements provisions of the PPA to provide relief to plan fiduciaries who invest the assets of participants in *qualified default investment alternatives* in the absence of participant investment direction.

.226 Upon adoption, the rule will remove a major impediment to automatic enrollment programs created by employers. Default investment alternatives under the proposed regulation are intended to encourage the investment of employee assets in appropriate investment vehicles for long-term retirement savings.

.227 The proposed rule and a fact sheet detailing the proposed rule can be found on the EBSA's Web site at www.dol.gov/ebsa.

EBSA's Final Amendment on Securities Lending Exemption

.228 On October 30, 2006, the EBSA adopted a final class exemption expanding the opportunities for securities lending between employee benefit pension plans and banks and broker-dealers. The exemption consolidates two existing class exemptions and provides conditions to safeguard the assets of plans involved in securities lending transactions. The updated requirements will permit pension plans to earn additional income by lending securities from their portfolios to a greater universe of permissible borrowers.

.229 Under the exemption, the categories of permissible borrowers have been expanded to include broker-dealers and banks of the United Kingdom, Canada, and certain other foreign broker-dealers and banks. In addition, the types of collateral that may be offered to plans for securities lending transactions have been broadened to include negotiable certificates of deposits payable in the United States, mortgage-backed securities, the British pound, the Canadian dollar, the Swiss franc, Japanese yen, the Euro, securities issued by Multilateral Development Banks, rated foreign sovereign debt, and irrevocable letters of credit issued by certain foreign banks.

.230 If the plan's U.S.-domiciled lending agent agrees to indemnify the plan against losses resulting from a borrower's default, the final exemption permits a plan to accept any other type of collateral currently permitted by the SEC under Rule 15c3-3 of the Securities and Exchange Act of 1934.

.231 The final exemption revokes and replaces Prohibited Transaction Exemptions 81-6 and 82-63.

Model Notice of Pending Election of Multiemployer Plan Status

.232 On December 1, 2006, the DOL published in the Federal Register a model notice that may be used by employee benefit plans that elect to be treated as multiemployer plans under the ERISA.

.233 The PPA amended ERISA to permit certain plans that elected to be single-employer plans to revoke that election and allow other plans to elect to be treated as multiemployer plans provided that notice of the election is furnished to participants and other interested parties no later than 30 days before the election. The notice must describe, among other things, the principal differences between ERISA's guarantee programs and benefit restrictions for single-employer and multiemployer plans.

.234 Plan administrators may use the model notice to fulfill their notice obligations when making an election, and elections must be made with the PBGC within one year after the enactment of the PPA.

.235 A copy of the model notice is available through the EBSA Web site at www.dol.gov/ebsa.

EBP Resources

.236 These are employee benefit plan-related educational courses, Web sites, publications, and other resources available to CPAs.

Related Publications

.237 The following are some of the AICPA publications that deliver valuable guidance and practical assistance as potent tools to be used on your employee benefit plan engagements:

- AICPA Audit and Accounting Guide *Employee Benefit Plans*, with conforming changes as of March 1, 2007 (product no. 012597kk) provides easy-to-follow guidance to prepare, audit, and report on financial statements of employee benefit plans.
- *Accounting Trends & Techniques—Employee Benefit Plans*, second edition (product no. 006624kk) offers the same kind of powerful help that the AICPA's *Accounting Trends and Techniques, 60th Edition* (product no. 009898kk) does. This comprehensive book illustrates a wide range of employee benefit plan financial statement disclosures and auditors' reports for both full-scope and limited-scope audits. The publication also includes a chapter dedicated to illustrative management letters and management letter comments. Look for a revised second edition to be released this summer.
- *SAS No. 70 Reports and Employee Benefit Plans* (product no. 061061kk) provides you with guidance on the use of SAS No. 70 reports in your employee benefit plan audits. In practice, auditors of employee benefit plans have continued to raise questions about how SAS No. 70 reports should be considered in their audits and the auditing procedures that should be applied to these reports to increase their reliability as audit evidence.
- These practice aids, developed by the AICPA's Accounting and Auditing Publications staff, are invaluable to anyone who prepares financial statements and reports (the 2007 checklists will be available this summer):

  a. *Checklists and Illustrative Financial Statements for Defined Benefit Pension Plans* (product no. 008996kk) (2007 product no. 008997kk)

  b. *Checklists and Illustrative Financial Statements for Defined Contribution Pension Plans* (product no. 009006kk) (2007 product no. 009007kk)

  c. *Checklists and Illustrative Financial Statements for Health and Welfare Benefit Plans* (product no. 009016kk) (2007 product no. 0090157kk)

Web Casts

.238 ***Strategic Industry Briefing—Employee Benefit Plans***. The April 30, 2007, Web cast *Strategic Industry Briefing—Employee Benefit Plans* was an AICPA strategic briefing that addressed current industry developments and emerging practice issues relating to employee benefit plans. Participants learned about current accounting, auditing, and regulatory developments, including the impact 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. This Web cast is available on CDROM (product no. 780102kk).

Conferences

AICPA Employee Benefit Plans Accounting, Auditing and Regulatory Update Conference

.239 This high level forum lets you interact with expert auditors and members of the DOL. The 2007 *Employee Benefit Plan Accounting, Auditing and Regulatory Update* Conference will be held December 12 through 13, 2007, in Washington, DC. For more information, visit the Web site at www.cpa2biz.com/conferences.

National Conference on Employee Benefit Plans

.240 Each spring, the AICPA sponsors a National Conference on Employee Benefit Plans that is specifically designed to update auditors, plan administrators, and plan sponsors on various topics, including recent and proposed employee benefit plan legislative and regulatory issues, and significant accounting, auditing, and tax developments. The 2008 National Conference on Employee Benefit Plans will be held May 12 through 15, 2008, in Las Vegas, NV. For a conference brochure, please call (888) 777-7077 and request brochure G50038. For more information, visit the Web site at www.cpa2biz.com/conferences.

Education Courses

.241 The AICPA has developed a number of continuing professional education (CPE) courses that are valuable to CPAs working on employee benefit plan engagements. Those courses include:

- Audits of 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
- Online CPE: AICPA InfoBytes

Service Center Operations

.242 To order AICPA products, receive information about AICPA activities, and find help answering your membership questions, call the AICPA Service Center Operations at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.243 The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

.244 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

.245 AICPA Online offers CPAs the unique opportunity to stay abreast of matters relevant to the CPA profession. AICPA Online informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, CPA2Biz.com offers all the latest AICPA products, including Audit Risk Alerts, Audit and Accounting Guides, *Professional Standards*, and CPE courses.

Other Helpful Web Sites

.246 Additional information on matters addressed in this Alert is available through various publications and services offered by a number of organizations. Some of those organizations are listed in the table at the end of this Alert.

.247 This Audit Risk Alert replaces *Employee Benefit Plans Industry Developments—2006*.

.248 The Audit Risk Alert *Employee Benefit Plans Industry Developments* is published annually. As you encounter audit and industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert would also be greatly appreciated. You may e-mail these comments to ldelahanty@aicpa.org or write to:

Linda C. Delahanty
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

.249

Information Sources

Organization	*General Information*	*Fax Services*	*Web Site Address*
American Institute of Certified Public Accountants	*Order Department* (888) 777-7077	*24-Hour Fax Hotline* (201) 938-3787	www.aicpa.org
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10	*24 Hour Fax-on-Demand* (203) 847-0700, menu item 14	www.fasb.org
Public Company Accounting Oversight Board	1666 K Street, NW Washington DC 20006-2803 (202) 207-9100		www.pcaobus.org or www.pcaob.com
Department of Labor Employee Benefits Security Administration:			www.dol.gov/dol/EBSA
Office of the Chief Accountant	(202) 693-8360		
Division of Accounting Services	ERISA related accounting and auditing questions (202) 693-8360		
Division of Reporting Compliance	Form 5500 preparation and filing requirements (202) 693-8360		
Office of Regulations and Interpretations	(202) 693-8500		

.250

Appendix A

IRS Limits on Benefits and Compensation

	2007	*2006*	*2005*
Defined benefit			
Maximum annual pension	$180,000	$175,000	$170,000
Defined contribution			
Maximum annual addition	45,000	44,000	42,000
401(k) plan			
Maximum elective deferral[1]	15,500	15,000	14,000
403(b) plan			
Maximum elective deferral	15,500	15,000	14,000
457 plans	15,500	15,000	14,000
SIMPLE plans	10,500	10,000	10,000
Qualified plans			
Maximum compensation limits	225,000	220,000	210,000
Highly compensated limits	100,000	100,000	95,000
Officer limits (key employee)	145,000	140,000	135,000
FICA taxable wage base	97,500	94,200	90,000
Employer and employee Social Security tax	6.20%	6.20%	6.20%

[1] Catch-up contributions for individuals over age 50 increased to $3,000 in 2004, to $4,000 in 2005, and to $5,000 in 2006 and 2007.

.251

Appendix B

Evaluating Control Deficiencies in an Employee Benefit Plan Audit (Applying SAS No. 112)

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. Auditors should be aware that 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[1] likelihood that a

---

[1] 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 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.

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 impact the consideration of likelihood and magnitude.

Likelihood

In addition to the factors listed in SAS No. 112 and *Understanding SAS No. 112 and Evaluating Control Deficiencies* (SAS No. 112 Alert), 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. The application of the definition of compensation, when incorrectly used, 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

The SAS No. 112 Alert provides a general list of circumstances that may be control deficiencies, significant deficiencies, or material weaknesses.

In addition to the items listed in the *SAS No. 112 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 should be used to supplement but not replace those listed in the SAS No. 112 Alert. This is a companion to but not a substitute for, the guidance in SAS No. 112 and the SAS No. 112 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
- 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 rather than FASB Statement No. 35 or using FASB Statement No. 106 rather than FASB Statement No. 112
- 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 often, these are 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:

- 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 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:

- 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, DOL, and PBGC)

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:

- Lack of oversight by the plan sponsor of the service provider including not obtaining and reviewing a SAS 70 report if available
- For service providers with no SAS 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 the SAS No. 112 Alert.

[Firm letterhead]

[Date]

[Addressee][2]

[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 control deficiency, or combination of control 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 impacted by this error. The

[2] The addressee should be the plan oversight entity such as the board of trustees, the board of directors, or the audit committee.

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 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 *Employee Benefit Plan* Audit Guide 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 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, etc.) 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 a significant deficiency.

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]

.252

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 two 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).

.253

Appendix D

FSP AAG INV-1 and SOP 94-4-1 Technical Practice Aids

TPA 6931.08, *Types of Investments Subject to SOP 94-4,* as Amended by FSP AAG INV-1 and SOP 94-4-1

Inquiry: What types of investments are subject to the financial statement presentation and disclosure requirements of SOP 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans*, as amended by Financial Accounting Standards Board (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*?

Reply: 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 (BIC), (*c*) a synthetic GIC composed of a wrapper contract and the underlying wrapped portfolio of individual investments, or (*d*) a contract with similar characteristics.

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, which own investment contracts. Insurance company pooled separate accounts that hold investment contracts also have similar characteristics.

It is important for the auditor to gain an understanding of the types of investments being held by the plan; this can be achieved by obtaining the underlying documents for the investments. Typically, investments have some form of underlying documentation to help determine the type of investment. For example, if a plan is invested in common collective trust funds (CCTs), there should be a trust declaration for that CCT, which would generally have audited financial statements.

TPA 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

Inquiry: Do the financial statement presentation requirements in paragraph 15 of SOP 94-4, as amended by FSP AAG INV-1 and SOP 94-4-1, apply to a plan's investment in a CCT or master trust that holds fully benefit-responsive investment contracts?

Reply: Yes. Paragraph 15 of SOP 94-4, as amended by FSP AAG INV-1 and SOP 94-4-1, requires the following presentation for fully benefit-responsive investment contracts.

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.

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.

A CCT is a trust for a collective investment and reinvestment of assets contributed from employee benefit plans maintained by more than one employer or a controlled group of corporations that is maintained by a bank, trust company, or similar institution that is regulated, supervised, and subject to periodic examination by a state or federal agency. Such CCTs allow several smaller unaffiliated plans to gain the economies of scale necessary to participate in the stable value marketplace. These CCTs generally issue separate standalone financial statements and are considered investment companies subject to the AICPA Audit and Accounting Guide *Investment Companies*.

TPA 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

Inquiry: Do plans that directly invest in CCTs or in master trusts that hold fully benefit-responsive investment contracts need to include in the plan financial statements the disclosures in paragraph 15 of SOP 94-4, as amended by FSP AAG INV-1 and SOP 94-4-1?

Reply: 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 the FSP 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, 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. These disclosures are necessary because, unlike a CCT (as discussed in TPA 6931.09), master trust financial statements are not required, and the related disclosure information would not be readily available.

Illustrative Financial Statements

The following illustrative financial statements are for the hypothetical XYZ Company 401(k) plan, modified to reflect the reporting and disclosure provisions of FSP AAG INV-1 and SOP 94-4-1. It does not illustrate other provisions that might apply in circumstances other than those assumed in this example. It also does 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, 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 footnote, and (3) the Investment Contract With Insurance Company footnote.

XYZ Company 401(k) Plan Statements of Net Assets Available for Benefits

	December 31,	
	20X1	20X0
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 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.

XYZ Company 401(k) Plan 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 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. As required by the FSP, the Statement of Net Assets Available for Benefits presents the fair value of the investment contracts as well as the adjustment of the fully benefit-responsive investment contracts from fair value to contract value. 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 fair value of the guaranteed investment contract is calculated by discounting the related cash flows based on current yields of similar instruments with comparable durations.

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 Contract with Insurance Company

In 20X0, the Plan entered into a benefit-responsive investment contract with National Insurance Company (National). 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 guaranteed investment contract issuer is contractually obligated to repay the principal and a specified interest rate that is guaranteed to the Plan.

As described in Note B, because the guaranteed investment contract is fully benefit-responsive, contract value is the relevant measurement attribute for that portion of the net assets available for benefits attributable to the guaranteed investment contract. Contract value, as reported to the Plan by National, 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.

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 it may not be less than four percent. Such interest rates are reviewed on a quarterly basis for resetting.

Certain events limit the ability of the Plan to transact at contract value with the issuer. Such events include the following: (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 Employee Retirement Income Security Act of 1974. The Plan administrator does not believe that the occurrence of any such value event, which would limit the Plan's ability to transact at contract value with participants, is probable.

The guaranteed investment contract does not permit the insurance company to terminate the agreement prior to the scheduled maturity date.

Average yields:	***20X1***	***20X0***
Based on actual earnings	4.68%	4.90%
Based on interest rate credited to participants	4.68%	4.90%

.254

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 agency's views on technical applications of the Employee Retirement Income Security Act of 1974 (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 ESOP 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 2004-01	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 2004-02	Addresses a fiduciary's duties with respect to missing participants in a terminated defined-contribution plan
FAB 2004-03	Addresses the fiduciary responsibilities of a directed trustee in the context of publicly traded securities
FAB 2006-01	Addresses the distribution to plans of settlement proceeds relating to late trading and market-timing

(continued)

FAB 2006-02	Addresses recurring questions about ERISA coverage of health savings accounts (HSAs) and evolving practices in the offering of HSAs in the workplace
FAB 2006-03	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 2007-01	Addresses guidance relating to the investment advice provisions of the Pension Protection Act of 2006

.255

Appendix F

Analytical Procedures as Substantive Tests

Analytical Procedures as Substantive Tests

For all audits of financial statements in accordance with generally accepted auditing standards (GAAS), analytical procedures should be applied to some extent for the purposes of assisting the auditor in planning the nature, timing, and extent of other auditing procedures, and as an overall review of the financial information in the final review stage of the audit. In some cases, however, analytical procedures can be more effective or efficient than tests of details for achieving particular substantive testing objectives. Analytical procedures may be used as substantive tests to obtain evidential matter about particular assertions related to account balances or classes of transactions.

AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1), as amended, 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.

Because the planning for employee benefit plan audits is often done after year end, preliminary analytics are performed using year-end numbers with minimum subsequent adjustment. In such instances, final analytics can be documented on the same schedule; however, because each type of analytic is done for a different purpose, different purposes, expectations, and conclusions need to be documented. There may be certain areas where the auditor knows during planning that substantive analytics will be performed. For these areas, it may be efficient to document preliminary, substantive, and final analytics on the same schedule, making sure the purpose of each test, expectation, and conclusion is documented appropriately. If there are any audit adjustments, a separate and final analytic would need to be performed.

Analytical Procedures in Planning the Audit

For planning purposes, these procedures should focus on (1) enhancing the auditor's understanding of the plan and the transactions and events that have occurred since the last audit date and (2) identifying areas that may represent specific risk relevant to the audit. These procedures can help identify such things as the existence of unusual transactions and events. They can also help identify amounts, ratios, and trends that might indicate matters that have financial statement and audit planning ramifications.

The following are examples of analytical procedures that the auditor may find useful in planning an audit of an employee benefit plan:

- Comparison of investment balances and rates of return with prior-period amounts
- Analysis of changes in contributions and benefit payments during the current period based on statistical data (for example, number of participants eligible to receive benefits in the current period, or the number of terminations)

Analytical Procedures Used as Substantive Tests

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 procedures to use to achieve a particular audit objective is based on the auditor's judgment on the expected effectiveness and efficiency of the available procedures.

The auditor considers the level of assurance, if any, he or she wants from substantive testing for a particular audit objective and decides, among other things, which procedure or combination of procedures can provide that level of assurance. For some assertions, analytical procedures are effective in providing the appropriate level of assurance. For example, the auditor may be able to obtain a moderate-to-high level of assurance over the accuracy of insurance premiums by performing an analytic regarding monthly premium amounts using the rates in the insurance agreement to set the expectation. For other assertions, however, analytical procedures may not be as effective or as efficient as tests of details in providing the desired level of assurance. For example, for a plan with multiple payroll locations, it may be difficult to obtain disaggregated information regarding participant contributions; therefore, substantive analytics may not be effective or efficient.

The expected effectiveness and efficiency of an analytical procedure in identifying potential misstatements depends on, among other things, (1) the nature of the assertion, (2) the plausibility and predictability of the relationship, (3) the availability and reliability of the data used to develop the expectation, and (4) the precision of the expectation.

Documentation of Substantive Analytical Procedures

When an analytical procedure is used as the principal substantive test of a significant financial statement assertion, the auditor should document all of the following:

1. The expectation, where that expectation is not otherwise readily determinable from the documentation of the work performed, and factors considered in its development

2. Results of the comparison of the expectation to the recorded amounts or ratios developed from recorded amounts

3. Any additional auditing procedures performed in response to significant unexpected differences arising from the analytical procedure and the results of such additional procedures

See AU section 329 for further guidance.

Examples of Analytical Procedures

Auditors should be aware that the examples contained in this section typically would not eliminate the need for detailed testing but may be used to supplement such testing.

- ***Investments.*** Investment balances may fluctuate during the year based on changes in (1) investment strategy resulting from management decisions (or resulting from participant decisions, in the case of a defined-contribution participant-directed plan), (2) market trends, or (3) other plan changes (for example, merger or termination). Once the auditor understands what types of changes have occurred, an expectation can be developed. Review market trends for similar types of investments and determine expectations based on plan activity (level of contributions or distributions), taking into account plan changes. Often the recordkeeper or investment manager prepares quarterly investment return reports that can be used to assist in developing an expectation. In addition, benchmarks for yields and total return can be obtained for asset classes or specific investments (for example, mutual funds).

- ***Participant contributions.*** Review the prior year Form 5500 to determine the participant headcount in the plan. Obtain the total contribution balance for the prior year and divide this amount by the participant headcount to determine an average participant contribution amount for the prior year. Determine (1) the growth or decline of participants for the current year, (2) changes in contribution rates (for example, plan amendments and so on), and (3) pay increases. Calculate current year contribution amount using last year's average contribution amount and this year's headcount, taking into account any changes in contribution rates or pay increases.

Participant Contributions Example

Prior-year headcount per the Form 5500 = 130 people

Prior-year participant contributions balance = $401,828

Prior-year "average" participant contribution = $401,828/130 = $3,091

Per discussion with management, during the current year, only 50 people remain actively contributing in the plan due to significant layoffs in the Company. No pay increases took effect during the year. Therefore, total participant contributions are expected to be:

$3,091 x 50 people = $154,550 expected contribution

Often, the recordkeeper prepares quarterly reports that include headcount and contribution rate information that can be used to assist in developing an expectation.

- ***Claims.*** Determine number of claimants receiving claims in the prior year and the average claim per participant. Determine the number of claims during the year. Apply the average claim per participant to the expected number of claimants, taking into account plan amendments, individual large claims, stop-loss insurance coverage, or the health care cost trend rate increase. Often, the third-party administrator prepares quarterly reports that include headcount and claim information that can be used to assist in developing an expectation.

- ***Payroll.*** For single employer plans, develop an expectation for current-year gross wages using prior-year gross wages and taking into account change in number of employees, average percentage pay increases, and addition and termination of highly compensated employees.

.256

Appendix G

Claims Testing

There are three sources that the auditor may need to consult when testing claims. They are the sources that contain Current Procedural Terminology (CPT) codes, Healthcare Common Procedure Coding System (HCPCS) codes, and International Classification of Diseases, Ninth Edition (ICD-9) codes.

Physicians' CPT is a listing of descriptive terms and identifying five-digit codes for reporting medical services and procedures. The purpose of CPT is to provide a uniform language that accurately describes medical, surgical, and diagnostic services and thereby serves as an effective means for reliable nationwide communications among physicians, patients, and third parties. In addition, for use in federal programs (Medicare and Medicaid), CPT is used extensively throughout the United States as the preferred system of coding and describing health care services.

CPT does not contain all the codes needed to report medical services and supplies. The Health Care Financing Administration (HCFA) developed level II and level III codes, which are published as HCPCS codes for supplies and services not covered by a CPT code (level I). These codes cover such items as durable medical equipment, ambulance services, and various drugs.

The ICD-9-CM is published by the United States government and is the classification employed for cause-of-death coding. The ICD-9 coding system is recommended for use in all clinical settings and is required for reporting diagnoses and diseases to the U.S. Public Health Service.

If medical claims are not submitted electronically, they are submitted on one of two types of forms. All hospital bills, both outpatient and inpatient, are submitted on a form UB92. All other bills are submitted on a form HCFA 1500.

.257

Appendix H

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. The AICPA Audit and Accounting Guide *Employee Benefit Plans* (EBP Guide), with conforming changes as of March 1, 2007 (product no. 012597kk), 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 *Attestation Standards: Revision and Recodification* (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 the EBP Guide 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 should 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 the EBP Guide states that "a representative group of contributing employers should 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 should be utilized in selecting at least some of the employers for audit. In that way, every employer would have the opportunity of being audited.

The plan should monitor from year to year the effectiveness of its payroll auditing program. The payroll audit program should help ensure the completeness objective in measuring employer contributions. The plan itself should 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.

[*The next page is 8179*.]

AAM Section 8070

State and Local Governmental Developments—2007

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

NOTICE TO READERS
STATE AND LOCAL GOVERNMENTAL DEVELOPMENTS—2007

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

Acknowledgments

The AICPA staff is grateful to the following individuals for their essential contributions in creating this publication.

Michael A. Crawford
Venita M. Wood
Marcia B. Buchanan
Martha Haines
L. Michael Howard
Randy Roberts
Donald L. Rahn
W. Michael Fritz
Christian J. Rogers
Caroline H. Walsh
Edward P. Chait

How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your state and local governmental 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 auditees 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 (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—2007* (product no. 022457kk). 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 State and local governments 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 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 auditee'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 auditee operates. Economic activities relating to factors such as interest rates, consumer confidence, grantor government interests, investor (in debt securities) information, 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 advance estimates, GDP increased at an annual rate of 3.4 percent. 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.

.11 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). Future federal fund rate adjustments will likely depend upon the outlook for economic growth and inflation.

Industry Trends and Conditions

.12 The Nelson A. Rockefeller Institute of Government (Institute) publishes frequent updates on state fiscal conditions. The Institute's report on the January through March 2007 quarter, at www.rockinst.org, showed continued improvement in the states' revenue picture and included these highlights:

- State tax revenue totaled $154 billion, up 4.8 percent from the same period in 2006.
- Adjusting for inflation and legislated tax changes, growth was 1.4 percent. This represents the 14th consecutive quarter of growth in real, adjusted terms, but was slightly below 2006 average growth.
- Revenue growth among the regions was strongest in the Rocky Mountain states for this quarter (10.5 percent) and weakest in the Great Lakes region (1.2 percent).
- The Western regions continue to lead the nation in employment growth, while the Great Lakes region and northeastern states were the weakest.
- State tax revenue growth was reduced by $1.3 billion in net enacted tax cuts.

.13 Another Institute report, at www.rockinst.org, entitled *The Effects of State-Level Tax and Expenditure Limitations on Revenues and Expenditures*, discussed the recent trends in states enacting tax or spending limitations through legislation, referenda, or voter initiatives. The report concludes that the spread of state-level tax- and expenditure-limitation initiatives has slowed in recent years. Most recent efforts to impose such limitations have either failed to get placed on voter's ballots or failed to win approval of voters. Only two states, Maine and Ohio, enacted spending limits in the past two years, and both were enacted through state legislation and not voter initiatives. The study's findings strengthened the claim that tax and spending limitations reduce total government spending on a real, per capita basis. However, the findings also suggest that the spending reductions are not uniform for all government services, with transportation spending showing little reduction compared to spending for public safety. Finally, the study expressed a concern that with the slowdown in the spread of the tax and expenditure limitations, a divide may be developing between the states that have implemented limitations and those that have not, which could result in large differences in spending and revenue priorities among the states.

.14 In May 2007, the United States Congress passed a $120 billion emergency appropriations bill. While the majority of the appropriations are for military purposes, over $22 billion was made available for domestic purposes. Some of these domestic purposes that may be of interest to state and local governments include:

- $6.3 billion for continued hurricane relief.
- $3 billion for crop disaster and livestock assistance.
- $1 billion for homeland security anti-terrorism programs.
- $650 million for funding state shortfalls in children's health insurance programs.
- $465 million for wildfire suppression.

.15 Also of interest to state and local governments in the bill is the provision to raise the minimum wage from $5.15 to $7.25 per hour over a three-year period. The increases would take effect as follows: (1) August 1, 2007 to $5.85; (2) August 1, 2008 to $6.55; and (3) August 1, 2009 to $7.25.

Retiree Health Care Costs

.16 The pending implementation of 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*, continues to be of interest to state and local governments and their auditors. Because many governments previously have not measured or disclosed in their financial statements their obligations to pay retiree health care costs and other postemployment benefits (OPEB) other than pensions, 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 into 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.

.17 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 also be prepared to answer their auditees' questions about managing those obligations.

.18 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 or contractual restraints. Whichever solutions are chosen by the entity, they likely will be difficult.

.19 The state of Texas has taken an unorthodox and unprecedented approach to dealing with measuring and reporting OPEB obligations. At the urging of the Texas state comptroller and representatives from certain Texas county governments, the Texas legislature passed and the governor has signed legislation in their 2007 session that would provide all Texas government entities, including the state and all political subdivisions, an alternative to following generally accepted accounting principles (GAAP). This alternative legislated basis of accounting, which is considered an other comprehensive basis of accounting, essentially follows GAAP with the exception of applying the accrual basis principles for recognizing OPEB expenses and obligations as constructively incurred pursuant to GASB Statement No. 45. The argument put forth by the legislation's supporters is that Texas governments are constitutionally prohibited from entering into long-term obligations, such as postemployment health care benefits, and that recording such a long-term obligation would misrepresent the government's financial condition. They do not support the notion that an OPEB liability exists based on a substantive plan or constructive obligation as put forth in GASB Statement No. 45. This position has been questioned by many outside of Texas. Rough estimates of the State of Texas's OPEB obligation place the amount around $50 billion.

.20 While concerns exist across the country that other states may follow the Texas lead, the governor of the state of Connecticut recently vetoed legislation which would have allowed the state comptroller the authority to prescribe special accounting rules for the state. The governor cited as a reason for her veto that she was concerned that deviating from GAAP that were established by an independent body would jeopardize the financial standing of the state. Financial statements prepared on a basis of accounting that is not generally accepted could result in the downgrading of the state's bond rating which could increase the cost of borrowing.

Sales Tax on Internet Sales

.21 For years, this alert has discussed the ongoing debate about the taxation of Internet sales. As discussed in the 2006 alert, the Internet Tax Nondiscrimination Act (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.

.22 The 110th United States Congress (2007) introduced legislation that would extend the current moratorium for another four years. Senate Bill 1453 would extend the moratorium to November 1, 2011, preserve the grandfather clause in the original legislation that protects state and local taxes imposed on Internet access prior to 1998, and clarify the definition of "Internet access." The bill's authors indicate that the bill is designed to ensure that customers continue to enjoy tax-free access to the Internet, but at the same time protect state and local governments' tax bases from possible erosion when future services, such as cable television, migrates to the Internet. The bill's authors also state that a temporary extension of the moratorium will allow Congress more time to understand the Internet's evolution and what it means for state and local governments.

Other Industry and Environmental Developments

.23 Questions have surfaced over the past few years regarding how to properly affect a government's right to collateral pledged by financial institutions to secure uninsured deposits. The provisions of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) could affect a government's rights to collateral. That is, unless the *financial institution* complies with FIRREA, the deposits may effectively be uncollateralized. Auditors may consider whether appropriate evidence exists to support whether the financial institution has satisfied FIRREA requirements. Courts have ruled that, based on FIRREA, a collateral pledge is not valid against the Federal Deposit Insurance Corporation (FDIC) unless it satisfies these requirements:

- It must be in writing.
- It must be approved by the institution's board of directors or loan committee, and that approval must be reflected in the minutes of the board or committee.
- It must be an official record of the depository institution since it was executed.

.24 In determining whether a collateral pledge is effective, the FDIC also considers whether the depositor has met the conditions of Article 9 of the Uniform Commercial Code (UCC) adopted by that particular state. A necessary component to perfecting a security interest in pledged collateral is to establish *control* over the securities. One way to establish control is by a control agreement. Risk therefore exists that collateral agreements may be ineffective unless FIRREA and UCC Article 9 requirements were met. Deposits covered by ineffective agreements should be disclosed as uncollateralized.

.25 As reported in last year's alert, the retirement of large numbers of baby boomers may undermine entities' internal control. Entities will suffer the loss of experience as workers retire almost en masse. Staff shortages will continue while recruitment efforts are under way. Governments and health care plans that provide prescription drug coverage to their Medicare-eligible retirees may find that the retiree drug subsidy, which may be available under the Medical Modernization Act (MMA), is a potential new source of revenue. As discussed in the "Recent Accounting Pronouncements and Related Guidance" section of this alert, the GASB has addressed the accounting for those revenues in Technical Bulletin 2006-1, *Accounting and Financial Reporting by Employers for Payments from the Federal Government Pursuant to the Retiree Drug Subsidy Provisions of Medicare Part D*.

> **Help Desk—**The U.S. Department of Health and Human Services, Centers for Medicare and Medicaid Services, maintains a Web page at www.cms.hhs.gov/EmplUnionPlanSponsorInfo to provide information to employers about the Medicare prescription drug benefit and retiree drug subsidy.

Legislative and Regulatory Developments

State and Local Government Audits Performed Under *Government Auditing Standards* and OMB Circular A-133

.26 State and local governments may receive federal or state assistance that results in additional audit requirements. For example, they may be required to comply with *Government Auditing Standards*. In addition, auditors may be required to perform a single audit and comply with applicable rules. A *single audit* is an audit of an entity's federal financial assistance, as required by the Single Audit Act Amendments of 1996 and OMB Circular A-133.

.27 When performing audits under *Government Auditing Standards* or single audits, auditors should refer to the guidance in the AICPA Audit Guide Government Auditing Standards *and Circular A-133 Audits* (GAS/A133 guide). This guide is updated each year for conforming changes. The 2007 update to the GAS/A133 guide is expected in winter 2007 (product no. 012747kk). Auditors should also refer to the AICPA Audit Risk Alert Government Auditing Standards *and Circular A-133 Audits—2007* (product no. 022457kk) for further developments.

.28 Also, auditors that perform single audits should be aware of a recently issued federal study on single audit quality, titled *Report on National Single Audit Sampling Project* (the PCIE report), that was issued by the President's Council on Integrity and Efficiency (PCIE) and addressed to the OMB. The report can be found at www.ignet.gov/pande/audit/NatSamProjRptFINAL2.pdf. The results of the study show that improvements are needed in many areas. Auditors should refer to the AICPA Audit Risk Alert Government Auditing Standards *and Circular A-133 Audits—2007* for more details on the study, its results, and a summary of the most common audit deficiencies. Further, this alert also covers other continued problems noted in Yellow Book and single audits found in recent peer reviews and AICPA Professional Ethics Division investigations of CPA firms, many of which relate to the financial statement audits of state and local government audits.

> **Help Desk—**More information about common governmental audit quality deficiencies can be found on the GAQC Web site under the Resources tab at http://gaqc.aicpa.org/Resources/Audits+Performed+Under+Government+Auditing+Standards/ and http://gaqc.aicpa.org/Resources/OMB+Circular+A-133/.

Internal Revenue Service Activities

.29 Internal Revenue Service (IRS) activities may affect the financial statement audits of your 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.

.30 In IRS news release IR-2006-82 and IRS Notice 2006-50, the IRS stated that it would stop collecting the excise tax on long-distance telephone service and provide an opportunity for taxpayers who paid such taxes to request refunds. The IRS has indicated that refund requests from governmental entities should be requested on Form 8849, Claim for Refund of Excise Taxes. Government entities should not use Form 990-T. The IRS instructions for governments completing Form 8849 can be found on the IRS Web site (www.irs.gov/govt/fslg/article/0,,id=168262,00.html). A government may request a refund for federal excise taxes on long-distance service billed after February 28, 2003 and for all federal telephone excise taxes billed after December 31, 2003. There are statutory deadlines for filing for the 2004 calendar year that range from April 30, 2007 to January 31, 2008.

.31 The IRS, along with the Department of Justice and the Securities and Exchange Commission (SEC), continues to be interested in alleged abuses in the tax exempt bond market. In October 2006, an official from the Tax Exempt Bond Division of the IRS Tax Exempt/Government Entities unit warned bond attorneys that enforcement against abusive bond deals would be the Division's top priority in 2007. Specifically, the official cited abusive arbitrage transactions as a focus area and his intent to discipline tax professionals through sanctions contained in IRS Code Section 6700. In addition to the possibility for such abusive bond deals to be declared taxable rather than tax exempt, the additional penalties under IRS Code Section 6700 could result in monetary penalties to the bond lawyer or tax professional. If the abuses are determined to be criminal in nature, the Department of Justice could bring criminal charges against those involved. Auditors should be alert to these investigations and their potential impact on the issuing government's financial statements, and also pay particular attention to the determination of arbitrage liabilities for state and local governments.

.32 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/bonds), and employee retirement plans (www.irs.gov/ep). These pages allow the opportunity to access and subscribe to various newsletters or e-mail alerts, such as *FSLG Newsletter* and *Tax Exempt Bond Community Update*, which will keep you updated about relevant IRS activities. A listing of IRS subscription services is available at www.irs.gov/taxpros/article/0,,id=99120,00.html.

Department of Labor Topics

.33 Department of Labor (DOL) activities might also affect the financial statement audits of your state and local government auditees. Noncompliance with federal wage and hour laws such as the Fair Labor

Standards Act (FLSA) and other employment related requirements could have a direct and material effect on the determination of financial statement amounts. In addition, changes in DOL regulations might result in changes in a government's activities.

> **Help Desk—**Information about the FLSA is on the Internet at www.dol.gov/compliance/laws/comp-flsa.htm.

Securities and Exchange Commission Topics

The SEC and Integrity in the Municipal Market

.34 In July 2007, the chairman of the SEC, Christopher Cox, publicly raised concerns regarding the need for a comprehensive review of the municipal bond disclosure rules. In a speech given in Los Angeles, the chairman discussed establishing a "limited regulatory regime" to improve standards governing the municipal securities market and touched on how such legislation might include requirements for governments issuing municipal securities to provide improved disclosures and to make their offering documents, periodic reports, and other financial information available to investors, taxpayers, and others on a timely basis by tapping the power of the Internet.

.35 Additionally, Chairman Cox noted that the rules put forth by GASB are not requirements; that is, government bodies adopt them voluntarily. He also cited two states—Texas and Connecticut—that have made direct challenges to GASB by passing legislation that allows them to depart from GASB standards. The measures were recently adopted in Texas and vetoed by the governor of Connecticut (see further discussion in "Industry Trends and Conditions"). Chairman Cox described the concept of creating an independent funding mechanism for GASB and establishing SEC oversight of GASB similar to the SEC relationship with FASB. The full text of the speech can be accessed at www.sec.gov/news/speech/2007/spch071807cc.htm. The SEC has since delivered a white paper to Congress that calls for the improvements that Chairman Cox outlined in his speech (see www.sec.gov/news/press/2007/2007-148wp.pdf). A press release on the topic can also be found at www.sec.gov/news/press/2007/2007-148.htm.

Auditor Responsibility for Disclosure in Official Statements

.36 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 SLG guide), 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 634.09, *Letters for Underwriters and Certain Other Requesting Parties* (AICPA, *Professional Standards*, vol. 1), 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.

.37 If the auditor is associated with an official statement, the guidance in AU section 550.04–.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 (AICPA, *Professional Standards*, vol. 1) 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.

.38 In some cases, issuers 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 encourage their governmental auditees to make appropriate disclosures to investors in situations where governmental auditees intend to use the audit opinion or audited financial information without the auditor's consent.

.39 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. Remember that most investors who read official statements are not accountants and may have limited accounting backgrounds. Stale and incomplete accounting information is at the core of many of the cases the SEC has brought against municipal bond 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 Rule 15c2-12 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 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.

Derivatives

.40 The widespread and growing use of complex derivative products, such as interest rate swaps, by municipal issuers raises concerns about the risks to investors, markets, and taxpayers. In March 1994, the SEC issued an interpretive release that continues to provide guidance for applying the antifraud provisions of the federal securities laws to the disclosure obligations of participants in the municipal securities market.

---

[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.

The release noted, among other matters, the SEC's concern about municipal issuers' use of derivative and other complex products and the disclosure issues arising from such activities, and reminded municipal issuers that the antifraud provisions apply to their statements that can be reasonably expected to reach the secondary market for their securities. Consider whether any auditee who is an issuer or other obligated person and uses derivative products should be made aware of this SEC release.

.41 In many instances, auditors play an important role in assisting issuers in meeting their obligations with respect to complex financial products. Although the GASB's project on derivatives, *Accounting and Financial Reporting for Derivatives*, is at the exposure draft stage (see the discussion in "On the Horizon"), auditors may consider educating their auditees regarding the potential ramifications of this project on the auditees' accounting and disclosures. In addition, auditors should consider their auditees' current disclosures regarding derivative activities in their financial statements, management discussion and analysis, and official statements and discuss deficiencies with those auditees. Current guidance on derivative disclosures, pending the outcome of the project, is available in GASB Technical Bulletin 2003-1, *Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets*.

> **Help Desk—**The interpretive release discussed above is Securities Act Release No. 7049, Securities Exchange Act Release No. 33741 (March 9, 1994), 59 FR 12748 (March 17, 1994). Note that the GASB is progressing on a project on the financial reporting of derivatives; "On the Horizon" in this alert discusses that project.

Employee Benefits

.42 The SEC's recent settlement with the city of San Diego has raised concerns about the adequacy of other governments' disclosure practices concerning future pension and retirement health care costs. The SEC sanctioned the city last November, saying it committed fraud when selling bonds to investors in 2002 and 2003 without disclosing the unfunded liability in its pension plan. In auditing pension and other postemployment benefit information in state and local government financial statements prepared in accordance with GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*, and GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, auditors often rely on information provided by plan actuaries. Auditors should keep in mind that audit procedures should include, among other considerations, evaluation of the actuary's qualifications under AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), assessment of management's assumptions, and testing of employee data used in the actuarial calculations, in addition to examining financial statement disclosures.

Recent Auditing and Attestation Pronouncements and Related Guidance

.43 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 *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.

.44 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) • 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.

(continued)

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

.45 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.

.46 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

.47 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.

.48 The auditor should determine the appropriate person(s) within the entity's governance structure with whom to communicate. Examples for state and local governmental entities might include governing boards, city councils, audit committees, mayors, governors, legislators, university/college presidents and chancellors. 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.

.49 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

.50 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 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). 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, 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 auditee 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

.51 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.

> **Help Desk**—The Government Audit Quality Center (GAQC) has provided a public link on its Web site to an archived conference call discussing SAS No. 112 and its impact on practice. Readers can find the link to the call at gaqc.aicpa.org/Resources/Impact+of+SAS+112+on+Governmental+Financial+Audits+Conference+Call.htm.

Discussions With Management and Others

.52 The new requirements of SAS No. 112 may change perceptions regarding the auditor's role in the auditee's internal control. Auditors may have to explain to auditees that the auditor *cannot* be a part of their internal control. Only the auditee—not the auditor—can correct control deficiencies. However, a CPA firm, other than the auditor, who does not provide attest services for the auditee can be part of an auditee's internal control. This may raise new questions regarding the role of outsourcing in achieving management's internal control objectives.

.53 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.

.54 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, detect, and correct material misstatements. As previously stated, the auditor cannot be part of an auditee'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 auditee.

Issues for Audits of Smaller Entities

.55 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.

.56 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 an auditee has ineffective controls over the preparation of its financial statements such that auditee controls are absent or controls are not effective in preventing, 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 auditee's controls, including monitoring ongoing activities, as doing so would impair independence.[3] How an auditor responds to an auditee's internal control weakness, in terms of designing and carrying out auditing procedures, does not affect or mitigate an auditee's internal control weakness. Just as an auditor's response to detection risk is independent of the auditee's control risk, so too is the auditor's response to an auditee's control weakness. Assisting in drafting the financial statements does not change that control weakness.

.57 The new requirements of SAS No. 112 introduce possible opportunities for auditors. Auditors can help auditees evaluate the cost-benefit implications of improving their internal control, including training their personnel to be more knowledgeable. Auditors can also teach auditees 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.

.58 The AICPA has published the AICPA Audit Risk Alert *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.

Audits Performed Under Government Auditing Standards

.59 Since 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* (also referred to as the Yellow Book) reporting is also impacted by the issuance of SAS No. 112. As noted by the Government Accountability Office (GAO) upon issuance of the 2007 revision to the Yellow Book (see further discussion in "Government Auditing Standards Developments" in this alert), 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 Government Audit Quality Center (GAQC) Web site at

[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).

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

.60 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 effect 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).

(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).

Key Provisions of the Risk Assessment Standards

.61 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 auditee'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 auditee 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 *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

.62 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

.63 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.

.64 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 Board's ISA 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 230 (Revised).

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.)

.65 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 following section of this alert, "Practice Alert 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 table "Recent Auditing and Attestation Pronouncements and Related Guidance" which refers to two AICPA Technical Practice Aids (TPA): Technical Questions and Answers (TIS) section 9100.06, "The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" and TIS section 8350.01, "Current Year Audit Documentation Contained in the Permanent File" (AICPA, *Technical Practice Aids*). These practice aids address issues related to audit documentation. This SAS is effective for audits of financial statements for periods ending on or after December 15, 2006.

Practice Alert 07-1, *Dating of the Auditor's Report and Related Practical Guidance*

.66 As discussed previously, one 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 auditee's office to update subsequent event analysis and management's representations may be required as well.

.67 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

.68 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.

Government Auditing Standards Developments

2007 Revisions to *Government Auditing Standards*

.69 In July 2007, the GAO issued the 2007 revision to *Government Auditing Standards (GAO-07-tbd)*. The revisions supersede the 2003 revision, are wide-ranging, and will affect your *Government Auditing Standards* (often referred to as the Yellow Book or GAGAS) 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 July 2007 version 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 printed version of the complete July 2007 revision is available and can be ordered from information provided on GAO's Yellow Book Web page (www.gao.gov/govaud/ybk01.htm). Among the significant revisions are:

- Chapter 1, "Use and Application of GAGAS," major changes:
  - — Reinforce the key role of auditing in government accountability and in achieving improved government operations.
  - — Add terminology defining the degree of responsibility that the professional requirements in *Government Auditing Standards* impose on auditors that is consistent with AU section 120, *Defining Professional Requirements in Statements on Auditing Standards* (AICPA, *Professional Standards*, vol. 1) and similar to the standards of the PCAOB and the International Auditing and Assurance Standards Board (IAASB).
  - — Provide guidance on citing *Government Auditing Standards* in the auditors' report when auditors do not comply with all unconditional or all presumptively mandatory requirements.
  - — Recognize that other sets of professional standards, such as those issued by the PCAOB and the IAASB, the Institute of Internal Auditors, and others, can be used in conjunction with *Government Auditing Standards* and to provide related guidance.
  - — Move guidance on types of governmental audits and attestation engagements (previously in Chapter 2) to this chapter.
- Chapter 2, "Ethical Principles in Government Auditing," is entirely devoted to the discussion of ethical principles auditors and audit organizations need to observe in performing their work. Several of the ethical concepts that are in this chapter were included in Chapter 1 of the 2003 *Government Auditing Standards*, but they were not separately labeled as ethical responsibilities. This chapter discusses the ethical concepts of public interest, professional behavior, integrity, objectivity, and the proper use of government information, resources, and position that auditors use to guide their work. (Chapter 2 of the 2003 *Government Auditing Standards* covered types of governmental audits and attestation engagements; that material has been moved to Chapter 1.)

- Chapter 3, "General Standards," major changes:
  - — Reorganize the discussion on independence and clarify the guidance on nonaudit services to facilitate implementing the standard. (The standards on nonaudit services are clarified but not substantially changed.) Specifically, the discussion of nonaudit services is moved from "personal impairments" to "organizational impairments" and reorganized into three categories of nonaudit services, namely, (1) those that do not impair auditor independence and, therefore, do not require compliance with the supplemental safeguards; (2) those that do not impair auditor independence if the supplemental safeguards are implemented; and (3) those that impair auditor independence. Further, the examples that had previously been interspersed throughout the independence section are consolidated and streamlined. Additional examples were added to each category of nonaudit services.
  - — Include additional guidance in an appendix to address nonaudit services that are frequently conducted by government audit organizations.
  - — Expand the discussion of professional judgment to emphasize its importance and relate it to key steps in performing an audit.
  - — Expand and clarify the discussion of competence and incorporate the revised continuing professional education (CPE) requirements issued by the GAO in April 2005, *Guidance on GAGAS Requirements for Continuing Professional Education* (GAO-05-568G).
  - — The July 2007 revision contains revisions to the quality control and peer review sections of the previous standards. The revisions related to the system of quality control are essentially consistent with the AICPA's quality control standards (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). A new requirement was also added for external audit organizations to make peer review reports publicly available and for internal auditor organizations to provide a copy to those charged with governance.
- Chapter 4, "Field Work Standards for Financial Audits," major changes:
  - — Add guidance on citing GAGAS in the auditor's report when auditors do not comply with GAGAS requirements that are applicable to the engagement performed.
  - — Update the AICPA field work standards cited to reflect recent AICPA changes.
  - — Add a clear and prominent discussion on consideration of fraud and illegal acts, and violations of contract provisions and grant agreements that clarify the existing standard.
  - — Clarify the description of abuse and the existing standard on the auditors' responsibility for abuse in a financial audit that is material, either qualitatively or quantitatively.
  - — Update the audit documentation standard for consistency with AU section 339.
  - — Define internal control deficiencies consistent with AU section 325.
  - — Define those charged with governance consistent with AU section 380.
- Chapter 5, "Reporting Standards for Financial Audits," major changes:
  - — Revise the internal control terminology and definitions used in reporting to be consistent with that of the AICPA and PCAOB. Those revisions replace the terms *reportable conditions* and *material weaknesses* with *significant deficiencies* and *material weaknesses* and revise the definitions for the new terms.
  - — Clarify the reporting requirements for internal control deficiencies, illegal acts, violations of provisions of contracts or grant agreements, and abuse. For example, the revised internal control reporting standards require auditors to (1) report deficiencies in internal control considered to be significant deficiencies, including material weaknesses; and (2) include all material weaknesses and other significant deficiencies in the auditor's *Government Auditing Standards* reporting on internal control.

— Add a discussion on emphasizing significant matters in the auditors' report and provide a listing of matters that the auditor may communicate, including significant concerns, uncertainties, or other unusual events.

— Add a section on reporting on restatements of previously issued financial statements that establish additional requirements for situations in which auditors are aware of known or potential misstatements that might have affected reports on those financial statements.

— Clarify the auditors' responsibilities for reporting views of responsible officials and for issuing and distributing reports.

— Clarify the auditor's responsibility for reporting confidential and sensitive information.

- Chapter 6, "General, Field Work, and Reporting Standards for Attestation Engagements," includes clarification and revision of the description of attestation engagements, conforming changes made to be consistent with changes made elsewhere in the 2007 revision, including definitions of internal control deficiencies, description of abuse, audit documentation, and use of terminology to define professional responsibilities.

- Chapters 7, "Field Work Standards for Performance Audits," and 8, "Reporting Standards for Performance Audits," include significant changes and updates to performance audit requirements within a framework related to significance (materiality), audit risk, and reasonable assurance. If you perform performance audits, you are strongly encouraged to carefully review these chapters.

- The 2007 revision added an appendix to provide supplemental guidance (not additional standards) to assist auditors in applying GAGAS requirements. Guidance includes:

— Examples of deficiencies in internal control, abuse, and indicators of fraud risk.

— Guidance for determining significance of laws, regulations, and provisions of contract and grant agreements in the context of the audit objectives.

— Laws, regulations, and guidelines that require use of GAGAS.

— Examples of nonaudit services provided to governmental entities by auditors or audit organizations.

— Description of types of evidence and evaluation of the appropriateness of the evidence in relation to the audit objectives.

— Performance audit report quality elements.

.70 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 (see "Recent Auditing and Attestation Pronouncements and Related Guidance" in 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.

.71 The GAO has indicated that until the 2007 revisions become effective, auditors should adopt the terminology and definitions contained in AU section 325 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 ASB standards.

.72 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 Web page at www.gao.gov/govaud/ybk01.htm:

- Government Auditing Standards*: Answers to Independence Questions* (GAO-02-870G, July 2002) and
- 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 AU section 325 are available on the GAQC Web site at gaqc.aicpa.org/Resources/Illustrative+Auditors+Reports.

Help Desk—The 2007 revision of *Government Auditing Standards* is available on the Internet 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.

Recent AICPA Independence and Ethics Pronouncements

.73 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

.74 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. 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 No. 27*
GASB Statement No. 49 (November 2006)	*Accounting and Financial Reporting for Pollution Remediation Liabilities*
GASB Statement No. 48 (September 2006)	*Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*
GASB Concepts Statement No. 4 (June 2007)	*Elements of Financial Statements*

.75 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.

GASB Statement No. 51

.76 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.

.77 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.

.78 The guidance specific to intangible assets referred to above 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 above to the development cycle of computer software.

.79 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.

.80 The requirements of this statement are effective for financial statements for periods beginning after June 15, 2009. 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 Statement 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, retroactive reporting is required for intangible assets acquired in fiscal years ending 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 these 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

.81 GASB Statement No. 50, *Pension Disclosures—an amendment of GASB Statements No. 25 and No. 27*, 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 required supplementary information (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 Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and No. 27, *Accounting for Pensions by State and Local Governmental Employers*, to conform with requirements of Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, and 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*.

.82 This statement amends Statement Nos. 25 and 27 to require defined benefit pension plans and sole and agent employers 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.

.83 This statement amends 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.

.84 This statement amends 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 or by contract, or on an actuarially determined basis) or that the cost-sharing plan is financed on a pay-as-you-go basis.

.85 This statement also amends 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 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.

.86 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 Statement Nos. 25 and 27, as amended, with regard to the minimum number of years or actuarial valuations to be included have been met.

GASB Statement No. 49

.87 Issued in November 2006, GASB Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*, is intended to ensure that certain costs and long-term obligations related to pollution clean up not specifically addressed by current governmental accounting standards will be included in financial reports.

.88 Specifically, GASB Statement No. 49 sets forth the key circumstances under which a government would be required to report a liability related to pollution remediation. According to the statement, a government would have to determine whether one or more components of a pollution remediation liability are recognizable if any of the following five obligating events or triggers occurs:

- A government is compelled to take remediation action because pollution creates an imminent endangerment to the public health or welfare or environment, leaving it little or no discretion to avoid remediation action.
- A government is in violation of a pollution prevention-related permit or license.
- The government is named, or evidence indicates it will be named, by a regulator that has identified the government as a responsible party or potentially responsible party for remediation, or as a government responsible for sharing costs.
- A government is named, or evidence indicates that it will be named, in a lawsuit to compel the government to participate in remediation.
- A government commences or legally obligates itself to commence clean up activities or monitoring or operation and maintenance of the remediation effort.

.89 Statement No. 49 indicates that pollution remediation liabilities should be measured at their current value using the expected cash flow technique, which measures the liability as a sum of probability-weighted amounts in a range of possible estimated amounts. Expected recoveries from other responsible parties and from insurers reduce the amount of remediation expense. Statement No. 49 also specifies criteria for capitalization of some pollution remediation outlays.

.90 The requirements of Statement No. 49 are effective for financial statements for periods beginning after December 15, 2007. Governments that have sufficient objective and verifiable information to apply the expected cash flow technique to measurements in prior periods should apply the provisions of the statement retroactively for all such prior periods presented. Governments that do not have that information should apply the provisions of the statement as of the effective date. In that case, pollution remediation liabilities should be measured at the beginning of that period so that beginning net assets can be restated. In the period the statement is first applied, the financial statements should disclose the nature of any restatement and its effect. Also, the reason for not restating prior periods presented should be explained. Early application is encouraged.

GASB Statement No. 48

.91 Issued in September 2006, GASB Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*, provides accounting standards for when certain transactions—such as the sale of delinquent taxes, certain mortgages, student loans, or future revenues such as those arising from tobacco settlement agreements—should be regarded as a sale or a collateralized borrowing. The GASB has observed considerable diversity in practice in the manner that such transactions have been reported. The financial reporting question addressed in Statement No. 48 is whether such transactions should be reported as a sale or collateralized borrowing.

.92 In addition to clarifying guidance on accounting for sales and pledges of receivables and future revenues, Statement No. 48 (1) requires enhanced disclosures pertaining to future revenues that have been pledged or sold; (2) provides guidance on the sales of receivables and future revenues within the same financial reporting entity; and (3) provides guidance on recognizing other assets and liabilities arising from the sale of specific receivables or future revenues.

.93 The requirements of Statement No. 48 are effective for financial statements for periods beginning after December 15, 2006. Early application is encouraged. The statement indicates that in the first period it is applied, changes to comply with the statement, except those that would result from applying the deferral provisions of the statement related to sales of future revenues, should be treated as an adjustment to prior periods, the financial statements presented for periods affected should be restated, and the nature of the restatement and its effect should be disclosed. The deferral requirements may be applied prospectively. If restatement of financial statements for prior periods is not practical, the cumulative effect of applying the statement should be reported as a restatement of beginning net assets or fund balance for the earliest period presented.

GASB Concepts Statement No. 4

.94 GASB Concepts Statement No. 4, *Elements of Financial Statements*, issued in June 2007, establishes definitions for the seven elements of historically based financial statements of state and local governments. Elements are the fundamental components of financial statements. The elements of a statement of financial position are defined as follows:

- *Assets* are resources with present service capacity that the government presently controls.
- *Liabilities* are present obligations to sacrifice resources that the government has little or no discretion to avoid.
- *A deferred outflow of resources* is a consumption of net assets by the government that is applicable to a future reporting period.
- *A deferred inflow of resources* is an acquisition of net assets by the government that is applicable to a future reporting period.
- *Net position* is the residual of all other elements presented in a statement of financial position.

The elements of the resource flows statements are defined as follows:

- *An outflow of resources* is a consumption of net assets by the government that is applicable to the reporting period.
- *An inflow of resources* is an acquisition of net assets by the government that is applicable to the reporting period.

.95 These definitions are primarily based upon the inherent characteristics of each element. Central to most of these definitions is a *resource*, which in the governmental context is an item that can be drawn on to provide services to the citizenry. These definitions apply to an entity that is a governmental unit (that is, a legal entity) and are applicable to any measurement focus under which financial statements may be prepared.

Technical Bulletin 2006-1

.96 In June 2006, the GASB staff issued a technical bulletin (TB), *Accounting and Financial Reporting by Employers and OPEB Plans for Payments from the Federal Government Pursuant to the Retiree Drug Subsidy Provisions of Medicare Part D*. The TB clarifies the proper accounting treatment for retiree drug subsidy (RDS) payments received under the provisions of the MMA (Public Law [P.L.] 108-173, December 8, 2003).

.97 The TB provides that:

- For RDS payments made to defined benefit OPEB plans that are administered as qualifying trusts (or equivalent arrangements), the employers should treat the payments as on-behalf payments for fringe benefits, using the provisions of GASB Statement No. 24, *Accounting and Financial Reporting for Certain Grants and Other Financial Assistance*.
- RDS payments to employers should be treated as voluntary nonexchange transactions in accordance with the provisions of GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*.
- For RDS payments to multiple-employer plans that are not administered as qualifying trusts (or equivalent arrangements), the employers in such plans should treat their payments as voluntary nonexchange transactions.
- Measurements in accordance with GASB Statement Nos. 43 and 45 should be made without reduction for RDS payments.

.98 The requirements of the TB generally were effective when it was issued. The portions of the TB guidance pertaining to measurement, recognition, or required supplementary information requirements of GASB Statement Nos. 43 and 45 should be applied simultaneously with the implementation of those statements.

User and Implementation Guides

Comprehensive Implementation Guide

.99 In October 2006, GASB published the 2006–2007 edition of 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 stand-alone guides have been published. The 2006–2007 edition includes for the first time the freestanding Implementation Guide to Statement 44 on the Statistical Section and the Implementation Guide to Statements 43 and 45 on OPEB.

.100 This year, the *Comprehensive Implementation Guide* has been reorganized to better accommodate the addition of new questions and employs a new numbering system designed to make it easier to follow changes from year to year. The 2006–2007 guide provides the answers to new questions about OPEB and a variety of other topics, including:

- Compensated absences
- The modified approach for reporting infrastructure assets
- Asset impairment
- Reporting net assets
- Termination benefits

.101 In addition, the guide revises existing questions and deletes obsolete questions (for example, transition guidance for standards that are now effective). It also features a new chapter that brings together questions on pronouncements not covered in other chapters and that are devoted to a particular pronouncement or subject.

> **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.

GASB User Guide

.102 In July 2005, the GASB staff published *Government Service Efforts and Accomplishments Performance Reports: A Guide to Understanding* as a part of its continuing research project on (SEA) service efforts and accomplishments reporting. The guide is intended to assist citizens and others in using SEA performance reports issued by state and local governments. In April 2007, the GASB added an SEA reporting project to its current technical agenda. Certain constituent groups have questioned whether a project dealing with the reporting of service performance is not within the scope of the GASB mission or jurisdictional authority. However, in November 2006, the Financial Accounting Foundation reaffirmed that the GASB does in fact have such jurisdictional authority.

> **Help Desk—**The GASB staff user guide is on the Internet at www.seagov.org/sea_gasb_project/sea_guide.pdf.

Other Recent GASB Statements With Current Effective Dates

.103 The following table illustrates the implementation dates of previously issued standards which may become effective in current fiscal periods as a result of phased effective dates.

GASB Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*	Effective in phases: Phase 1—periods beginning after December 15, 2005 Phase 2—periods beginning after December 15, 2006 Phase 3—periods beginning after December 15, 2007
GASB Statement No. 45, *Accounting and Reporting by Employers for Postemployment Benefits Other Than Pensions*	Effective in phases: Phase 1—periods beginning after December 15, 2006 Phase 2—periods beginning after December 15, 2007 Phase 3—periods beginning after December 15, 2008
GASB Statement No. 47, *Accounting for Termination Benefits*	Effective for financial statements for periods beginning after June 15, 2005. However, for termination benefits that affect defined benefit postemployment benefits other than pensions, governments should implement GASB Statement No. 47 simultaneously with GASB Statement No. 45.

On the Horizon

.104 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 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 GAAP or GAAS.

.105 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/
Governmental Accounting Standards Board (GASB)	www.gasb.org
Government Accountability Office (GAO)	www.gao.gov
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

.106 The ASB has formed a Clarity Task Force to address concerns over the clarity, length, and complexity of the ASB's standards. In March 2007, the ASB approved for exposure a discussion paper titled *Improving the Clarity of ASB Standards*. This discussion paper sought 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.

.107 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

.108 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 SSAE Regarding Reporting on an Entity's Internal Control Over Financial Reporting

.109 In January 2006, the ASB issued a revised exposure draft of a proposed Statement on Standards for Attetstation 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 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's Web site at www.aicpa.org.

Accounting Pipeline

.110 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

.111 The GASB has two exposure drafts of statements that it plans to finalize in 2007 and 2008.

.112 The exposure draft, *Land and Other Real Estate Held as Investments by Endowments*, issued in March 2007, proposes to report investments in land and other real estate held by permanent and term endowments, including permanent funds, at fair value rather than historical cost.

.113 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 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 requirements of this proposed statement would be effective for financial statements for periods beginning after June 15, 2009. Earlier application would be encouraged.

Upcoming GASB Due Process Documents

.114 Projects for which the GASB expects to release documents relating to proposed accounting and financial reporting standards in the remainder of 2007 and 2008 include (1) fund balance reporting and definition of governmental fund types (a related Invitation to Comment was released in October 2006), (2) intergovernmental financial dependency risk, and (3) service efforts and accomplishments reporting.

> **Help Desk—**To track the progress of the GASB's projects, go to the GASB Web site at www.gasb.org. The 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.

Resource Central

.115 The following are various resources that practitioners may find useful with respect to state and local governments.

Publications

.116 Practitioners may find the following publications useful with respect to state and local governments:

- Audit and Accounting Guide *State and Local Governments* (2007) (product no. 012667kk)
- 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 *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)
- Audit Risk Alert Government Auditing Standards *and Circular A-133 Audits—2007* (product no. 022457kk)
- Audit Risk Alert *Health Care Industry Developments—2007* (product no. 022347kk)
- 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 *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*—2007 Edition (product no. 009037kk)
- *Independence Compliance: Checklists and Tools for Complying with AICPA and GAO Independence Requirements* (product no. 006627kk)
- *Audit and Accounting Manual* (2007) (product no. 005137kk)

AICPA reSOURCE: Accounting and Auditing Literature

.117 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

.118 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:

- *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*

Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.119 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 related to state and local governments 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*

To register or learn more, visit www.cpa2biz.com.

Webcasts

.120 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

.121 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

.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 (888) 777-7077.

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 Conferences

.125 The AICPA sponsors three annual Governmental Accounting and Auditing Conferences in the late summer and fall.

.126 *Governmental Accounting and Auditing Update Conference (GAAC) EAST* is held in late summer in Washington, DC, and its counterpart *Governmental Accounting and Auditing Update Conference (GAAC) WEST* takes place in Tempe, Arizona 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 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.

.127 *AICPA National Governmental and Not-for-Profit Training* is held in Lake Buena Vista, Florida. 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 impacting the not-for-profit sector and more.

.128 For further information about the conferences, call (888) 777-7077 or visit www.cpa2biz.com.

AICPA Governmental Audit Quality Center

.129 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.

.130 The GAQC has been in existence since September 2004. Since its launch, Center membership has grown to over 800 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 (http://harvester.census.gov/sac/) for the year 2004 (the latest year with complete submission data).

.131 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:

- 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 section "Legislative and Regulatory Developments"), 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

.132 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 Governmental Accounting Standards Board, regulators such as the Government Accountability Office and the U.S. Office of Management and Budget, 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.

Industry Web Sites

.133 The Internet covers a vast amount of information that may be valuable to auditors of state and local governments, including current industry trends and developments. Some of the more relevant sites for state and local governments and their auditors are shown in the appendix of this alert. The governmental audit practices of some of the larger CPA firms may also contain specific auditing and accounting information that is helpful to auditors.

* * * *

.134 This Audit Risk Alert replaces *State and Local Governmental Developments—2006*.

.135 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

.136

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

Web Site Name	*Content*	*Web Site*
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 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

Acknowledgments

The AICPA staff wishes to thank Gayle L. Cagianut, CPA, Jeffrey L. Ducker, CPA, Candido Fernandez, CPA, Mitchell Frumkin, RS, PE, Monte Kane, CPA, Douglas M. Kleine, CAE, Annette Murray, CPA, Gary A. Porter, CPA, Gary Rosen, CPA, and Clifford J. Treese, CPCU, CIRMS, for their assistance and contributions to this Audit Risk Alert.

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.

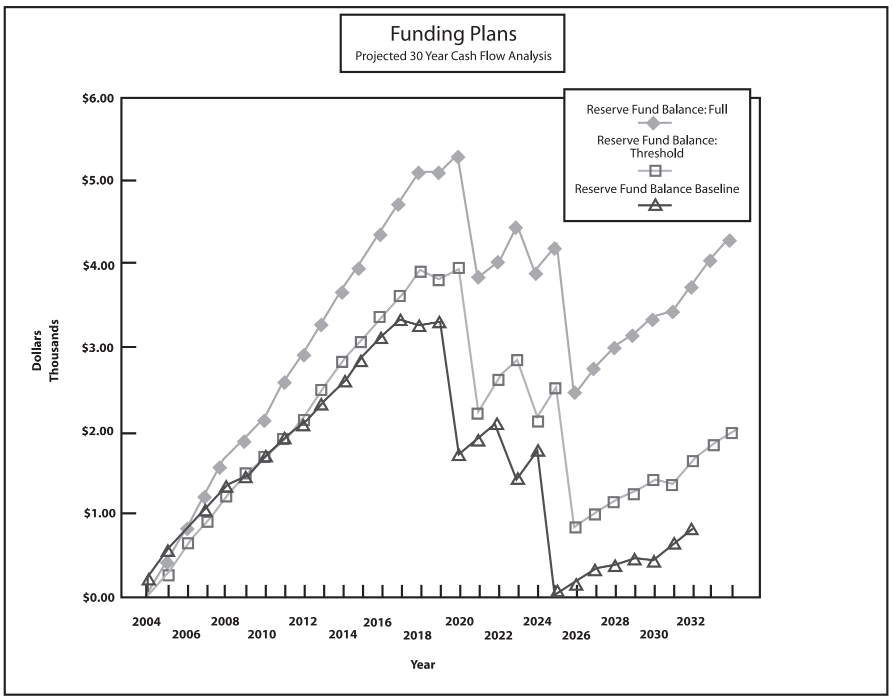
- *Statutory funding.* Although not discussed in detail, in some states governmental regulations exist which require certain levels of reserves to be accumulated. The original governing documents should comply with these regulations.

.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.

---

[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, *Compilation 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/

[*The next page is 8247*.]

AAM Section 8090

Construction Contractors Industry Developments—2006/07

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

NOTICE TO READERS

CONSTRUCTION CONTRACTORS INDUSTRY DEVELOPMENTS—2006/07

This Audit Risk Alert is intended to provide auditors of construction contractors with an overview of recent economic, industry, technical, and professional developments that may affect the audits 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 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. This publication was reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA, and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Written by J. Russell Madray, CPA

Edited by Christopher Cole, CPA
Technical Manager
Accounting and Auditing Publications

How This Alert Can Help You

.01 This Audit Risk Alert helps you plan and perform your construction industry audits. The knowledge delivered by this Alert assists you in achieving a more robust understanding of the business and economic environment in which your clients operate. This Alert is an important tool in helping you identify the significant risks that may result in the material misstatement of your client's financial statements. Moreover, this Alert delivers information about emerging practice issues and current accounting, auditing, and regulatory developments.

.02 This Alert describes trends and issues facing most contractors in many of the construction markets in the country. National trends and industry-wide benchmarks can help you understand financial statement relationships and how they may affect your client. However, broad national trends have their limitations. Keep in mind that your client will be affected much more by local economic, political, and industry conditions that exist in the specific markets your client serves.

.03 This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2006/07* (product no. 022337kk).

.04 ***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, SAS No. 54 is referred to as AU section 317 of the AICPA *Professional Standards*.

Industry and Economic Developments

.05 Read the AICPA general *Audit Risk Alert—2006/07* for an overview of the current U.S. and global economic environment.

General Industry Trends and Conditions

.06 After a string of years of solid construction growth, analysts are predicting no slowdown, and in many cases, even more growth in commercial construction jobs. Analysts agree that single-family residential construction will soften in the remainder of 2006 and into 2007, but they believe commercial construction will pick up the pace, replacing residential work with commercial work. The 2006 U.S. construction market amounts to $1.2 trillion, of which single- and multi-family residential construction accounts for just over $642 billion. Most construction economists believe that as residential construction tails off, commercial projects will pick up the slack, resulting in a 5 percent increase in total put-in-place construction in the U.S. in 2007. Forecasters at FMI, a consultant group to commercial contractors and the construction industry, predict growth in nonresidential construction of 8 percent in 2006 and 9 percent in 2007. Ed Sullivan, chief economist at the Portland Cement Association, sees an even brighter picture for nonresidential construction in 2007. He predicts a growth rate of 8.5 percent, up from 6.4 percent in 2006 and only 1.5 percent in 2005. According to Sullivan, the nonresidential market turned in 2005 after five years of decline. But despite the large percentage gains for 2006, most markets could still be considered weak from a historical perspective, he says.

.07 While the economy is chugging along, inflationary pressures have market watchers at the Federal Reserve Board concerned. According to Ken Simonson, economist at the Associated General Contractors, the inflation level in the general economy is 3 to 4 percent, but building materials costs have increased nearly 8 percent and transportation costs have gone up 16 percent. This is spurring the Federal Reserve to increase prime interest rates, and the general consensus is that the economy may see the prime lending rate touch 6 percent in 2007. This will further dampen residential work, but commercial work will continue, barring any unforeseen event, economists predict.

.08 Most economists believe inflationary fears will ease and business growth will slow enough by the second half of 2007 that the Federal Reserve will ease up on interest rates. This should keep the fire cooking under the economy without it boiling over to feed inflation into 2008.

Construction Put in Place

.09 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* (value-in-place) is a measure of the value of construction installed or erected at the site during a given period. For an individual project, this includes:

- New buildings and structures.
- Additions, alterations, major replacements, and so on, to existing buildings and structures.
- Installed mechanical and electrical equipment.
- Installed industrial equipment, such as boilers and blast furnaces.
- Site preparation and outside construction, such as streets, sidewalks, parking lots, utility connections, and so on.
- Cost of labor and materials (including owner-supplied).

- Cost of construction equipment rental.
- Profit and overhead costs.
- Cost of architectural and engineering (A&E) work.
- Any miscellaneous costs of the project that are on the owner's books.

.10 The total value-in-place for a given period is the sum of the value of work done on all projects under way 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.

.11 Exhibit 1, "New Construction Put in Place," presents details of construction put in place for various market segments. (Note that the amounts are in billions of dollars and represent seasonally adjusted annual rates.) To add some perspective, in January 1992, at the start of the current construction boom, the total new construction put in place was $452 billion, as compared with the estimated 2006 amount of $1,200 billion—a gain of more than 165 percent during the period.

Exhibit 1

New Construction Put in Place

(Billions of Dollars—Seasonally Adjusted Annual Rate, in Current Dollars)

	July 2005	*July 2006*
Private construction	856.1	930.9
Public construction	243.2	269.1
Total construction	**1,099.3**	**1,200.0**
Residential building	615.8	627.4
Nonresidential building		
Office	33.9	45.1
Power	24.8	34.7
Commercial	65.4	77.2
Lodging	11.7	21.0
Other nonresidential	104.5	125.5
Total nonresidential	240.3	303.5
Total private construction	856.1	930.9
Highways and streets	63.9	76.6
Infrastructure	35.1	36.9
Educational	63.7	69.9
Other public buildings	23.8	24.6
Other public construction	56.7	61.1
Total public construction	243.2	269.1

.12 The U.S. Census Bureau of the Department of Commerce announced that construction spending during July 2006 was estimated at a seasonally adjusted annual rate of $1,200.0 billion, 1.2 percent below the revised June 2006 estimate of $1,214.2 billion. The July 2006 figure is 5.1 percent above the July 2005 estimate of $1,141.2 billion. During the first seven months of 2006, construction spending amounted to $680.4 billion, 8.0 percent above the $630.2 billion for the same period in 2005.

.13 Spending on private construction was at a seasonally adjusted annual rate of $930.9 billion, 1.3 percent below the revised June estimate of $943.2 billion. Residential construction was at a seasonally adjusted annual rate of $627.4 billion in July, 2.0 percent below the revised June estimate of $640.5 billion. Nonresidential construction was at a seasonally adjusted annual rate of $303.5 billion in July, 0.3 percent above the revised June estimate of $302.7 billion.

.14 In July, the estimated seasonally adjusted annual rate of public construction spending was $269.1 billion, 0.7 percent below the revised June estimate of $271.1 billion. Educational construction was at a seasonally adjusted annual rate of $69.9 billion, 1.0 percent above the revised June estimate of $69.2 billion. Highway construction was at a seasonally adjusted annual rate of $76.6 billion, 0.6 percent below the revised June estimate of $77.0 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

.15 The residential building segment of the construction industry includes new single- and multi-family housing as well as residential repairs and improvements. Conditions with the most impact on the demand for residential construction include the following:

- *Housing affordability.* Housing affordability is the extent to which potential buyers have the means to purchase a home. Affordability can be measured in several ways by considering average home prices and income levels. For example, some analysts create an "affordability index" by comparing median home prices to household income levels. As income levels get closer to housing prices, the average home becomes affordable to more local residents.
- *Interest rates.* Most homes are financed, 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 have to be in effect for several quarters to reverse home-buying trends.
- *Land availability/pricing.* As one of the major costs of residential building, land availability and pricing have a major impact on the affordability of housing. With land suitable for residential building becoming scarce in certain parts of the country, housing prices will be affected.
- *Demographics.* Shifts in demographics can have a significant impact on housing demand. For example, the aging of the U.S. population has increased demand for low-maintenance and multifamily housing. A large number of baby boomers are now entering their peak earning years, which is expected to affect the affordability and demand for single-family homes.
- *Market velocity.* According to industry sources, more than half of all home improvements occur within 18 months after a new owner moves in, or within 12 months before the home is sold. Thus, during times when new and used home markets are active, residential remodeling and improvement activity also increases.

.16 The consensus forecast for 2007 U.S. housing starts is 1.775 million units, down from an estimated 1.902 million units this year. This forecast matches the current activity level, which was 1.795 million units in July 2006. If this forecast is accurate, the damage by "leaking bubbles" to construction volume is now almost entirely in the past, although the damage to home prices will not be over for another year. For 2008, most forecasters expect starts to decline a further 30,000 to 70,000 units but this is the consequence of weaker economic growth and not any developments specific to the housing market.

.17 The Reed Construction Data 2007 housing outlook has been lowered from nearly 1.9 million units earlier this year, because of a weaker-than-expected economic environment. Energy and other commodity inflation continued well into the summer, sapping both consumer buying power and the confidence to spend. According to economists, the impact of bad news on consumer spending is geometric, not linear. Consumers ignore the first reports of bad news because rising commodity prices are often random and quickly reversed. With the next wave of news that commodity prices are still rising, consumers are forced to partially adjust spending to accommodate the higher prices, whether or not they believe that the price spike will be reversed. With the third wave of news that commodity prices are still rising, more accommodation is needed to balance household budgets. Many consumers begin to believe that the world has changed and that there will be no price reversal soon. As a result, their spending cuts are now larger than the recent price rises require, in order to restore used-up savings and set aside money to cover future price increases.

.18 The shrinking of the housing market from 2.1 to 1.8 million units is due primarily to cuts at the top and bottom of the market, rather than across the board. At the top, speculative investment buying has been reduced sharply because prospects for quick capital gains have disappeared. The futures market for the housing price index expected home prices to stop rising this past summer and then fall 3 percent to 4 percent by next summer. Longer term investors are also leaving the housing market. Investor carrying costs are higher with higher mortgage and vacancy rates. Currently, there is little prospect of widespread double-digit home price appreciation for perhaps four to five years, according to industry analysts.

.19 At the bottom of the market, prospective entry-level buyers are being increasingly priced out of the market by higher mortgage rates, fewer subsidized mortgage rates, and tighter credit approval standards. At the same time, homebuilders who specialize in entry-level homes are now competing with a rising number of homes they built in 2004 and 2005 that are coming back on the market. Variable interest rate mortgages have adjusted higher, meaning buyers who were only marginally qualified financially to buy a new home have found themselves unable to afford the monthly payments. Now they are putting their newer homes up for sale.

.20 These developments at the bottom of the market were expected. However, the unexpected changes in the inflation environment have severely worsened buying conditions in this segment of the housing market. This situation is a repeat of what happened in the early 1980s. High inflation in a growing economy impacts the low end of the income distribution curve much more heavily than the high end because low income households are less able to cushion against the impact of higher prices by drawing on savings or easily available credit. Wage gains lag inflation, so their household financial situation progressively worsens.

.21 As of mid-2006, one of the keys to increased construction activity for 2006 and 2007 was rebuilding after Hurricane Katrina. However, the rebuilding in the affected areas has gone much more slowly than anticipated, as can be documented with residential construction trends. Almost 136,000 homes were lost in the Katrina-affected areas of Louisiana, according to Red Cross estimates. In 2004, there were almost 5,800 new housing permits in these areas. In the first nine months after the hurricane, there were fewer than 2,500 new housing permits in these areas, so construction levels were not even back to pre-Katrina levels, much less at levels that serve to replace any homes lost.

.22 The situation is not much better in Mississippi. Over 64,000 homes were lost in this state to Katrina, and there were over 3,600 new homes permitted in 2004 in the area eventually affected by Hurricane Katrina. In the first nine months after Katrina, fewer than 3,000 new homes were permitted in these areas, so residential construction in these areas was barely back to its pre-Katrina pace, with almost nothing added to compensate for lost units.

.23 Inflation is the key variable in the housing outlook—not because it will change mortgage rates but because it will change confidence. In the absence of hurricanes or new political disputes that threaten oil supplies, Reed Construction Data believes that inflation is ebbing. However, too much damage to confidence may already have been done to see housing starts rise over 1.8 million units in 2007.

Nonresidential Building

.24 Despite several concerns with the fundamentals of the nonresidential construction market—including rising short-term interest rates, ongoing inflation in key construction materials prices, and recent concerns over the economic outlook—the American Institute of Architects Consensus Construction Forecast Panel (AIA Panel) is expecting solid levels of activity through the remainder of 2006 and through 2007. After adjusting for inflation, the AIA panel is anticipating a 6.3 percent increase in nonresidential activity in 2006, and an additional 6.2 percent in 2007 with growth evenly balanced between the commercial/industrial and institutional sectors. If achieved, this would be the best two-year period for nonresidential construction activity since this market grew by about 30 percent in 1997 to 1998.

.25 The optimism of the AIA Panel comes despite recent evidence of softening in the broader economy. The Federal Reserve Board has raised short-term interest rates by 4 percentage points since 2004, which has cooled off the stock market and other interest-sensitive sectors of the economy, such as housing and auto sales. Overall inflation in consumer and producer prices has begun to increase while it continues for several key building commodities.

Office Market

.26 Office construction—almost 11 percent of total nonresidential activity—has benefited from falling office vacancy rates nationally. Vacancy rates peaked nationally in early 2004 at almost 15 percent in downtown locations, and about 18 percent in suburban locations. The most recent readings from CB Richard Ellis show rates declining to 13.6 percent overall—12.3 percent downtown and 14.3 percent in the suburbs. Metro areas with the lowest office vacancy rates (Orange County, California; New York City; Palm Beach, Florida; Honolulu; and Fort Lauderdale) are heavily concentrated in coastal areas, whereas areas with the highest vacancy rates (Detroit; Dallas-Fort Worth; Columbus, Ohio; Louisville; and Cleveland) are heavily concentrated in the interior regions, particularly the industrial Midwest.

Retail and Other Commercial Markets

.27 Retail construction, the largest commercial sector, accounting for over 20 percent of all nonresidential construction, has seen steady growth in recent years. With the unemployment rate falling and disposable personal income rising, the AIA panel is projecting an almost 4 percent increase in retail construction in 2006, and over 4 percent in 2007.

Hospitality Market

.28 Hotel construction, at just over 3 percent of total nonresidential activity, has seen a dramatic improvement in construction levels in recent years. The AIA panel is projecting an increase of almost 11 percent in 2006, followed by another 6.5 percent in 2007.

Institutional Market

.29 Education construction is the largest institutional construction category, accounting for about 16.5 percent of total nonresidential building activity. Strong growth in enrollments, particularly at the high school and college levels, has pushed up construction levels. The AIA panel is projecting a 4.4 percent increase in educational construction levels in 2006, and an additional 7.4 percent in 2007.

.30 Healthcare construction, the other major institutional sector, accounts for over 7 percent of nonresidential construction activity. The aging of the population coupled with a modernization of existing healthcare facilities—often spurred by industry consolidation—has produced strong numbers in recent years in this sector. The AIA panel is projecting a 6.3 percent increase in 2006 in the construction of healthcare facilities followed by an additional 5.0 percent in 2007.

.31 The overall nonresidential construction sector is seeing the healthiest business conditions this decade. The AIA's Architectural Billings Index indicates somewhat slower growth in design activity in recent months, which will translate into a slower pace of growth in nonresidential construction activity as we get into 2007. However, given that the broader economy continues to expand and given the current strong levels of construction activity in the planning and design stages, most analysts expect healthy levels of nonresidential construction activity to continue at least through 2007.

> **Help Desk—**The demand for construction can vary significantly among different geographic regions. One of the most comprehensive analyses of commercial real estate demands and construction activity is published by the Society of Industrial and Office Realtors (SIOR). Annually, SIOR publishes *Comparative Statistics of Industrial and Office Real Estate Markets*, which provides detailed real estate and construction statistics on all the country's larger cities. You can purchase and download this publication directly from the publications section of the SIOR Web site at www.sior.com.

Public Construction

.32 Public construction spending rises rapidly when state and local governments have generous financial reserves and they are meeting or beating their revenue targets. There is a strong correlation between public construction spending and state budget reserves two years earlier.

.33 State budgets underestimated receipts for income and sales taxes by 4.2 percent in the last fiscal year. This conservative budgeting boosted reserves to 6.9 percent of annual spending as of June 30, 2005, the end of the fiscal years for all but four states. This assures above-average spending growth well into 2007. That strength is expected to extend into 2008 because state income and sales tax receipts in the first quarter of the 2006 fiscal year (July to September 2005) were up 9.2 percent from a year earlier. The gain was 9.5 percent excluding tax cuts. This is far above the aggregate 3.3 percent sales and income tax receipts gain that states have budgeted for fiscal year 2006.

.34 State budgets expect a 4 percent rise in sales tax receipts during the 12 months ending on June 30th, 2006. Receipts were 7.5 percent above the previous year in the first three months. Similarly, personal income tax receipts were up 9.2 percent compared to the budgeted 2.8 percent and corporate income tax receipts were running at a 25.9 percent annual rate of increase instead of the expected 2.0 percent. State budget reserves at the end of the current fiscal year are likely to be 7 percent to 8 percent of annual spending.

.35 State budget reserves vary considerably from no reserves at all in Michigan, Wisconsin, and Arkansas to 75 percent in Alaska. According to the National Association of State Budget Officers, the following states have more than double the national average of budget reserves.

State	*Reserves as a percent of spending*
Alaska	75.0 percent
Delaware	30.1 percent
Georgia	23.7 percent
Montana	21.7 percent
Nebraska	21.3 percent
North Dakota	18.7 percent
Texas	15.8 percent
Florida	15.7 percent
Massachusetts	15.5 percent

.36 The budget balances of the following states are less than half of the national average, according to the National Association of State Budget Officers.

State	*Reserves as a percent of spending*
New Jersey	3.4 percent
Pennsylvania	3.0 percent
Maine	2.9 percent
Ohio	2.9 percent
Mississippi	2.9 percent
Colorado	2.4 percent
Wisconsin	0.1 percent
Michigan	0.0 percent
Arkansas	0.0 percent

Surety Industry Trends

.37 The surety industry is critical to the well-being of the construction industry. Nearly half of all work performed by contractors is bonded, so any change in the surety market will have a significant effect on the construction industry.

.38 Surety bonding is a rigorous process in which surety companies prequalify contractors and then guarantee that the contractors will complete their projects and pay first-tier subcontractors, laborers, and materials suppliers (those hired directly by the general contractors). Construction projects can involve three types of surety bonds:

- *Bid bonds* provide financial assurance that the bid has been submitted in good faith and that the contractor intends to enter into the contract at the bid price.
- *Performance bonds* protect the owner from financial loss should the contractor fail to perform the contract in accordance with its terms and conditions.
- *Payment bonds* guarantee that the contractor will pay subcontractors, laborers, and suppliers associated with the project. (Government property is not subject to mechanic's liens, meaning that laborers, suppliers, and subcontractors would be without redress if the contractor defaulted and there were no payment bonds.)

.39 Section 270 of the Miller Act, enacted in 1935, governs performance and payment bonds on federal construction projects.

.40 Additionally, each of the 50 states, the District of Columbia, Puerto Rico, and almost all local jurisdictions have enacted legislation requiring surety bonds on public works projects. Generally referred to as "Little Miller Acts," these laws often set minimum thresholds for which state agencies and local governments may require surety bonds. Sometimes no threshold is set and the local entities themselves determine what minimum project value necessitates surety bonding.

.41 While surety credit is similar to obtaining bank credit, it still is a form of insurance. Surety bonds and insurance both are risk transfer mechanisms that are regulated by state insurance commissioners, and both provide protection against financial loss.

.42 Unlike other lines of insurance, however, surety actually is a form of credit. Whereas bankers either lend money or extend a line of credit, a surety grants a "pledge guarantee." The surety does not lend the contractor money but instead allows the surety's financial resources to be used to back the commitment of the contractor; if the contractor defaults the surety pays for completion of the contractor's work.

.43 The basic function of surety is prequalification. That process involves a surety underwriter taking an in-depth look at the contractor's entire business operation and thoroughly analyzing the contractor's financial strength and capacity to perform before credit is extended. The underwriter will concentrate on the three "C's"—character, capacity, capital—when making bond credit decisions.

.44 To issue a surety bond, the surety must be confident that the contractor has good character, experience matching the requirements of its contracts, financial strength, an excellent credit history, an established banking relationship and line of credit, and ownership of (or the ability to obtain) the equipment to carry out the contract.

.45 Although there have been a number of high-profile mergers in the surety market, there have been instances of surety company failures. In most cases, capacity remains sufficient to support the nation's construction needs. However, contractors in different market sizes may see changes in the near future and those contractors considered "marginal" may be dropped by their surety.

- Capacity for small and emerging contractors remains available, although they will be subject to the same underwriting standards as their larger peers. Small and start-up contractors who have difficulty meeting today's underwriting standards may opt to explore the U.S. Small Business Administration's (SBA's) Surety Bond Guarantee Program. The SBA has proposed changes in the program in an effort to renew interest by sureties and to encourage sureties to extend credit to companies that have no surety bond history. The proposed improvements include allowing sureties to charge prevailing rates under state law, a reduction in the frequency of required audits of participating surety companies, and increased loss coverage guarantees on bonds for companies owned by veterans.
- The mid-market contractor is least likely to be affected by capacity issues. This segment is the primary target of the industry, and qualified contractors will continue to receive strong support. However, in some cases, contractors are being required to provide audited financial statements instead of reviewed financial statements, and some sureties are requiring quarterly reporting. The same back-to-basics underwriting standards apply: quality financials, capital retention, and personal and corporate indemnity are all required.
- Contractors in the $250 million-and-over market may need to address changes in the industry. Surety companies are less likely to assume the risks of massive, multiyear projects on their own. Co-sureties, segmented bonding, and joint ventures may be more common, due to the fact that approximately 80 percent of the reinsurers from the 1990s are gone because of the massive surety losses incurred in the past few years. The tightened reinsurance market is a factor in the need for more creative surety solutions on mega-projects.

.46 There are also alternatives to surety, generally referred to as alternate products. These insurance products were originally designed to protect a general contractor from subcontractor default. Unlike a surety bond, an alternate product has a deductible and guarantees payment in the event of default, but not performance. Although this is a relatively new concept, some think it may be a way to circumvent some of the limitations of the surety industry.

.47 In some parts of the country sureties are requiring clients to upgrade from reviews to audits. Other sureties are willing to accept reviewed financial statements when accompanied by a review of the client's internal controls. In some cases, sureties are also requiring quarterly financial statements, in addition to year-end statements. In addition, some smaller contractors are being required to strengthen their financial position with personal guarantees and additional indemnity.

.48 Contractors can expect sureties to look at their work programs more closely, which can lead to changes in the amount of capacity sureties are willing to offer. Although many surety companies have the capacity to support an increased work program, they may not have the same appetite for risk they had in the past. Nevertheless, a contractor with a solid reputation and sound financials should have no problem obtaining the surety credit it needs. Overall, the surety industry is attempting to return to a healthy state and will continue to respond to the challenges in the construction industry.

.49 At this critical juncture in the surety industry's life cycle, the following steps may be helpful to ensure that your client's surety relationship remains free from any dramatic exposure to the surety industry's changes. Your client may need to:

- Meet regularly with its surety underwriters and bond agents and foster a partnering relationship.
- Know its surety—its results, reinsurance, capacity limitations, credit, and AM Best (a worldwide insurance rating and information agency) ratings.
- Plan for more lead time for larger or unique projects and major decisions.
- Provide high-quality and timely financial information.
- Understand the working capital and equity requirements for the bonding program.
- Understand the adjustments that the surety makes to the financial statements to arrive at bonding capacity. You should be aware that this can be one of the biggest pressures on a contractor and recognize the associated audit risk.
- Involve its surety in major financial decisions.
- Understand the working capital and equity requirements for its bonding program (single and aggregate limit).
- Use a CPA and an attorney who specialize in construction contractors and relationships with sureties.
- Use a professional surety broker who specializes in surety, and have a "backup" surety available in case the current surety is unable to provide proper coverage.

.50 The Surety & Fidelity Association of America (SFAA) provides information about the Surety Bond Authenticity Program. This process allows interested parties to verify a contractor's bond coverage directly with the insurance provider and might be a useful audit tool. Instructions can be obtained at the SFAA Web site link www.surety.org.

Construction Cost Trends

.51 Contractors should get used to higher prices for building materials. Experts across the country see strong world demand and increased shipping costs affecting supply and boosting costs for most building supplies. The rate of increase for building material costs is generally leveling off. Some experts see this as a new plateau, but don't see the costs coming down.

.52 Cement availability continues to be an issue in many parts of the country and will be a concern in 2007, according to Portland Cement Association chief economist Ed Sullivan. Cement consumption will grow in excess of 3 percent of the record consumption in 2005. Tight market conditions will reappear in 2007 as plants are operating at high rates, inventories are lean, and our dependence on imports increases, according to Sullivan.

.53 Lumber is one building supply that has tempered its price increases. Prices have opened up some as a tariff on Canadian lumber was reduced, which has increased supply. Lumber prices have gone down in the near term and should remain stable through 2007.

.54 Associated General Contractors economist, Ken Simonson, reports double-digit price increases in several building supplies. According to Simonson, contractors and building owners should get used to it because it may level off but won't drop to past levels. The average Producer Price Index (PPI) for construction materials jumped 7.8 percent from June 2005 to June 2006. Material costs reached as high as 16 percent for highway construction. There have also been increases as high as 87 percent for copper and brass mill shapes, 48 percent for asphalt, 40 percent for diesel fuel, 26 percent on gypsum products, 18 percent for plastic construction products and 15 percent for cement. Simonson expects a few of these increases to level off as the housing market cools, but most are tied to strong U.S. and world demand for materials and freight transportation.

.55 All sectors of the construction industry are concerned about finding qualified labor as the market improves in 2007. The present workforce is getting older and replacement workers aren't coming up through the ranks in great enough numbers to meet coming demand.

.56 Unemployment remains low, worker availability is low, and labor rates are increasing. Some believe that as residential housing slows, it will free up more workers for nonresidential and commercial work, but not all skills and trades are transferable. That's why analysts believe the unemployment rate will rise to 4.9 percent in 2007.

.57 The U.S. Department of Labor Bureau of Labor Statistics reports job opportunities in the construction field will remain strong for experienced workers. As demand increases and the labor supply stays the same, wage rates will increase, especially for more experienced workers who already are paid higher than average wages. Plumbers and electricians are two groups most affected by this trend, according to research conducted by FMI, Inc.

.58 In fact, the concern for construction labor is so great in hurricane-damaged areas that the Biloxi suburb of D'Iberville, Mississippi is courting China-based construction companies to import Chinese construction workers to build shopping malls, condominiums, and casinos in a city where 35 percent of the real estate was damaged by Hurricane Katrina. Given the debate over immigration and American labor law constraints, this may be a difficult undertaking, but it is a sign of the lengths that developers and others are considering to meet the looming labor shortage. The firms, which propose to partner with private developers in the United States, plan to use Chinese materials to avoid paying higher post-Katrina prices for American materials.

.59 To a large extent, Latino workers are filling the gap of needed workers. Sources report that as much as 45 percent of the workers at some nationally-based construction companies are Hispanic. However, growing sentiment to make sure these workers are registered aliens could greatly affect worker availability and increase labor costs for those contractors who rely on short-term workers or day laborers to get their portion of the project completed.

> **Help Desk—**The *Engineering News Record* publishes detailed quarterly cost studies that track average prices for a wide variety of materials and labor classifications in major cities across the country. You can access summaries of the studies at the magazine's Web site at www.enr.com.

Legislative and Regulatory Issues

New Tax Credit for Homebuilders

.60 The Energy Policy Act of 2005 included many provisions regarding coal, natural gas, renewable energy, and energy efficiency and distribution. It also enacted a new tax credit under Internal Revenue Code (IRC) section 45L—the energy-efficient home credit—available to eligible contractors. Depending on the energy savings achieved, the credit is $1,000 or $2,000 per home.

.61 Under section 45L, a home qualifies for the credit if it has all the following characteristics:

- It is located in the United States.
- Its construction was substantially completed after August 8, 2005.
- It meets the energy-saving requirements specified in section 45L.
- It is acquired from an eligible contractor in either 2006 or 2007 for use as a residence.

.62 The Internal Revenue Service (IRS) issued IR news release 2006-32 and notices 2006-27 and 2006-28 to explain how homebuilders can qualify newly constructed homes for the credit. Notice 2006-28 provides procedures for manufactured homes; notice 2006-27 for all other homes. They include information about the certification process a builder must undergo to qualify and a public list of software programs that can help calculate energy consumption to obtain the proper certification.

.63 The credit is reported by the taxable entity or, for pass-through entities (for example, S corporations and partnerships), on the shareholder's or partner's individual return. It cannot be applied against the alternative minimum tax; thus, it may be limited and carried forward. It is not refundable. The credit can be significant; thus, obtaining the proper certification is important.

> **Help Desk—**For more information, see Tax Clinic, "Tax Credit for Home Builders," by Joel Ackerman, CPA, in the October 2006 issue of *The Tax Adviser*.

AGCxml Project

.64 The Associated General Contractors of America (AGC) recently undertook an industry-wide initiative aimed at enabling the efficient and reliable exchange of electronic construction project information among all building construction and design professionals. The project, known as the AGCxml Project, is managed by the National Institute of Building Sciences (NIBS) under a contract to AGC. This project will result in a set of extensible markup language (XML) schemas that will enable design and construction professionals to exchange electronically the information contained in common construction and communication documents, such as owner/contractor agreements, schedules of values, requests for information (RFI), requests for proposals (RFP), architect/engineer supplemental instructions, change orders, change directives, submittals, applications for payment, and addenda.

.65 XML schemas will enable the exchange of information among dissimilar and proprietary software applications, without requiring the reengineering or redesign of those applications, by establishing a common, nonproprietary data format and classification system for the information to be exchanged. Software developers will be able to modify their applications with minimal effort to reliably import and export data in AGCxml format, without having to change or share their proprietary software code and data formats.

.66 AGC also extended a nationwide invitation to architects, building owners, contractors, engineers, material suppliers, software developers, and subcontractors to serve as volunteer members of a Review and Validation Committee (RVC) for the AGCxml Project. The role of the RVC is to review and validate the development work of the NIBS technical team.

Current Audit and Accounting Issues and Developments

Assessing Audit Risk in the Current Environment

.67 The proper planning and execution of an audit has always required you to have a thorough understanding of the construction industry and the nature of your client's business.

Professional Skepticism

.68 The third general audit standard stipulates that due professional care be exercised in planning and conducting an audit engagement. Due professional care requires that you exercise professional skepticism in gathering and evaluating audit evidence.

.69 As a result of perceived external pressures, companies may be tempted to manage earnings by using nonrecurring transactions or through changes in the method of calculating key estimates, such as reserves, fair values, or impairments. Companies may also adopt inappropriate accounting practices resulting in improper recognition or omission of financial transactions. Material nonrecurring transactions may require special disclosure to facilitate the readers' understanding of the reported financial results, and the guidance in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections*, should be applied in reporting the effects of changes in estimates. Auditors of public companies should see the section titled "Staff Accounting Bulletin No. 108" in the "Recent Auditing and Attestation Pronouncements and Related Guidance" section of this Alert. Inappropriate transactions or accounting practices that may result in errors requiring adjustments of financial statements might include premature recognition of revenue, failure to appropriately accrue for contingent liabilities that are probable and estimable, and failure to record unpaid purchase invoices. Additionally, you should be particularly skeptical of fourth-quarter events that result in significant revenue recognition, loss accrual, or noncash earnings.

.70 The appropriate level of professional skepticism is needed when corroborating management's representations. Management's explanations should make business sense. Additionally, you may need to consider corroborating management's explanations with members of the board of directors or audit committee.

.71 Other indicators of potential increased accounting and reporting risk calling for increased professional skepticism include:

- Bonuses for estimators, project managers, purchasing agents, or supervisors depend on specific criteria (such as budgets, targets, or performance).
- Tax-motivated income or loss goals exist.
- There are ownership disputes, potential sale of business, or a contemplated or current divorce situation.
- Management has been unable to accurately project gross profit in the past.
- Loan covenants or bonding equity requirements have either been closely met or barely failed in the past.
- The company is committed (awarded or notified as low bidder) to a large contract in excess of capacity.
- The company is involved in construction projects subject to significant regulatory restrictions (the Environmental Protection Agency, Federal Emergency Management Agency, or federal or state projects).
- The company is undercapitalized, relying heavily on bank loans and other credit, and is in danger of violating loan covenants.
- The company is having difficulty obtaining or maintaining financing or surety bonding.
- The company is changing significant accounting policies and assumptions to less conservative ones.
- There are increasing amounts of underbillings on the balance sheet.

- The company is generating profits but not cash flow.
- The company has a consistent gross profit fade.
- The company has been entering into new types of projects or new geographic areas.
- The company has been awarded a job that has a dramatic difference in bid spread.
- There has been a significant change in senior management or the board of directors.

Evaluating Audit Risks

.72 Your evaluation of audit risk should start with a good understanding of your client's business. To develop this understanding, you should be knowledgeable about the entity's strategies for dealing with business conditions—both current conditions and those most likely to exist in the near future. In the construction industry, business conditions vary greatly across contractor types and from region to region. The risks associated with building office buildings are different from those faced by a homebuilder; a contractor in the Northeast may face different issues than a similar contractor located on the Pacific Coast. For this reason, you must be knowledgeable about contractor types and the location in which the entity operates.

Evaluating Control Deficiencies

.73 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* (AICPA, *Professional Standards*, vol. 1, AU sec. 325A), 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.

.74 The Statement requires that auditors (1) evaluate identified control deficiencies and determine whether these deficiencies, individually or in combination, are significant deficiencies or material weaknesses and (2) 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.

.75 Some examples of potential control deficiencies you might find in construction companies are:

- Lack of segregation of duties in the cash management function due to a small number of administrative staff and without effective compensating controls
- Management override of controls by owners of privately held companies or by project managers in the invoice approval process
- Inadequate monitoring of the financial accounting process to detect deficiencies in internal control by management
- Improper revenue recognition through recording change orders that have not been approved
- Estimates regarding job completion percentage or costs to complete not reviewed and approved by a person in the company competent to evaluate the estimates
- Lack of client expertise in preparing financial statements including the process for identification, consolidation and disclosure of variable interest entities (VIEs)

.76 The AICPA has published the Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk) to assist in the implementation of this Statement.

Accounting and Auditing Issues Related to Construction Contracts

.77 Auditors of construction contractors should recognize that the traditional balance sheet approach to auditing usually is not adequate when performing an audit of a contractor. The financial statements of a contractor are built from the financial results of individual contracts. The more effective audit approach requires you to focus on the terms, financial estimates, and results of individual contracts, rather than the contract-related balance sheet that accounts for the company as a whole.

.78 The authoritative guidance on auditing contractors is contained in the AICPA Audit and Accounting Guide *Construction Contractors*. Included in the Audit and Accounting Guide is a copy of Statement of Position (SOP) 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, which is the primary authoritative accounting guidance for construction contractors.

.79 Auditing construction contractors is complex. Such businesses rely on accurate and reliable estimates to operate their business as well as to prepare financial statements. Therefore, it is critical that you gain an understanding of the contractor's significant estimates and the assumptions that are used in operating the business. Remember that the audit of a construction contractor's financial statements is an audit of the contractor's ability to estimate. There are several things to consider when auditing estimates: understand the internal control structure surrounding the estimate, consider the contractor's history of accurate estimates, compare actual to budgeted figures, and review subsequent events.

.80 The Professional Issues Task Force of the AICPA has identified certain procedures that should be considered in performing an audit of a construction contractor. They are as follows:

- Read significant contracts. This procedure may seem obvious, but it is necessary to identify the terms of the contract, any guarantees, penalties, or incentives, as well as cancellation and postponement provisions. For example, reading the contract might identify the party responsible for additional expenses incurred as a result of weather delays.
- Identify unique contracts and increase the amount of testing and professional skepticism related to such contracts. These contracts increase the risk of improper estimates and thus improperly stated financial statements. If a company cannot reasonably estimate the cost or progress of a contract, it should be accounted for under the completed-contract method.
- Understand the company's cash flow and how it will manage expenses. Often, expenses are payable prior to receiving the related cash from the contract revenue. Some companies win long-term contracts, but cannot fund the project long enough to realize the revenue on the contract.
- Recognize that the longer the contract period, the greater the risk that an estimate will be incorrect. Also, the farther along a contract is toward completion, the less risk there is of an incorrect estimate. Finally, with more variables inherent in an estimate there is a greater risk that the estimate will be incorrect.
- Confirm the terms and conditions of the contract as well as the normal billing procedures. When confirming a receivable, you should strongly consider confirming the original contract price, total approved change orders, total billings and payments, retainage held and whether it accrues interest, detail of any claims, back charges, or disputes, and estimated completion date or the estimate of percentage to complete.
- Review the unapproved change orders of significant contracts. Change orders often arise during the life of a contract and estimated revenue and cost should be adjusted for changed orders that have

been approved, both as to scope and price. However, when a change order has been approved as to scope but not as to price, carefully evaluate the specific facts and circumstances prior to including in estimated contract revenues. To the extent that change orders are disputed or are unapproved as to both scope and price, they should be evaluated as claims. Generally, if there is no verifiable evidence to support recognition of revenue on an unapproved change order or claim, it should not be recognized.

- Visit construction contract sites. Visiting contract sites can be a very useful audit procedure. Such a visit can provide an opportunity to view the progress of a contract. Consideration of a site visit might include significant contract sites in which the work is in the very early stages of the contract. Such a visit may identify the complexities of performing the contract. The site visit may also provide you with the opportunity to interview operational personnel and to gain a better understanding of the responsibility the company has for performing the contract. At the site visit, you should also speak with available subcontractors to get additional information about the progress of the contract. Furthermore, you should consider observing equipment and uninstalled inventory at the site.

- Meet with project managers. Project managers play an important role in controlling and reporting job site costs. They are also close to the facts and are likely to provide more prompt and accurate information than the accounting personnel. Meeting with the project managers will also assist you in developing expectations for use in performing analytical procedures.

- Identify and understand the significant assumptions and uncertainties. This procedure is fundamental to performing an effective audit of an entity using contract accounting.

- Test contract costs to make sure that costs are matched with appropriate contracts. In some instances companies may shift costs from unprofitable contracts to profitable ones in order to defer losses.

- Audit estimated costs to complete. The focus should be on the key factors and assumptions, such as those that (1) are significant to the estimate, (2) are sensitive to variation, (3) deviate from historical patterns, and (4) are subjective and susceptible to bias or misstatement. It is also useful to review revised or updated estimates of costs to complete and compare estimates with actual costs incurred after the balance sheet date.

- See that losses are recorded as incurred, regardless of whether the entity is using the percentage-of-completion or the completed-contract method of recognizing revenue.

- Analytically review contracts completed and in progress. A detailed analytical review of completed contracts and contracts in progress will provide meaningful information in helping to focus your efforts on potential problem areas.

- See that there are appropriate disclosures relating to SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. Entities using contract accounting should have more than generic disclosure about the use of significant estimates used in the preparation of financial statements.

- Review the aging of receivables on contracts. This procedure will provide evidence that the company is collecting funds on a timely basis.

.81 For additional guidance on auditing construction contracts, see Appendix B of this Alert.

Job Performance

.82 It is difficult for contractors to be profitable when projects are not completed on time. A number of contracts may even require the contractor to pay penalties if the job is not completed by a specified date. Jobs that are significantly behind their established timetable may require additional audit attention and procedures to determine that the original estimates of gross profit have not deteriorated (called "profit fade") and that the job has not incurred a loss (which should be recognized immediately).

.83 The tight labor market and the difficulty in scheduling subcontractors may result in your clients failing to complete jobs according to their pre-established timetables. For example, a key operational employee may leave the company before the job is completed, and finding a competent replacement may require some time. A number of contractors may also be forced to use less experienced personnel in certain positions, including management, and a lack of experience can result in the job taking longer to complete than originally anticipated. Consider making inquiries of management to determine how they have factored these circumstances into their estimation process.

.84 A disruption in the supply of key materials can also affect the ability of the contractor to complete the project on time. During the past year, many construction materials were in short supply. In addition, the events of recent years have shown that an unexpected or continuing surge in demand for materials can quickly outpace supply and create shortages and delays. The lead time required for specifically fabricated items may affect the contractor's ability to deliver the project on time. You may also perform procedures to identify price hikes in your client's vital materials. Determine whether those price hikes are the result of inadequate supply. If so, assess your client's vulnerability to delays caused by the inability to obtain these materials on a regular and timely basis. You can make inquiries to discover what steps the client has taken to mitigate these risks.

Estimating Costs to Complete

.85 A contractor's ability to estimate job costs is critical both from an operational and a financial reporting standpoint. Contractors that cannot accurately estimate job costs will be unable to manage their working capital and maintain consistent levels of profitability over an extended period of time. For most contractors, the estimate of costs to complete a project drive revenue recognition. For that reason, inaccurate or unsupported estimates of costs to complete jobs in progress can result in materially misstated financial statements.

.86 When auditing construction estimates, you should be familiar with SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), and SOP 94-6.

.87 Because of the economic uncertainty, estimates may be difficult for management to make and for auditors to evaluate. Pay close attention to the underlying assumptions used by management when auditing accounting estimates. Management is responsible for making estimates included in the financial statements, and those estimates may be based, in whole or in part, on subjective factors such as judgment based on experience about past as well as current events and about conditions expected to exist. You should be alert to the possibility of management's over reliance on economic information based on favorable conditions to predict future outcomes.

> **Help Desk—**Marshall and Swift is a consulting firm that provides comprehensive cost data for the construction industry. Included on its Web site is a cost estimator that allows the user to estimate the cost of a project based on current costs in the user's geographic area. You may find these estimates helpful in performing analytical procedures on client estimates. You can access the cost estimator at www.construction.com.

Accounting Systems and Controls

.88 Companies that expand quickly frequently outgrow the capabilities of their accounting systems and controls. Contractors with a large backlog and demand for their work tend to focus primarily on completing existing projects and bidding on new ones. Little thought may be given to whether the accounting system and related controls are capable of handling the new volume of business. In the current environment, this problem is exacerbated by the lack of sufficient staffing, the high turnover rate of employees, or both. You should not underestimate the importance of accounting systems and controls in the operation of your client's business.

.89 When clients rely on technology to manage and analyze information, audit strategies change. For example—

- Audit evidence that previously existed in paper form may only be available electronically. Accessing electronic audit evidence may require you to become proficient in the use of data extraction or other audit software tools.
- The design and operation of internal control in a computer environment differs greatly from a predominately manual environment.

.90 As more construction contractors expand their use of information technology, you may need to become aware of the unique audit issues in a highly computerized environment. In addition, you should identify the risks of material misstatement that can arise during the transition from a highly manual environment to a more computerized operating environment.

.91 For further information and guidance on auditing in this paperless environment, see SAS No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319).

Affiliated Entities

.92 In the construction industry, contractors frequently participate in joint ventures or have a direct or indirect affiliation with other entities and, as a result, are frequently involved in related party transactions as that term is defined in FASB Statement No. 57, *Related Party Disclosures*. The prevalence of such arrangements in the industry can be attributed to factors such as legal liability, taxation, competition, ownership and operating arrangements, labor and labor union considerations, and regulatory requirements.

.93 You should review your contractor client's participations in joint ventures to evaluate whether investments in joint ventures are reported properly. You should also review joint venture agreements and document your client's participation.

.94 The audit considerations for a contractor's participation in a partnership are similar to those for participation in corporate joint ventures. They may differ primarily in relation to the contractor's unlimited liability as a general partner for partnership obligations.

.95 For any type of venture, you should consider the nature of the venture, the scope of its operations, and the extent of involvement of each participant.

Variable Interest Entities

.96 For a variety of legitimate business reasons, many construction companies create and utilize affiliated entities to facilitate, among other things, leasing arrangements and joint ventures. These separate entities are often created for asset protection, limitations on bonding capacity, and income and estate tax planning purposes. Typically, these entities have multiple owners and, very commonly, the entities are owned by related parties. In the past, reporting entities have not been consolidating these affiliated entities into the financial statements unless the entities were controlled through owning a majority of stock. Since many of the affiliated entities are not formed as voting interest entities, the accounting literature did not require entities to consolidate the affiliated entities. As a result, in many circumstances, commonly-controlled (and other related) entities were not reflected in one set of financial statements. Essentially, rather than reflecting assets, liabilities, revenues, and expenses within the financial statements, notes to financial statements included a disclosure of transactions between and among the related entities.

Principles for Consolidation

.97 In January 2003, the FASB issued FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*. Many variable interest entities had commonly been referred to as special-purpose entities or off-balance sheet structures, but the guidance applies to a larger population of entities (referred to as VIE). In December 2003, the FASB issued a revision to FASB Interpretation No. 46 (with the same title) to clarify some of the provisions in the original document. The revised document (FASB Interpretation No. 46(R)) was issued in response to input received from constituents regarding certain issues arising in implementing the original FASB Interpretation No. 46. Examples of "connects" between and among reporting entities that could trigger the consolidation provisions within this literature include:

- Equity investments in the affiliated entity
- Guarantees of the value of assets or liabilities of the affiliated entity
- Contracts to purchase assets or equity from the affiliated entity
- Contracts for services with the affiliated entity
- Synthetic lease agreements involving the affiliated entity
- Transfers or sales of assets to the affiliated entity
- Structures designed to house assets in the affiliated entity
- Providing administrative services for the affiliated entity
- Having loans to or from the affiliated entity

.98 Essentially, FASB Interpretation No. 46(R) contains the requirement that we "look through" the form of transactions and arrangements and analyze the substance of the "connects" between and among affiliated entities. If there is an effort to structure a deal to circumvent the spirit of this accounting guidance, the odds are significant that a variable interest in an affiliated entity exists and the entity would be a VIE subject to consolidation. FASB Interpretation No. 46(R) became effective for private companies in calendar year 2005.

Importance in Construction

.99 FASB Interpretation No. 46(R) already has had, and will continue to have, a significant impact on accounting in the construction industry. Some of the more common arrangements that may be affected in implementing this literature include:

- Real estate developers frequently form separate legal entities to own property to be developed. The purpose of the separate legal entity is to isolate the developer's other assets from the project to be developed in the event the project is unsuccessful.
- The owners of closely-held construction contractors may establish separate legal entities to acquire equipment that is then leased to the contractor. Often, these type entities are created for estate-planning purposes.
- Contractors also may form joint ventures to develop a project. Joint venture partners could include another party with unique capabilities in some facet of the project. In some circumstances (for example, when the bid documents require that a prime contractor perform more than half of the work) two or more contractors may form a joint venture to become the prime contractor in order to meet the contractual requirements.

Overview of the Guidance in FASB Interpretation No. 46(R)

.100 Issued in 2003 as a result of the negative fall-out of the failure of Enron (and other entities), the guidance in FASB Interpretation No. 46(R) was intended to clarify and expand the requirements of existing consolidation guidance. However, unlike previous guidance, which based consolidation requirements on voting control, this Interpretation requires an analysis and consideration of consolidation in circumstances where "substantive control" is evidenced by attributes and factors other than direct equity ownership. FASB Interpretation No. 46(R) expands the definition of related parties, and requires the consolidation of certain insufficiently capitalized entities that are connected to the reporting company through certain contractual or other interests. The literature incorporates a "principles based" model that is utilized in determining when entities need to be consolidated.

.101 Fundamentally, the objectives associated with FASB Interpretation No. 46(R) are to explain how to identify VIEs and how to determine when a reporting entity should include the assets, liabilities, noncontrolling interests, and results of activities of VIEs in consolidated financial statements. In developing this guidance, the FASB noted that some entities have entered into arrangements using VIEs that appear to be designed to avoid reporting assets and liabilities for which they are responsible, to delay reporting losses that already have been incurred, or to report gains that are illusory.

.102 In general, a VIE is a corporation, partnership, trust, or any other legal structure used for business purposes where any of the following conditions exist:

- Equity investors do not have voting rights.
- Equity investors do not provide sufficient financial resources for the entity to support its activities.
- Equity investors have voting rights that are not proportionate to their economic interests, and the activities of the entity involve or are conducted on behalf of an investor with a disproportionately small voting interest.

.103 A VIE often holds financial assets, including loans or receivables, real estate, or other property. A VIE may be essentially passive or it may engage in research and development or other activities on behalf of another company.

What Is a VIE and Who Needs to Consolidate a VIE?

.104 Technically, a VIE is an entity subject to consolidation utilizing the accounting guidance in FASB Interpretation No. 46(R). An entity (VIE) must be consolidated into the financial statements of the primary beneficiary when, by design, either of the following conditions exist:

- The VIE does not have enough equity investment.
- Equity investors in the VIE lack any one of three characteristics of controlling financial interest.

.105 For a VIE not to be subject to consolidation by a primary beneficiary, the general rule is that at least 10 percent of the fair value of the assets of a VIE must be provided as equity by unrelated third parties. The equity provided by these unrelated third parties cannot be provided or financed by the primary beneficiary (that is, there must be a legitimate equity investment on the part of unrelated third parties). In some cases, there may be a need for greater than a 10 percent investment so that the VIE can be determined to have sufficient equity to permit financing of activities without additional support from other parties.

.106 Equity investors in voting interest entities have at least three characteristics associated with ownership. These investors participate in the decision-making processes of the entity (they can vote their shares), they expect to share in returns generated by the entity, and they are subject to losses should the entity incur those losses. For purposes of analyzing VIEs to determine whether these entities need to be consolidated, if the equity investors lack any of these three characteristics, the primary beneficiary of the VIE will need to consolidate the entity.

.107 The primary beneficiary (the entity that should consolidate the VIE) associated with a VIE is the entity that will receive a majority of expected returns from the VIE (if they are generated), absorb a majority of expected losses from the VIE (if they are incurred), or both. In those cases where "shared decision making" exists between and among investors (decision-making is not the primary criterion utilized in deciding which entity should consolidate), where one entity receives the majority of expected returns and another entity absorbs the majority of expected losses, the entity that absorbs the expected losses is considered to be the primary beneficiary (expected losses is the "tie breaker" in deciding which entity will consolidate). In other words, if things "go bad" for the VIE, which entity is subject to absorbing the losses? These losses could be in the form of losing invested amounts, fulfilling commitments to advance funds, or fulfilling commitments related to guarantees related to the VIE.

Related Parties

.108 For purposes of determining whether it is the primary beneficiary of a VIE (whether the VIE needs to be consolidated), an entity with a variable interest must treat variable interests in that same entity held by its related parties as its own interests. For purposes of this guidance, the term related parties includes those parties identified in FASB Statement No. 57, *Related Party Disclosures*, and certain other parties that are acting as de facto agents or de facto principals of the variable interest holder. The following are considered to be de facto agents of an entity:

- A party that cannot finance its operations without subordinated financial support from the entity.
- A party that received its interests as a contribution or a loan from the entity.
- An officer, employee, or member of the governing board of the entity.
- A party that has (1) an agreement that it cannot sell, transfer, or encumber its interests in the entity without the prior approval of the reporting entity, or (2) a close business relationship like the relationship between a professional service provider and one of its significant clients. The right of prior approval creates a de facto agency relationship only if that right could constrain the other party's ability to manage the economic risks or to realize the economic rewards from its interests in a VIE through the sale, transfer, or encumbrance of those interests.

.109 If two or more related parties, including de facto agents, hold variable interests in the same VIE, and the aggregate variable interest held by those parties would, if held by a single party, identify that party as the primary beneficiary, then the party within the related party group that is most closely associated with the VIE is the primary beneficiary. The determination of which party within the related party group is most closely associated with the VIE requires judgment and must be based on an analysis of all relevant facts and circumstances, including:

- The existence of a principal-agency relationship between or among parties within the related party group.
- The relationship and significance of the activities of the VIE to the various parties within the related party group.
- A party's exposure to the expected losses of the VIE.
- The design of the VIE.

Impact on Construction Companies

.110 When it has been determined that a company is the primary beneficiary of a VIE, the affiliated entity (the VIE) needs to be consolidated. Consolidation may improve or diminish financial results, and therefore impact credit analyses and a variety of other things. Consolidation not only will have an impact on total assets, liabilities, revenues, expenses, and net income, but also will potentially impact factors such as working capital, working capital ratios, debt-to-equity ratios, gross margins, and operating cash flows. In addition, presentation of consolidated financial statements may impact disclosures with respect to contingencies and litigation, as well as various other disclosures regarding lease commitments and commitments of cash flows for debt service. In certain circumstances, consolidation may force a rethinking of wording incorporated into buy-sell agreements between and among shareholders where those agreements set transaction values based upon book value (or otherwise use book value as a starting point for determining the value of a transaction).

.111 As mentioned previously, it is not uncommon for construction companies to have arrangements with affiliated entities for a variety of reasons. Since guarantees constitute one of the more frequently-encountered variable interests that "trigger" the applicability of FASB Interpretation No. 46(R), the following examples focus on guarantee issues.

.112 ***Example 1.*** A construction company has only one shareholder. The shareholder owns the real estate that is used by the construction company outside the company, and the real estate is housed in a single-member limited liability company (LLC) (where the single member is the owner of the construction company). The real estate LLC initially was "thinly" capitalized (5 percent equity contribution). The LLC borrowed funds associated with the acquisition of the real estate, and the lending institution required a guarantee from the construction company. The construction company leases the real estate from the LLC and the terms of the lease parallel the 15-year time period associated with the loan. Because the LLC did not have sufficient equity at risk (or perhaps in order to just secure a reduced interest rate associated with the borrowing), the lending institution required a guarantee of the loan. The construction company has a variable interest (in the form of the guarantee) related to the real estate LLC. In this circumstance, it is relatively clear that the construction company is the primary beneficiary of the LLC since there is no other entity available to absorb any expected losses attributed to the LLC. Therefore, the construction company should consolidate the LLC.

.113 ***Example 2.*** Assume the same facts as Example 1, except that the guarantee is provided by the owner of the construction company rather than through the construction company. As in the first example, because the LLC did not have sufficient equity at risk, the lending institution required a guarantee of the loan. The shareholder has a variable interest in the real estate LLC through the guarantee of the loan of the LLC. In applying the provisions of FASB Interpretation No. 46(R), related parties need to be "collapsed" with the primary reporting entity in an effort to determine the primary beneficiary, if any, associated with any affiliated entities. Since the shareholder is, by definition, a related party of the construction company, the LLC would be considered a VIE. Since the only user of the asset housed in the LLC is the construction company, the construction company would be considered the primary beneficiary and should consolidate the LLC (even though the guarantee was provided by the shareholder).

.114 ***Example 3.*** A construction company has only one shareholder. The shareholder owns the real estate that is used by the construction company outside the company, the real estate is housed in a single-member LLC, and the single member is the owner of the construction company. The real estate LLC initially was "heavily" capitalized (40 percent equity contribution). The construction company only utilizes 30 percent of the facility that is housed in the LLC; the other 70 percent of the facility is utilized by unrelated third parties. The LLC borrowed funds associated with the acquisition of the real estate, and the lending institution did not require a guarantee from either the shareholder or the primary reporting entity (the construction company). The construction company and the third-party lessees lease the real estate from the LLC and the terms of the lease parallel the 15-year time period associated with the loan. Since (1) the real estate LLC was designed to have sufficient equity at risk, (2) the entity was able to secure the loan from the financial institution without help from either the construction company or the shareholder, and (3) the LLC is not a single-lessee entity (the LLC is not economically dependent on the construction company) the LLC has demonstrated the ability to operate on a stand-alone basis without help from related parties. In this circumstance, there would be no requirement for the construction company to consolidate the LLC.

Other Construction Industry Examples

.115 ***Refundable Deposits.*** It is common practice in the homebuilding industry for a builder to place a nonrefundable deposit on a land parcel to secure the land for the company's future homebuilding operations.

The deposit, along with the provisions on the land option contract, may run afoul of the FASB Interpretation No. 46(R) rules because (1) the deposit may represent a significant portion of the land owner's total equity and (2) the option contract may contain provisions that restrict the land owner's activities. Either of these issues may cause the landowning entity to be considered a VIE. This is true even though the homebuilder's financial risk is strictly limited to the amount of the nonrefundable deposit. If it is determined that the landowning entity is a VIE and the homebuilder is the primary beneficiary, the homebuilder will be required to place the entire cost of the land and all debt of the landowning entity onto its balance sheet.

.116 ***Project Special Purpose Entities (SPEs).*** Often an investor in a project SPE receives its investment for nominal equity and in consideration for other services (for example, construction, input supply, output purchase or marketing, or operations and maintenance services). Note that such equity will not count for the "sufficient equity" purpose to the extent that it is received and/or financed by the transaction. In addition, in many projects interested parties will receive compensation that includes participations in profits (for example, a bonus payable to an operator for exceeding specified financial targets), which can cause the equity to have insufficient participation in profits. Similarly, in many projects risk of loss will be borne under project contracts by third parties with the possible result that equity will not sufficiently participate in losses for purposes of FASB Interpretation No. 46(R), making the project SPE a VIE.

.117 ***Primary Beneficiary Determination.*** In many construction projects, there is a party that performs day-to-day operations and maintenance under an operations and maintenance agreement. If the operations and maintenance contractor is the "decision maker" of the project VIE, fees payable to such contractor will count disproportionately in the determination of the primary beneficiary, making it more likely that the contractor will be the primary beneficiary. Similarly, many equipment vendors to project VIEs will provide performance and other guarantees with respect to the equipment. If periodic fees are payable to such a vendor they will also be weighted disproportionately in the primary beneficiary determination.

.118 ***Consolidation Issues.*** In addition to the complexities associated with evaluating the application of FASB Interpretation No. 46(R), the Interpretation requires the resolution of many practical issues as well. For example, should a contractor be required to consolidate an entity whose financial information has not been audited, it will be necessary to audit the entity being consolidated as well. Although such an audit may not be difficult and time-consuming for certain types of assets and liabilities, it may be extremely challenging for others. On the other hand, information that now requires consolidation may be readily available in audited form, but it might not suit the comparative analysis needs of those using the financial statements. This situation may require the use of supplemental disclosure of consolidating information.

.119 ***Conclusion.*** While FASB Interpretation No. 46(R) has had, and will continue to have, a significant impact on reporting entities throughout various industry sectors, reporting entities within the construction industry might feel the greatest impact in financial reporting. Because of the variety of arrangements that are commonly encountered within the construction industry, there exists a variety of "connects" between and among reporting entities and parties that are related to those entities and those "connects" easily could be considered variable interests in applying FASB Interpretation No. 46(R).

Recent Technical Practice Aids (TPAs) Related to FASB Interpretation No. 46(R)

.120 The AICPA staff recently issued the following technical questions and answers related to FASB Interpretation No. 46(R).

TPA 1400.29: Consolidated Versus Combined Financial Statements Under FASB Interpretation No. 46(R), Consolidation of Variable Interest Entities

.121 TPA 1400.29 addresses the question of whether it would be appropriate to issue combined financial statements rather than consolidated financial statements. The TPA points out that Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, paragraph 22, permits combined financial statements in certain situations in which consolidated financial statements are not required. However, FASB Interpretation No. 46(R) states in paragraph 14 that "an enterprise shall consolidate a variable interest entity if that enterprise has a variable interest (or combination of variable interests) that will absorb a majority of the entity's expected losses, receive a majority of the entity's expected residual returns, or both." Furthermore, the starting point for the preparation of combined financial statements is two or more sets of financial statements that are prepared in accordance with generally accepted accounting principles (GAAP); in the case of a primary beneficiary of a VIE, financial statements prepared in accordance with GAAP would be consolidated financial statements. Therefore, combined financial statements would not be an appropriate alternative when consolidated financial statements are required by GAAP.

TPA 1400.30: Stand-Alone Financial Statements of a Variable Interest Entity

.122 TPA 1400.30 addresses the question of whether it is appropriate to present stand-alone financial statements of a VIE. The TPA points out that FASB Interpretation No. 46(R) does not specifically address this issue. However, subsidiary-only financial statements are appropriate under GAAP and, by extension, it may be appropriate to present stand-alone financial statements of a VIE.

TPA 1400.31: GAAP Departure for FIN 46(R)

.123 TPA 1400.31 addresses the implications for the auditor's report if the reporting entity does not consolidate a VIE. The TPA points out that AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), addresses departures from generally accepted accounting principles. AU section 508 states that when financial statements are materially affected by a departure from GAAP and the auditor has audited the statements in accordance with generally accepted auditing standards (GAAS), he or she should express a qualified or an adverse opinion. In deciding whether the effects of a departure are sufficiently material to require either a qualified or adverse opinion, the auditor should use qualitative as well as quantitative judgments. The significance of an item to a particular entity, the pervasiveness of the misstatement (such as whether it affects the amounts and presentation of numerous financial statement items), and the effect of the misstatement on the financial statements taken as a whole are all factors to be considered in making a judgment regarding materiality.

.124 If you conclude that a qualified opinion is appropriate, you should disclose the GAAP departure in a separate explanatory paragraph(s) preceding the opinion paragraph of the report. Furthermore, the opinion paragraph of the report should include the appropriate qualifying language and a reference to the explanatory paragraph(s). The explanatory paragraph(s) should disclose the principal effects of the departure on financial position, results of operations, and cash flows, if practicable. If the effects are not reasonably determinable, the report should so state. If such disclosures are made in a note to the financial statements, the explanatory paragraph(s) may be shortened by referring to it.

TPA 1500.06: Application of FASB Interpretation No. 46(R), Consolidation of Variable Interest Entities, *to Income Tax Basis Financial Statements*

.125 TPA 1500.06 addresses the question of whether the consolidation or disclosure provisions of FASB Interpretation No. 46(R) apply to financial statements prepared under the income tax basis of accounting. The TPA points out that, for income tax basis financial statements, consolidation is based on the IRC. Therefore, the consolidation requirements of FASB Interpretation No. 46(R) would not apply to financial statements prepared under the income tax basis of accounting. However, SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623.09–.10), as amended, and Interpretation No. 14, "Evaluating the Adequacy of Disclosure and Presentation in Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting (OCBOA)" (AICPA, *Professional Standards*, vol. 1, AU sec. 9623.90–.95), discuss disclosures in financial statements prepared using an other comprehensive basis of accounting (OCBOA). The literature states that if OCBOA 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.

.126 The TPA points out that a VIE that is not consolidated under the income tax basis of accounting is analogous to a 60-percent-owned subsidiary that would be consolidated under GAAP but is not consolidated under the income tax basis of accounting because the threshold for consolidation under the IRC is 80-percent ownership. Therefore, the primary beneficiary of the VIE should perform the same analysis in determining which disclosures are appropriate as would the parent company of the 60-percent-owned subsidiary. Examples of matters that might require disclosure are related-party transactions, guarantees, and commitments.

TPA 1400.32: Parent-Only Financial Statements and Relationship to GAAP

.127 TPA 1400.32 addresses the question of whether there are any circumstances in which an entity may prepare parent company-only financial statements without preparing related consolidated financial statements and state that the parent company-only financial statements are in accordance with GAAP. The TPA states that paragraph 1 of ARB No. 51 notes the presumption in GAAP that consolidated financial statements are more meaningful than parent company-only financial statements. Paragraph 3 of ARB No. 51 states that all majority-owned subsidiaries shall be consolidated, with few exceptions. Paragraph 24 of ARB No. 51 adds that parent company financial statements may be needed in addition to consolidated financial statements, but it does not suggest that parent company financial statements may be prepared in place of consolidated financial statements. Therefore, parent company-only financial statements would not be appropriate when consolidated financial statements are required by GAAP.

Using the Work of a Specialist

.128 It may be necessary to use a specialist (such as a construction engineer) to perform or assist in job site visits or other audit procedures. The specialist may help you gain assurance as to percent complete, identify problems on the job, and identify possible uninstalled materials or items to be classified as inventory. In addition, the specialist will generally be able to "talk shop" with your client's job site personnel.

.129 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 competent evidential matter.

.130 The use of an outside specialist[1] does not absolve the auditor from a certain level of understanding about the construction contractor. Audit planning comes into play because of the lead time necessary to contract for a specialist's services and the time required for the auditor to obtain the minimum 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

[1] Note that AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), does not apply to specialists who are employed by the firm and are part of the engagement team. AU section 336 indicates that the auditor uses the work of the specialist as evidential matter in performing substantive tests to evaluate material financial statement assertions. The specialist does not, however, perform the substantive tests or analytical procedures.

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.

.131 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.

Important Information for Review Engagements

.132 The majority of CPA practitioners serving construction contractors perform a higher number of reviews than audits. Readers interested in guidance for review engagements should refer to the AICPA *Compilation and Review Alert—2006/07* (product no. 022307kk). However, a brief overview of 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, AR secs. 100 and 200) is provided in this Alert due to its impact on review engagements.

SSARS No. 12, Omnibus Statement on Standards for Accounting and Review Services—2005

.133 In July 2005, the AICPA Accounting and Review Services Committee (ARSC) issued SSARS No. 12, *Omnibus Statement on Standards for Accounting and Review Services—2005*. SSARS No. 12 includes revisions to existing SSARS that were accumulated over a period of time and addresses the following issues.

Consideration of Fraud and Illegal Acts in a Compilation or Review Engagement

.134 Guidance in SSARS No. 1, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR sec. 100.05), stated 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. SSARS No. 12 revised SSARS No. 1 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.

Obtaining an Updating Representation Letter

.135 SSARS do not provide guidance on when an accountant should obtain an updating representation letter from management. SSARS No. 12 revised SSARS No. 1 to provide such guidance, by adding a paragraph in the section titled "Management Representations" and an illustrative updating management representation letter.

.136 The new guidance states that there are circumstances in which you should consider obtaining an updating representation letter from management. For example, if you obtain a management representation letter after completion of inquiry and analytical review procedures but do not issue your review report for a significant period of time thereafter, or if 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.

.137 The updating management representation letter should state (1) 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 (2) 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.

.138 The following is an example of an updating management representation letter:

> [*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*]

Restricting the Use of a Compilation or Review Report

.139 SSARS No. 12 revised SSARS No. 1 to provide guidance to accountants on restricting the use of reports issued pursuant to SSARS. The term *general use* applies to compilation and review reports that are not restricted to specified parties, while the term *restricted use* applies to reports intended only for one or more specified third parties. The need for restriction on the use of a report may result from a number of circumstances, including, but not limited to, the purpose of the report and the potential for the report to be misunderstood when taken out of the context in which it was intended to be used.

.140 You should restrict the use of a report when the subject matter of your report or the presentation being reported on is based on measurement or disclosure criteria contained in contractual agreements or regulatory provisions that are not in conformity with GAAP or an OCBOA.

.141 You should also consider informing your client that restricted-use reports are not intended for distribution to nonspecified parties, regardless of whether they are included in a document containing a separate general-use report. The new guidance does not preclude you, in connection with establishing the terms of the engagement, from reaching an understanding with the client that the intended use of the report will be restricted, and from obtaining the client's agreement that the client and the specified parties will not distribute the report to parties other than those identified in the report. However, you are not responsible for controlling a client's distribution of restricted-use reports. Accordingly, a restricted-use report should alert readers to the restriction on the use of the report by indicating that the report is not intended to be and should not be used by anyone other than the specified parties.

.142 An accountant's report that is restricted as to use should contain a separate paragraph at the end of the report as follows:

> This report is intended solely for the information and use of [*the specified parties*] and is not intended to be and should not be used by anyone other than these specified parties.

Restated Prior-Period Financial Statements

.143 Guidance in the section titled "Changed Prior-Period Financial Statements" in SSARS No. 2, *Reporting on Comparative Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR sec. 200.25–.26), required that either the predecessor or successor accountant report on changed prior-period financial statements, as restated. The successor accountant was precluded from reporting on the restatement adjustment only. SSARS No. 12 revised SSARS No. 2 to allow the successor accountant to report on the restatement adjustment while indicating that a predecessor accountant reported on the financial statements of the prior period before restatement.

.144 The following is an example of a successor accountant's compilation report when the predecessor accountant's report is not presented and the successor accountant compiles the restatement adjustment(s):

> I (we) have compiled the accompanying balance sheet of XYZ Company as of December 31, 20X2, 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. I (we) also compiled the adjustment(s) [described in Note X, if applicable] that were applied to restate the 20X1 financial statements. The financial statements of XYZ Company as of December 31, 20X1, before the adjustments [described in Note X, if applicable][2] that were applied to restate the 20X1 financial statements, were compiled by other accountants whose report dated March 31, 20X2, did not express an opinion or any other form of assurance on those financial statements.
>
> [*Same second paragraph as the standard report*]

.145 The following is an example of a successor accountant's review report when the predecessor accountant's report is not presented and the successor accountant has reviewed the restatement adjustment(s):[3]

> I (we) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company. The financial statements of XYZ Company as of December 31, 20X1 before the

---

[2] In the situation where management elects to omit substantially all disclosures, the accountant should follow the guidance in Statement on Standards for Accounting and Review Services (SSARS) No. 1, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR sec. 100.16–.18), as amended.

[3] The accountant should follow the performance requirements in SSARS No. 1 (AICPA, *Professional Standards*, vol. 2, AR sec. 100.26–.38), as amended.

adjustment(s) described in Note X that was (were) applied to restate the 20X1 financial statements were reviewed by other accountants whose report dated March 31, 20X2, stated that they were not aware of any material modifications that should be made to those financial statements in order for them to be in conformity with generally accepted accounting principles.

[*Same second and third paragraphs as the standard report*]

I (we) also reviewed the adjustment(s) as described in Note X that was (were) applied to restate the 20X1 financial statements. Based on my (our) review, nothing came to my (our) attention to indicate that the adjustment(s) is (are) not appropriate and properly applied.

.146 SSARS No. 12 was effective for compilations and reviews of financial statements for periods ending after December 15, 2005.

Recent Auditing and Attestation Pronouncements and Related Guidance

.147 Presented below is a list of auditing and attestation pronouncements, guides, and other 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/members/div/auditstd/technic.htm. The Public Company Accounting Oversight Board (PCAOB) sets auditing and attestation standards for audits of public companies. See the PCAOB Web site at www.pcaobus.org for information about its activities. 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.

SAS No. 102, *Defining Professional Requirements in Statements on Auditing Standards* SSAE No. 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (December 2005) (Not applicable to audits conducted in accordance with PCAOB standards)	These standards established two categories of professional requirements that are identified by specific terms. The words *must* or *is required* are used to indicate an unconditional requirement. The word *should* is used to indicate a presumptively mandatory requirement. (The words *may*, *might*, *could*, and *should consider* represent actions that auditors have a professional obligation to consider.) The provisions of SAS No. 102 and SSAE No. 13 were effective upon issuance. It is the ASB's intention to make conforming changes to AICPA literature over the next several years to remove any language that would imply a professional requirement where none exists.
SAS No. 103, *Audit Documentation* (December 2005) (Not applicable to audits conducted in accordance with PCAOB standards)	SAS No. 103 (AICPA, *Professional Standards*, vol. 1, AU sec. 339) supersedes SAS No. 96, *Audit Documentation*, and amends SAS No. 1, section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 530). 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.

(continued)

SAS Nos. 104–111, *Risk Assessment Standards*	See "Spotlight on the AICPA Risk Assessment Standards" section, below.
SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (May 2006) (Not applicable to audits conducted in accordance with PCAOB standards)	The new standard supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325A), as amended. 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.
PCAOB Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist* (February 2006) (Applicable to audits conducted in accordance with PCAOB standards only)	This standard applies if auditors report on the elimination of a material weakness in a company's internal control over financial reporting. The standard establishes a voluntary engagement that would be performed at the election of the company.
PCAOB Conforming Amendment to AT 101.04*f*, *Attest Engagements* (February 2006) (Applicable to audits conducted in accordance with PCAOB standards only)	*Conforming Amendment to PCAOB Auditing and Related Professional Practice Standards Resulting from the Adoption of Auditing Standard No. 4* This standard states that Auditing Standard No. 4 must be used for reporting on whether a material weakness continues to exist for any purpose other than a company's internal use.

Spotlight on the AICPA Risk Assessment Standards

.148 In March 2006, the AICPA's Auditing Standards Board (ASB) issued eight SASs that provide extensive guidance concerning the auditor's assessment of the risks of material misstatement in a financial statement audit, and the design and performance of audit procedures whose nature, timing, and extent are responsive to the assessed risks. Additionally, the SASs establish standards and provide guidance on planning and supervision, the nature of audit evidence, and evaluating whether the audit evidence obtained affords a reasonable basis for an opinion regarding the financial statements under audit. The following table lists the eight SASs and their effect 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")*	Amends SAS No. 1, *Due Professional Care in the Performance of Work* (AU section 230)
SAS No. 105, *Amendment to Statement on Auditing Standards No. 95*, Generally Accepted Auditing Standards	Amends SAS No. 95, *Generally Accepted Auditing Standards* (AU section 150)

SAS No. 106, *Audit Evidence*	Supersedes SAS No. 31, *Evidential Matter* (AU section 326A)
SAS No. 107, *Audit Risk and Materiality in Conducting an Audit*	Supersedes SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AU section 312A)
SAS No. 108, *Planning and Supervision*	Supersedes SAS No. 1, *Appointment of the Independent Auditor* AU section 310; and supersedes SAS No. 22, *Planning and Supervision* (AU section 311A)
SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*	Together with SAS No. 110, supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AU section 319)
SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*	Supersedes SAS No. 45, *Substantive Tests Prior to the Balance-Sheet Date* (AU section 313); and together with SAS No. 109, supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AU section 319)
SAS No. 111, *Amendment to Statement on Auditing Standards No. 39*, Audit Sampling	Amends SAS No. 39, *Audit Sampling* (AU section 350)

Key Provisions of the New Standards

.149 The SASs emphasize the link between understanding the entity, assessing risks, and the design of further audit procedures. The SASs introduce the concept of risk assessment procedures, which are deemed necessary to provide a basis for assessing the risk of material misstatement. Risk assessment procedures, along with further audit procedures which include tests of controls and substantive tests, provide the audit evidence to support the auditor's opinion of the financial statements. According to the SASs, the auditor should perform risk assessment procedures to gather information and gain an understanding of the entity and its environment, including its internal controls. These procedures include inquiries, analytical procedures, and inspection and observation. Assessed risks and the basis for those assessments should be documented; therefore, auditors may no longer default to maximum control risk for an entity's risk assessment without documenting the basis for that assessment. The SASs also require auditors to consider and document how the risk assessment at the financial statement level affects individual financial statement assertions, so that auditors may tailor the nature, timing, and extent of their audit procedures to be responsive to their risk assessment. It is anticipated that generic audit programs will not be appropriate for all audit engagements, as risks vary between entities.

Effective Date and Implementation

.150 The SASs are effective for audits of financial statements for periods beginning on or after December 15, 2006; earlier application is permitted. In most cases, implementation of the SASs will result in an overall increased work effort by the audit team, particularly in the year of implementation. 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. Readers can obtain the SASs and the related AICPA Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk) at www.cpa2biz.com.

New Companion Audit Guide

.151 In December 2006, the AICPA will publish an Audit Guide titled *Assessing and Responding to Audit Risk in a Financial Statement Audit*. This Guide will help practitioners 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.

Statement on Auditing Standards No. 103

.152 The ASB has issued SAS No. 103, *Audit Documentation.* SAS No. 103 (AICPA, *Professional Standards*, vol. 1, AU sec. 339) supersedes SAS No. 96, *Audit Documentation*, and amends SAS No. 1, section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 530). SAS No. 103 is effective for audits of financial statements for periods ending on or after December 15, 2006, with earlier application permitted. One 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 should 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.

Staff Accounting Bulletin No. 108

.153 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.

.154 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.

.155 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.

.156 If, in correcting a prior year error in the current year, the amount 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 the SAB. 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. It is possible that guidance similar to that found in SAB No. 108 will be developed for nonissuers in the future as a result of FASB projects that are currently underway.

Recent AICPA Independence and Ethics Pronouncements

.157 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.

.158 The AICPA general *Audit Risk Alert—2006/07* and other AICPA industry-specific Alerts contain summaries of recent pronouncements not included here. To obtain copies of AICPA standards and Guides, contact AICPA Service Center Operations at (888) 777-7077 or go online at www.cpa2biz.com.

Recent Accounting Pronouncements and Related Guidance

.159 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 *The CPA Letter* and *Journal of Accountancy*.

FASB Statement No. 155	*Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*
FASB Statement No. 156	*Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140*
FASB Statement No. 157	*Fair Value Measurements*
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)*
FASB Interpretation No. 48	*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. 143 and No. 150, among others, and FASB Interpretation No. 46(R).
AICPA Technical Practice Aids TPA section 2130.09–.37 (Nonauthoritative)	Various topics on the application of SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*, to debt securities
AICPA Technical Practice Aids TPA section 5600.07–.17 (Nonauthoritative)	Various lease topics
AICPA Technical Practice Aids TPA section 6910.16–.20 (Nonauthoritative)	"Nonregistered Investment Partnerships"

On the Horizon

.160 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 very significant changes. Read the AICPA general *Audit Risk Alert—2006/07* for a more complete list of ongoing auditing and accounting projects. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS.

.161 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 beyond 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/
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.pcaobus.org or www.pcaob.com
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/members/div/ethics/index.htm
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 above.

Auditing Pipeline

Proposed Statement on Standards for Attestation Engagements, Reporting on an Entity's Internal Control Over Financial Reporting *(AT Section 501)*

.162 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 would establish standards and provide 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). In May 2006, the PCAOB announced plans to amend certain aspects of PCAOB Auditing Standard

No. 2 to improve its implementation. Because the forthcoming changes to the PCAOB Standard will be relevant to the revision of AT section 501, the ASB has decided to defer the issuance of final revised AT section 501 until the PCAOB issues its amendments and the ASB has time to consider them.

Proposed Amendment to SAS No. 69, The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles, for Nongovernmental Entities*

.163 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 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 FASB proposed statement, which can be obtained at www.fasb.org.

Accounting Pipeline

Proposed FASB Statement, The Hierarchy of Generally Accepted Accounting Principles

.164 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 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 Statement, Accounting for Transfers of Financial Assets

.165 The exposure draft *Accounting for Transfers of Financial Assets* (Transfers Project) is a revision of a June 2003 exposure draft, *Qualifying Special-Purpose Entities and Isolation of Transferred Assets,* and would amend FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The proposed Statement seeks to (1) clearly specify the permitted activities of a qualifying special-purpose entity (QSPE), (2) address practice issues related to which arrangements should be considered and how they should be considered in the legal isolation analysis, (3) eliminate the prohibition on a QSPE's ability to hold passive derivative financial instruments that pertain to beneficial interests held by a transferor, (4) revise the methodology used to initially measure at fair value interests related to transferred financial assets held by a transferor, and (5) clarify guidance related to when rollovers of beneficial interests are permitted within a QSPE. At its July 26, 2006 meeting, the FASB decided to combine the Servicer Discretion Project (which addressed issues relating to the waiver of due-on-sale, collateral substitution, and foreclosed asset activities) into the Transfers Project. The FASB expects to issue a final Statement, which would amend FASB Statement No. 140, in the second quarter of 2007. See the FASB Web site at www.fasb.org for complete information.

Proposed FASB Statement, The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115

.166 The fair value option project has two phases. This proposal represents Phase 1, which addresses the fair value option for certain financial assets and financial liabilities. Phase 2 will consider permitting the fair value option for certain nonfinancial assets and nonfinancial liabilities and some of the financial assets and financial liabilities excluded from the scope of Phase 1.

.167 The proposed FASB Statement would create a fair value option under which an entity may irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and financial liabilities on a contract-by-contract basis, with changes in fair value recognized in earnings as those changes occur. The proposed FASB Statement has specific financial presentation requirements to display fair values and those values that are measured using other measurement techniques. The proposed FASB Statement would amend FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, to require that securities reported at fair value in accordance with FASB Statement No. 115 satisfy the specific financial statement presentation requirements. The planned effective date is for years beginning after December 15, 2006. Visit the FASB Web site at www.fasb.org for additional information.

Proposed FASB Statements, **Business Combinations** *and* **Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries**

.168 In these proposed Statements, the FASB plans to revise the existing guidance on the application of the purchase method. The following are among the main proposals:

1. That all acquisitions of businesses be measured at the fair value of the business acquired.
2. That substantially all the assets acquired and liabilities assumed of the acquired business are recognized and measured at their fair values at the acquisition date.
3. That entities following U.S. GAAP and international standards apply substantially the same accounting requirements for their business combinations.

.169 Exposure drafts on business combinations—purchase method procedures and noncontrolling interests—were issued on June 30, 2005. The target effective date for the two proposed Statements is for fiscal years beginning on or after December 15, 2006.

FASB Project on Derivative Disclosures

.170 FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, has been criticized by certain analysts, auditors, investors, and others for lacking transparent disclosures, allowing a user of the financial statements to assess the overall risk of derivatives on a reporting entity from both a quantitative and qualitative perspective. An exposure draft on derivative disclosures is expected in the fourth quarter of 2006. The objective 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. Additionally, the project is expected to reconsider the existing disclosure requirements under FASB Statement No. 133 for relevance and applicability. It is also expected that derivative loan commitments will fall under the scope of this project and could have a significant impact on the financial statements of entities with derivative loan commitments.

Proposed FASB EITFs and FASB Staff Positions

.171 ***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.

.172 ***Proposed FASB Staff Positions (FSPs).*** A number of proposed FSPs are in progress addressing issues related to financial institutions. Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/proposed_fsp.shtml for complete information.

AICPA Resource Central

.173 The following publications deliver valuable guidance and practical assistance as potent tools to be used on your construction engagements.

- Audit and Accounting Guide *Construction Contractors* (product no. 012586kk). The Audit and Accounting Guide, as of May 1, 2006, summarizes applicable practices and delivers "how to" advice for handling almost every type of financial statement. It describes relevant matters, conditions, and procedures unique to the construction industry, and illustrates treatments of financial statements and reports to caution auditors and accountants about unusual problems. This Audit and Accounting Guide is available as a CD-ROM or online subscription.
- Checklist Supplement and Illustrative Financial Statements *Construction Contractors* (product no. 008926kk). Developed by AICPA's Accounting and Auditing Publications staff as a supplement to *Checklists and Illustrative Financial Statements for Corporations* (product no. 008936kk), this practice aid is invaluable to anyone who prepares financial statements and reports for construction contractors.
- *Accounting Trends & Techniques, Sixtieth Edition* (product no. 009898kk). This is the must-have resource for any CPA who frequently creates or uses financial reports. Filled with current reporting techniques and methods used by the nation's top organizations, this 650-page AICPA bestseller will provide the guidance you need to improve your accounting preparation and procedures.
- Practice Aid *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* (product no. 006701kk). Authoritative guidance on cash- and tax-basis financial statements is rather vague and leaves a great deal to professional judgment. Section One of this publication provides nonauthoritative, practical guidance on preparing and reporting on cash- and tax-basis financial statements. Section Two includes example financial statements, disclosures, and other engagement practice aids. The appendix provides an example checklist to be used for cash- and tax-basis financial statements.
- Audit Guide *Auditing Derivative Instruments, Hedging Activities and Investments in Securities* (product no. 012526kk). The *Auditing Derivative Instruments, Hedging Activities and Investments in Securities* guide has been updated with conforming changes as of May 1, 2006. In it you'll find an overview of derivatives and securities in addition to case studies to help you better understand auditing derivative instruments.
- Audit Guide *Auditing Revenue in Certain Industries* (product no. 012516kk). This publication, as of May 1, 2006, assists auditors in fulfilling their professional responsibilities with regard to auditing assertions about revenue.
- Audit Guide *Analytical Procedures* (product no. 012556kk). Receive guidance on the effective use of analytical procedures with an emphasis on analytical procedures as substantive tests.

Audit and Accounting Manual

.174 The *AICPA Audit and Accounting Manual* (product no. 005136kk) is developed exclusively for small- and medium-size CPA practices. This unique manual explains and demonstrates useful techniques and procedures for conducting compilation, review, and audit engagements—from planning to internal control to accountants' reports.

AICPA reSOURCE: Online Accounting and Auditing Literature

.175 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's 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.

Educational Courses

.176 The AICPA has developed a number of continuing professional education (CPE) courses that are valuable to CPAs working in the construction industry. Those courses include:

- *Construction Contractors: Accounting, Auditing and Tax* (product no. 736430kk). 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. 731992kk). Delve beyond the basics of many issues the construction industry brings to the accounting profession. Get hands-on advice on the accounting, audit, and tax issues that make construction industry clients high-risk. 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.
- *Real Estate Accounting and Auditing* (product no. 730606kk). This course provides an in-depth study of the unique requirements that apply at each stage of the real estate life cycle. It gives practical, how-to-do-it coverage of accounting considerations related to the development, ownership, and operation of real estate assets.

.177 Accountants in the construction industry, as well as in other industries, may also find the following courses helpful:

- *FASB Review for Industry* (2006–2007 edition) (product no. 730563kk). Comprehensive coverage of recent FASB, AcSEC, IASB, and EITF pronouncements is provided in this course geared to the specific interests of the CPA in corporate management.
- *Accounting Update: A Review of Recent Activities* (2006 edition) (product no. 732762kk). This course keeps you current and shows you how to apply the most recent financial accounting and reporting standards. Highlights include FASB Statement No. 154 on accounting changes and error corrections, fair value concepts and measurements, and the revised FASB Statement No. 123 on share-based payment.
- *AICPA's Annual Accounting and Auditing Update Workshop* (2006 edition) (product no. 736182kk, text; also available in video and DVD formats with a manual). 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.
- *Accounting for Income Taxes—Applying SFAS No. 109/FIN 48: A Whole New Ballgame!* (product no. 732792kk). No other area in accounting is as far reaching, and requires knowledge of a vast number of topics in financial and tax accounting, as accounting for deferred taxes. This course addresses the application of this complex standard to many common differences between financial accounting and tax compliance. You will gain a sound knowledge of the theory of deferred taxes and how this theory can be applied to practical situations. Many practical examples are included to illustrate the theory, and the information is presented so you will be able to apply this theory to any situation you may encounter.
- *The AICPA's Guide to Business Consolidations, Goodwill and Other Consolidation Issues* (product no. 735134kk). Learn how FASB Statements No. 141 and No. 142 have changed the rules for business combinations and goodwill accounting. Develop standards for applying purchase accounting and how to allocate the acquired entity now that it's the only game in town under FASB Statement No.

141. Identify variable interest entities' impact under FASB Interpretation No. 46(R). Learn how FASB Statement No. 142 deals with goodwill from initial recognition to the annual impairment review requirements.

.178 For a listing of additional courses available, please download the *Fall/Winter 2006 AICPA CPE Catalog* at www.cpa2biz.com/CPE/default.htm.

Online CPE

.179 AICPA CPExpress (formerly 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 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. Some topics of special interest to construction company auditors are:

- *Construction Contractors: Internal Controls and Substantive Auditing Procedures*
- *Construction Contractors: Sureties and Applying the Audit Risk Model*
- *Revenue Recognition: Income Statement Presentation and Disclosures*

.180 To register or learn more, visit www.cpa2biz.com.

Webcasts

.181 Stay plugged in to what's 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 on the discussion. If you can't make the live event, each Webcast is archived and available on CD-ROM.

CFO Quarterly Roundtable Series

.182 The CFO 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

.183 The SEC Quarterly Update Webcast Series—brought to you each calendar quarter—showcases the profession's leading experts on what's "hot" at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and CorpFin activities, these hard-hitting sessions will keep you "plugged in" to what's important. A must for both 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 Satisfaction Center

.184 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.

Technical Hotline and Ethics Hotline

.185 Do you have a complex technical question about GAAP, OCBOA, 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.

.186 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.

Conferences

.187 Among the many interesting conferences the AICPA offers, there is one that might interest you. Held late each fall, the AICPA National Construction Industry Conference presents a comprehensive program revealing latest trends and developments in the construction industry. The conference offers a national perspective and addresses the newest trends in conducting business, among other topics.

.188 For additional information, contact CPA2Biz at its Web site, www.cpa2biz.com.

Web Sites[4]

AICPA Online and CPA2Biz

.189 Here is a unique opportunity to stay abreast of matters relevant to the CPA profession. AICPA Online, at aicpa.org, informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, cpa2biz.com offers you all the latest AICPA products, including more than 15 Audit Risk Alerts, more than 20 Audit and Accounting Guides, the professional standards, and CPE courses.

.190 *Construction Contractors Industry Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Alert would also be appreciated. You may e-mail these comments to ccole@aicpa.org or write to:

Christopher Cole
AICPA
Palladian Corporate Center
220 Leigh Farm Road
Durham, NC 27707-8110

[4] Additional helpful Web sites are presented in Appendix A.

.191

Appendix A

Helpful Web Sites

Here are some useful Web sites that may provide valuable information as you plan your client engagements. In addition to these Web sites, be sure to review those listed in the "On the Horizon" section of this Alert.

General Web Sites of Interest

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
AuditNet	Electronic communications among audit professionals	www.auditnet.org
CPAnet	Links to other Web sites of interest to CPAs	www.cpalinks.com
Accountant's Home Page	Resources for accountants and financial and business professionals	www.computercpa.com
U.S. Tax Code Online	A complete text of the U.S. Tax Code	www.fourmilab.ch/ustax/ustax.html
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
Ask.Com	Useful search engine	www.ask.com
Governmental Accounting Standards Board	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org
Society of Industrial and Office Realtors	Industrial and office real estate information	www.sior.com
Engineering News Record	Source of important information for owners, contractors, and design and engineering professionals	www.enr.com
Construction.com	A McGraw-Hill company that unifies the resources of Dodge, Sweets, *Architectural Record*, ENR, and regional publications and includes market analysis and forecasting, industry trends, and insights	www.construction.com

(continued)

Name of Site	*Content*	*Internet Address*
Associated Builders and Contractors	A national association representing all specialties within the construction industry and primarily comprising firms that perform work in the industrial and commercial sectors of the industry	www.abc.org
Associated General Contractors of America	An organization of qualified construction contractors and industry-related companies	www.agc.org
Construction Financial Management Association	The only nonprofit organization dedicated to serving the construction financial professional	www.cfma.org
Construction Industry Compliance Assistance Center	The source for plain language explanations of environmental rules for the construction industry	www.cicacenter.org
Construction Owners Association of America	A focal point and voice for the interests of owners in the construction industry	www.coaa.org
Contractor's License Reference Site	Information about state license requirements, with search functions to find out if a contractor is licensed in a particular state	http://contractors-license.org/index.html
Home Builders Institute	Dedicated to the advancement and enrichment of education and training programs serving the needs of the housing industry	www.hbi.org
National Association of Home Builders	A trade association that helps promote the policies that make housing a national priority	www.nahb.org
National Association of the Remodeling Industry	Focusing on educating both trade professionals and remodeling-ready homeowners through a variety of formats including education, training, publications, and programs	www.nari.org
Disaster Contractors Network	Facilitating information sharing and resource matching among government, the construction community, and home and business owners before, during, and after disasters strike	www.dcnonline.org

.192

Appendix B

Audit Considerations of Various Types of Contracts—Revenue Issues[1]

Fixed Price

This type of contract can be considered the riskiest for both the contractor and the auditor. This is generally the type of contract that one has in mind when considering the need for adequate auditing procedures. As the riskiest contract type in an audit, the auditor must employ all of his or her 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 can consist of (1) contract confirmation; (2) testing of the contractor's business functions over estimating, billing, collection, project management, and generally all controls that influence the contractor's ability to manage estimates; (3) use of testing the contractor's subsequent performance; (4) 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; and (5) using other analytical procedures.

Cost Type

This is a lower risk 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

These types of contracts are also lower risk revenue issues for the auditor as long as the contractor has identified all of its costs, including its overhead costs, and defined its needed 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. Often, time and material contracts cannot be confirmed due to the contract's length of time. Other auditing procedures can be employed, such as internal control systems testing and/or subsequent billings and collections of the outstanding time and material costs as of the period end.

Unit Price

Unit price contracts are often small variables of fixed price contracts. Under a unit price contract, the contractor knows the amounts that will be due as each unit price is performed. The auditor's procedures in this area should consist of (1) verifying the work performed with outside parties through the use of confirmations, including the terms of the contract; (2) verifying the terms of the contract concerning the provisions for unit prices, their amounts, and contract billing terms by examining the contract; and (3) determining the revenue balance available to be performed and billed under the contract. Other procedures to be applied can be similar to the procedures applied to fixed price contracts.

Service Contract

This category of contract can include a blend of other contract types, such as time and material. The auditor should separate out these other contract type elements and perform the appropriate testing under those

[1] These audit considerations were developed by Eric P. Wallace, CPA, and are used by permission.

categories. A service contract can consist of the provision 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 to the auditor. 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 would consist of (1) scheduling out the earned and unearned parts of the contract and recording the unearned part as deferred revenue; (2) 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); (3) determining whether the contractor has the ability to job cost each service contract in order to determine whether the service contracts require a loss reserve; (4) testing the service revenues and costs analytically to see if the gross profits earned are typical compared to industry averages; and (5) testing the contractor's prior abilities to estimate with reasonable certainty. Service contracts that have provisions that require estimations should be tested in a manner similar to a fixed price contract.

Construction Management

Construction management (CM) contracts can also be a blend of the various types of contracts described and defined above. 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 CM 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 5 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 CM contract presents will depend on the CM contract terms. If a CM contract calls for a fee based upon a percentage of costs, audit risk is lower. On the other hand, if the CM fee is a fixed price, the auditor will need to examine its revenue recognition methods and test the progress to date. An example of this would be where a CM estimates that it will take 1,000 man-hours to earn the CM fee of $500,000 over an 18-month period. The auditor 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 CM internal controls and prior abilities to estimate with reasonable certainty can also be used to gather audit evidence.

Design Build

This is the newest 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 bid separately on the design and construction work in different phases? The answers to these questions and other facts and circumstances should lead the auditor to make judgment calls about the appropriateness of the use of audit procedures described under the contract types listed above. If a design build contract outcome is uncertain, the auditor should consider the possibility that 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.

The Above Type Contracts With Incentive Provisions

All the contract types can have provisions for incentives. The auditing of contracts that include incentive provisions should consist of but not be limited to the following procedures: (1) an examination of the contract terms to determine the conditions for incentive achievement, (2) a test to see if the conditions for achievement have been met, (3) confirmation of incentive earnings, (4) subsequent billing and collection of incentive revenues, (5) analysis of whether incentive provisions can be earned incrementally or are under "all or none" terms, and/or (6) a determination whether the incentive should be considered a gain contingency properly accounted for under Financial Accounting Standards Board Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*.

[*The next page is 8301*.]

AAM Section 8095

Construction Contractors Accounting Developments—2005/06

NOTICE TO READERS
CONSTRUCTION CONTRACTORS ACCOUNTING DEVELOPMENTS—2005/06

This Financial Reporting Alert is intended to provide accountants in the construction industry with an overview of recent economic, industry, technical, and professional developments that may affect their financial reporting.

This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Written by J. Russell Madray, CPA

Edited by Yelena Mishkevich, CPA
Technical Manager
Accounting and Auditing Publications

How This Alert Can Help You

.01 The knowledge that this Financial Reporting Alert delivers can assist you in achieving a more robust understanding of the business environment in which your company operates. Also, this Alert delivers information about current accounting and regulatory developments. This Alert describes trends and issues facing most contractors in many of the construction markets in the country.

.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. 95 is referred to as AU section 150 of the AICPA *Professional Standards*.

Industry and Economic Developments

Effects of Hurricane Katrina

.03 The physical and psychological damage caused by Hurricane Katrina is likely to reverberate across the global economy in ways that will curb growth well into 2006, economists say. Most economists predict, however, that Hurricane Katrina will reduce, not derail, U.S. economic growth.

.04 A spike in already-high energy costs in the United States and around the world tops the list of risks, especially since oil prices are unlikely to return to the levels of early 2004 when they were 50 percent lower than they are today. Hurricane Katrina shut down large portions of oil and gas production in the Gulf of Mexico at a time when worldwide energy output was already stretched thin. While the storm's impact was most acute in the United States, it also sent fuel costs higher around the globe, squeezing consumers in Europe and Asia and hurting everyone from truckers to fishermen to airlines. But most analysts agree that the sharp increase in gasoline prices since the storm was a "temporary disruption." Oil industry officials say that several refineries and pipelines will soon be back in operation. Initially, 25 percent of U.S. crude oil production and a large portion of refining capacity were knocked out by the storm. Much of the pressure on oil supplies has been relieved by the release of 60 million barrels from emergency supplies. The full extent of the damage to oil and natural gas infrastructure in the Gulf of Mexico is not yet known, but it is expected to be some time before output is back to normal. The same goes for the facilities that refine crude oil into gasoline, heating oil, and jet fuel.

.05 The storm also wiped away up to half a million jobs in New Orleans and other Gulf Coast areas. And its tab is almost certain to top $100 billion, with only about a quarter of that covered by insurance, according to an assessment by Risk Management Solutions of Newark, Calif.

.06 The federal government has pledged billions of dollars of rebuilding funds, but it will take months for the basic recovery efforts to be completed before the money for reconstruction starts flowing.

.07 In Katrina's aftermath, forecasts for U.S. economic growth in the fourth quarter have dropped from 3.5 percent on an annualized basis to 2.5 percent. And that is probably what gross domestic product will average for all of 2006, economists said.

.08 Some local economies will no doubt benefit from the fact that New Orleans will be out of commission for months. Tourists who might have visited the Big Easy will go elsewhere, corporate conferences will be relocated, and cities throughout the South will witness a tightening of their rental housing markets as evacuees from New Orleans reestablish their lives elsewhere.

.09 But when winter arrives and the higher cost of home heating strikes the Northeast and Midwest, consumer spending, particularly among lower income families, is expected to take a noticeable hit. Michael P. Niemira, chief economist at the International Council of Shopping Centers, said the U.S. retail sector will face its toughest Christmas since the September 11, 2001, terrorist attacks.

.10 While the humanitarian situation is horrific, the economic blow may not be as bad as first feared. Treasury Secretary John Snow and Federal Reserve Chairman Alan Greenspan have stated that it would not have a significant long-term effect on the U.S. economy, although growth will be slowed for a short period. Mr. Snow described the impact of the hurricane as mind-boggling and acknowledged that the U.S. economy was facing a challenging time. But its inherent strength, he said, meant that economic growth would only be hit for three to four months.

.11 The Gulf Coast was hit again just three and a half weeks after Hurricane Katrina, by Hurricane Rita, a category 3 storm. Although Hurricane Rita caused far less destruction than Katrina, it still caused between $2.5 billion to $6 billion in insured damage.

.12 The rebuilding of the Gulf Coast after Hurricanes Katrina and Rita will likely have a positive effect on the construction industry. The opportunities for new work will be immense, and while it has positive implications for contractors, it will also present many challenges as well. As a result of the expected increase in construction, contractors may face the following risks:

- Accepting work beyond their abilities to manage
- Accepting work that could put dangerous pressures on their financial capacity (for example, not having sufficient working capital)
- Expanding their labor force with people who are unfamiliar with the entity's practices and methodologies.

General Industry Trends and Conditions

.13 Construction activity through July showed widespread improvement compared to the first seven months of 2004, but the devastation wrought by Hurricanes Katrina and Rita will have varied impacts on construction markets for the rest of 2005 and into 2006.

.14 Construction outlays in July were reported at a seasonally adjusted annual rate of $1.099 trillion, unchanged from June, which was revised up from a previously reported $1.093 trillion. June spending was restated as a 0.6 percent decline from a 0.3 percent fall previously reported.

.15 The gains were well distributed. Private residential construction climbed 12 percent year-to-date, private nonresidential was up 5.3 percent, and public construction was 5.8 percent higher. Within the private residential market, multifamily construction jumped 20 percent, nearly twice the growth rate for single-family and improvements. Manufacturing construction continued to lead the private nonresidential category with a 27 percent year-to-date advance, followed by "multiretail" (general merchandise stores, shopping centers, and shopping malls), 23 percent; communications, 12 percent; and lodging, 9.4 percent. The leading public categories, educational and highways and streets, were up 5.9 and 7.2 percent, respectively.

.16 However, these figures overstate "real" growth because they don't adjust for a large run-up that has occurred in the cost of cement, steel, copper, gypsum, and petroleum-based inputs. Unfortunately, Hurricanes Katrina and Rita will push many of these costs much higher. Contractors use a lot of diesel fuel for off-road equipment, their own trucks, and the multitude of deliveries of materials and equipment. Petroleum or natural gas is a key ingredient in asphalt, roofing materials, plastic pipe, and insulation. And energy costs are built into the price of mining, milling, making, molding, and transporting metals, concrete, and most other construction materials.

.17 Cement was already in short supply in 32 states and the District of Columbia, and the disruption to ocean, barge, and rail transport from Hurricanes Katrina and Rita, and the loss of power to cement plants in the storm's path, will cut further into cement supplies. At the same time, the urgent need to stabilize and rebuild roads, other infrastructure, and buildings will increase demand for cement and other materials.

Construction Put in Place

.18 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* (value-in-place) is a measure of the value of construction installed or erected at the site during a given period. For an individual project, this includes:

- New buildings and structures.
- Additions, alterations, major replacements, and so on, to existing buildings and structures.
- Installed mechanical and electrical equipment.
- Installed industrial equipment, such as boilers and blast furnaces.
- Site preparation and outside construction, such as streets, sidewalks, parking lots, utility connections, and so on.
- Cost of labor and materials (including owner supplied).
- Cost of construction equipment rental.
- Profit and overhead costs.
- Cost of architectural and engineering (A&E) work.
- Any miscellaneous costs of the project that are on the owner's books.

.19 The total value-in-place for a given period is the sum of the value of work done on all projects under way 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.

.20 Exhibit 1, "New Construction Put in Place," presents details of construction put in place for various market segments. (Note that the amounts are in billions of dollars and represent seasonally adjusted annual rates.) To add some perspective, in January 1992, at the start of the current construction boom, the total new construction put in place was $452 billion, as compared with the estimated 2005 amount of $1,099 billion—a gain of more than 143 percent during the period.

Exhibit 1—New Construction Put in Place

(Billions of Dollars—Seasonally Adjusted Annual Rate, in Current Dollars)

	July 2005	*July 2004*
Private construction	856.1	758.3
Public construction	243.2	238.9
Total construction	**1,099.3**	**997.2**
Residential building	615.8	537.5
Nonresidential building		
Office	33.9	31.4
Power	24.8	24.0
Commercial	65.4	61.6
Lodging	11.7	11.6
Other nonresidential	104.5	92.2
Total nonresidential	240.3	220.8
Total private construction	**856.1**	**758.3**
Highways and streets	63.9	65.7
Infrastructure	35.1	28.9
Educational	63.7	63.8
Other public buildings	23.8	24.3
Other public construction	56.7	56.2
Total public construction	**243.2**	**238.9**

.21 The U.S. Census Bureau of the Department of Commerce announced that construction spending during July 2005 was estimated at a seasonally adjusted annual rate of $1,099.3 billion, nearly the same as the revised June estimate of $1,099.7 billion. The July figure is 6.0 percent above the July 2004 estimate of $1,037.5 billion. During the first seven months of this year, construction spending amounted to $617.9 billion, 9.3 percent above the $565.4 billion for the same period in 2004.

.22 Spending on private construction was at a seasonally adjusted annual rate of $856.2 billion, 0.2 percent above the revised June estimate of $854.5 billion. Residential construction was at a seasonally adjusted annual rate of $615.8 billion in July, 0.2 percent above the revised June estimate of $614.6 billion. Nonresidential construction was at a seasonally adjusted annual rate of $240.4 billion in July, 0.2 percent above the revised June estimate of $239.9 billion.

.23 In July, the estimated seasonally adjusted annual rate of public construction spending was $243.2 billion, 0.8 percent below the revised June estimate of $245.2 billion. Educational construction was at a seasonally adjusted annual rate of $63.7 billion, 0.6 percent below the revised June estimate of $64.1 billion. Highway construction was at a seasonally adjusted annual rate of $63.9 billion, 2.4 percent below the revised June estimate of $65.5 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

.24 The residential building segment of the construction industry includes new single- and multifamily housing as well as residential repairs and improvements. Conditions with the most impact on the demand for residential construction include the following:

- *Housing affordability.* Housing affordability is the extent to which potential buyers have the means to purchase a home. Affordability can be measured in several ways by considering average home prices and income levels. For example, some analysts create an "affordability index" by comparing median home prices to household income levels. As income levels get closer to housing prices, the average home becomes affordable to more local residents.

- *Interest rates.* Most homes are financed, 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 have to be in effect for several quarters to reverse home-buying trends.

- *Land availability/pricing.* As one of the major costs of residential building, land availability and pricing have a major impact on the affordability of housing. With land suitable for residential building becoming scarce in certain parts of the country, housing prices will be affected.

- *Demographics.* Shifts in demographics can have a significant impact on housing demand. For example, the aging of the U.S. population has increased demand for low-maintenance and multifamily housing. A large number of baby boomers are now entering their peak earning years, which is expected to affect the affordability and demand for single-family homes.

- *Market velocity.* According to industry sources, more than half of all home improvements occur within 18 months after a new owner moves in, or within 12 months before the home is sold. Thus, during times when new and used home markets are active, residential remodeling and improvement activity also increases.

.25 As one of the main drivers of construction's recent 10-year expansion, home building continues to lead the industry's growth. However, there are signs that years of strong growth in the national housing market may finally be leveling off. Overall, new housing starts in July, which include apartment buildings and condominiums, were flat. The new housing figures, released by the Commerce Department, bolster the view of economists who have predicted a gradual slowdown in housing starts and an easing of price increases as mortgage rates tick up with the prospect of passing the 6 percent mark by next year.

.26 Although sales have certainly been sizzling this year, putting the country on track for a fifth straight year of record purchases of new and existing homes, homes in some areas are staying on the market longer before they sell and the Mortgage Bankers Association reports that its index of demand for home mortgages now stands 11 percent below a June peak.

.27 The issue of how much of a slowdown will occur and whether home prices will fall or just not rise at double-digit rates will depend to large extent on the course of interest rates in coming months.

.28 Ironically, the devastation from Hurricanes Katrina and Rita could turn out to help the housing industry, mainly through falling interest rates. Investors pushed rates lower after the storms in anticipation that the hurricanes and the resulting surge in energy prices would act as a drag on economic growth and could persuade the Federal Reserve to pause in its 14-month campaign to push rates higher. As a result, rates on 30-year mortgages dipped to 5.71 percent, down from a high this year of 6.04 percent set in late March.

.29 David Seiders, chief economist for the National Association of Home Builders, said rebuilding from the hurricanes' devastation probably will not have much impact on the overall housing market since residential building permits for all of Louisiana and Mississippi last year amounted to just 1.8 percent of the national total.

.30 But analysts are forecasting that housing sales will begin to decline from record levels by the end of this year and into 2006. The slowing sales pace is expected to end the super-sized price gains many parts of the country have experienced.

Nonresidential Building

.31 Nonresidential building in July grew 3 percent to an annual rate of $172.1 billion. Much of the upward push came from health care facilities, which soared 42 percent. July included the start of five large projects valued at $100 million or higher, including a $300 million hospital in Cleveland, Ohio; a $148 million hospital complex in San Francisco, Calif.; a $140 million hospital expansion and seismic upgrade in Seattle, Wash.; a $135 million hospital addition in Jacksonville, Fla.; and a $106 million hospital in Granville, N.C. Showing large percentage gains compared to weak contracting in June were transportation terminals, up 81 percent; and manufacturing plants, up 66 percent. Growth was also registered in July by warehouses, up 17 percent; and stores, up 3 percent.

.32 Nonresidential building in July showed reduced contracting for hotels, down 37 percent; and offices, down 15 percent. For both structure types, the declines were relative to a June that was the strongest month so far in 2005. On the institutional side, July showed a slower pace for churches, down 1 percent; public buildings (courthouses and detention facilities), down 2 percent; school construction, down 6 percent; and amusement-related projects, down 18 percent.

Office Market

.33 The U.S. office market took a big step toward recovery in the second quarter, with absorption exceeding 30 million square feet and the vacancy rate falling below 15 percent. Healthy demand for office space was widespread, with both downtown and suburban markets enjoying a robust quarter. Office construction picked up slightly but is still at relatively low levels. Rents posted another modest increase, continuing a trend for the past several quarters.

.34 Office construction took a surprising jump in the second quarter, with 12.6 million square feet completed—the most since the fourth quarter of 2003, when 16.1 million square feet were completed. This was 18.9 percent more than the 10.6 million square feet completed in the first quarter or the 11.6 million square feet completed in the second quarter of 2004. Office construction has been subdued since the middle of 2002, with completions barely averaging 10 million square feet per quarter.

.35 The outlook for the office market remains positive for the third quarter and indeed for the balance of 2005. The most important feature of the first half of the year was the sustained growth in employment. The first quarter saw job creation total 546,000, followed by a further 542,000 new jobs in the second quarter.

.36 Specific to the office market, "office-using employment" increased by 154,000 in the first quarter and 153,000 in the second quarter. Second half projections show continued job creation, which can only be good news for office markets. On the supply side, new office construction is expected to pick up in coming quarters as under-construction activity jumped from 40.3 million square feet at the end of the first quarter to 58.4 million square feet at the end of the second quarter.

Industrial Market

.37 The industrial real estate market experienced an extremely robust second quarter this year, with absorption totaling 69.4 million square feet—far surpassing the 40.9 million square feet recorded during the first quarter of 2005 and 42.2 million square feet during the second quarter of 2004—according to a report by Colliers International, the global real estate services firm.

.38 All the drivers of the U.S. industrial market are going strong—with a subsequent greater need for warehouse space, according to Colliers International. Transportation and distribution companies, manufacturers, retailers, the housing market, and consumer spending all continue to post positive results. There are no indications the industrial market will wane anytime soon.

.39 New construction during the second quarter totaled 30.5 million square feet, exceeding both the 23.2 million square feet recorded during the same quarter last year, and the 27.0 million square feet recorded during the first quarter of 2005. Almost half of the nation's new warehouse construction occurred in five markets: Chicago (2.9 million square feet), Atlanta (2.9 million square feet), Central New Jersey (2.9 million square feet), Seattle (2.7 million square feet), and Inland Empire of California (2.5 million square feet).

Retail and Other Commercial Markets

.40 The favorable conditions witnessed over the past several years have continued into 2005 with the economy on the upswing, steady job creation, disposable income on the rise, and most importantly, consumers who continue to spend. This has led retailers to increase sales and open new stores in a wide variety of centers. Occupancy levels have increased and rents have moved higher. Community rents, neighborhood rents, and power center rents have all increased during the year by 9 percent, 4 percent, and 16 percent, respectively. Going forward, rising interest rates have some concerned, but leasing conditions generally look favorable for some time to come. However, some analysts are predicting that the U.S. retail sector will face its toughest Christmas since the September 11, 2001 terrorist attacks due to the effects of Hurricanes Katrina and Rita.

Hospitality Market

.41 Hotel construction spending, which has been very erratic, is up 28 percent since the bottom of the hotel building cycle two years ago. Although hotel construction spending fell 10 percent in November and December of 2004 and January of 2005, most analysts expect a cumulative 66 percent increase by the end of 2006. That will bring the 2004-to-2006 gain to 80 percent compared to 125 percent during 1995-to-1997 at the same period in the previous building cycle.

.42 The expected building boom is being fueled both by an unusually favorable real estate financial environment and by large increases in demand for hotel rooms. Last year, according to Smith Travel Research, hotel operators added only 1 percent more rooms while they raised the occupancy rate 4 percent and boosted room rates 4 percent. Hotel profits improved sharply, although only to the bottom of the normal range. Together with unusually cheap credit costs, this prompted investors to bid up the price of hotel properties enough that building a new hotel is now a better investment than buying an existing hotel in many markets.

.43 Most real estate investors now believe that hotels offer higher returns than other types of commercial buildings. It is now much easier for hotel developers to get construction loans because real estate investment trusts (REITs) are flush with cash that they need to invest and developers have learned to add condos to hotel projects to use the condo down payments for some of their financing.

.44 Portsmouth, N.H.-based Lodging Econometrics recently released its Lodging Development Forecast that reports the hotel "pipeline"—which consists of hotels in early planning stages and those under construction or scheduled to start in the next 12 months—increased for the fifth straight quarter in the first quarter of 2005, to 2,388. The hotel pipeline has been growing since it bottomed out in the fourth quarter of 2003, and the forecast looks bright for the future of hotel construction. The report predicts that an estimated 322,177 hotel rooms will be built between the first quarter of 2005 and the first quarter of 2006.

Help Desk—The demand for construction can vary significantly among different geographic regions. One of the most comprehensive analyses of commercial real estate demands and construction activity is published by the Society of Industrial and Office Realtors (SIOR). Annually, SIOR publishes *Comparative Statistics of Industrial and Office Real Estate Markets*, which provides detailed real estate and construction statistics on all the country's larger cities. You can purchase and download this publication directly from the publications section of the SIOR Web site at www.sior.com.

Public Construction

.45 According to the Associated General Contractors of America (AGC), public construction is heading for a modest revival, with gains in highway, school, and most other categories. Highway construction will rise modestly. Congress approved a 2 percent increase in federal-aid funds for fiscal 2005 (ending September 30), with small increases likely in future years. State fuel and vehicle tax receipts, which typically fund the state share of highway spending, also are growing slowly.

.46 Educational spending will benefit from the housing boom. Single-family houses appreciated 13 percent nationally in the year ending July-September 2004, according to the Office of Federal Housing Enterprise Oversight. Where property-tax assessments keep pace, school districts that depend on property taxes can afford more construction. School construction is likely to shift more toward high schools and away from elementary schools.

.47 Census estimates show that the elementary-school population in 36 states has fallen since 2000 as the "baby boom echo" cohort is becoming older.

.48 State higher-education construction, as well as other categories, will benefit from a pickup in state general-fund revenues. Income and sales tax receipts climbed 7.5 percent in fiscal 2004 (covering July 2003 to June 2004 for most states) after much slower growth in 2001 and 2003 and a sharp decline in 2002, according to a February 2005 tally by the Nelson A. Rockefeller Institute of Government. That will enable legislatures to reverse some of the construction cuts and freezes imposed in the last several years. However, delays in the design, permit, hearing, and contract phases that follow legislative approval mean the public pickup in construction may not gather steam until 2006. Meanwhile, federal assistance and direct spending for water, wastewater, and building construction are likely to slow by 2006 due to tight budgets for domestic discretionary programs.

.49 Putting the pieces together yields a total for construction put in place in 2005 that will be close to the 2004 level, with growth resuming in all three segments by 2006. Meanwhile, more of the dollar total will represent new projects rather than merely higher materials prices.

.50 The important news affecting public works, of course, is the August enactment of the new multiyear federal transportation bill, after a delay of close to two years. The new bill includes a 38 percent funding increase compared to the previous legislation, plus its passage removes the uncertainty over long-term financing that had hampered state departments of transportation.

Surety Industry Trends

.51 The surety industry is critical to the well-being of the construction industry. Nearly half of all work performed by contractors is bonded, so any change in the surety market will have a significant effect on the construction industry.

.52 Surety bonding is a rigorous process in which surety companies prequalify contractors and then guarantee that the contractors will complete their projects and pay first-tier subcontractors, laborers, and materials suppliers (those hired directly by the general contractors). Construction projects can involve three types of surety bonds:

- Bid bonds provide financial assurance that the bid has been submitted in good faith and that the contractor intends to enter into the contract at the bid price.
- Performance bonds protect the owner from financial loss should the contractor fail to perform the contract in accordance with its terms and conditions.
- Payment bonds guarantee that the contractor will pay subcontractors, laborers, and suppliers associated with the project. (Government property is not subject to mechanic's liens, meaning that laborers, suppliers, and subcontractors would be without redress if the contractor defaulted, and there were no payment bond.) Section 270 of the Miller Act, enacted in 1935, governs performance and payment bonds on federal construction projects.

.53 Additionally, each of the 50 states, the District of Columbia, Puerto Rico, and almost all local jurisdictions have enacted legislation requiring surety bonds on public works projects. Generally referred to as "Little Miller Acts," those laws often set minimum thresholds for which state agencies and local governments may require surety bonds. Sometimes, no threshold is set, and the local entities themselves determine what minimum project value necessitates surety bonding.

.54 While surety credit is similar to obtaining bank credit, it still is a form of insurance. Surety bonds and insurance both are risk transfer mechanisms that are regulated by state insurance commissioners, and both provide protection against financial loss.

.55 Unlike other lines of insurance, however, surety actually is a form of credit. Whereas bankers either lend money or extend a line of credit, a surety grants a "pledge guarantee." The surety does not lend the contractor money but instead allows the surety's financial resources to be used to back the commitment of the contractor; if the contractor defaults, the surety pays for completion of the contractor's work.

.56 The basic function of surety is prequalification. That process involves a surety underwriter taking an in-depth look at the contractor's entire business operation and thoroughly analyzing the contractor's financial strength and capacity to perform before credit is extended. The underwriter will concentrate on the three "C's"—character, capacity, capital—when making bond credit decisions.

.57 To issue a surety bond, the surety must be confident that the contractor has good character, experience matching the requirements of its contracts, financial strength, an excellent credit history, an established banking relationship and line of credit, and ownership of (or the ability to obtain) the equipment to carry out the contract.

.58 The surety industry has weathered the turbulent times of the late 1990s and the first years of the 21st century, and has come through intact and on course for a potential recovery. The large losses faced by the industry in the past few years served as a wakeup call to the industry. By returning to the fundamentals, namely solid underwriting practices, many experts believe that the industry is heading toward recovery. However, some of the sureties may experience some additional short-term losses as the result of loosening of underwriting standards demonstrated by some sureties in the 1990s.

.59 Even though there have been a number of high-profile mergers in the surety market, there have been instances of surety company failures. In most cases, capacity remains sufficient to support the nation's construction needs. However, contractors in different market sizes may see changes in the near future and those contractors considered "marginal" may be dropped by their surety.

- Capacity for small and emerging contractors remains available, though they will be subject to the same underwriting standards as their larger peers. Small and start-up contractors who have difficulty meeting today's underwriting standards may opt to explore the U.S. Small Business Administration's Surety Bond Guarantee Program.

- The midmarket contractor is least likely to be affected by capacity issues. This segment is the primary target of the industry, and qualified contractors will continue to receive strong support. However, in some cases, contractors are being required to provide audited financial statements instead of reviewed financial statements, and some sureties are requiring quarterly reporting. The same back-to-basics underwriting standards apply: quality financials, capital retention, and personal and corporate indemnity are all required.

- Contractors in the $250 million-and-over market may need to address changes in the industry. Surety companies are less likely to assume the risks of massive, multiyear projects on their own. Co-sureties, segmented bonding, and joint ventures may be more common, due to the fact that approximately 80 percent of the reinsurers from the 1990s are gone because of the massive surety losses incurred in the past few years. The tightened reinsurance market is a factor in the need for more creative surety solutions on mega-projects.

.60 There are also alternatives to surety, generally referred to as alternate products. These insurance products were originally designed to protect a general contractor from subcontractor default. Unlike a surety bond, an alternate product has a deductible and guarantees payment in the event of default, but not performance. Although this is a relatively new concept, some think it may be a way to circumvent some of the limitations of the surety industry.

.61 With further consolidation in the marketplace, continued tight terms and conditions for surety credit will continue. With the 10 largest premium volume surety companies now controlling more than 65 percent of the market, it is likely that premium rates will increase. Less negotiation will be available on terms such as bonding subcontractors, acceptable contract specifications, full indemnity and other underwriting requirements. There will also likely be a rise in the frequency of credit schemes using creative, unlicensed surety entities and alternative products.

.62 In some parts of the country, sureties are requiring clients to upgrade from reviews to audits. Other sureties are willing to accept reviewed financial statements when accompanied by a review of the client's internal controls. In some cases, sureties are also requiring quarterly financial statements, in addition to year-end statements. In addition, some smaller contractors are being required to strengthen their financial position with personal guarantees and additional indemnity.

.63 Contractors can expect sureties to look at their work programs more closely, which can lead to changes in the amount of capacity sureties are willing to offer. Although many surety companies have the capacity to support an increased work program, they may not have the same appetite for risk as they have had in the past. Nevertheless, a contractor with a solid reputation and sound financials should have no problem obtaining the surety credit it needs. Overall, the surety industry is attempting to return to a healthy state and will continue to respond to the challenges in the construction industry.

.64 At this critical juncture in the surety industry's life cycle, the following steps may be helpful to ensure that your company's surety relationship remains free from any dramatic exposure to the surety industry's changes. You may need to:

- Meet regularly with your surety underwriters and bond agents and foster a partnering relationship.

- Know your surety—its results, reinsurance, capacity limitations, credit, and AM Best (a worldwide insurance-rating and information agency) ratings.

- Plan for more lead time for larger or unique projects and major decisions.

- Provide high-quality and timely financial information.

- Understand the working capital and equity requirements for the bonding program.
- Understand the adjustments that the surety makes to the financial statements to arrive at bonding capacity.
- Involve your surety in major financial decisions.
- Understand the working capital and equity requirements for your bonding program (single and aggregate limit).
- Use a professional CPA and attorney who specialize in construction contractors and relationships with sureties.
- Use a professional surety broker who specializes in surety, and have a "backup" surety available in case the current surety is unable to provide proper coverage.

Construction Cost Trends

.65 Cleaning up after Hurricanes Katrina and Rita could clean out construction suppliers over the next year. Builders working far away from the Gulf Coast are likely to experience shortages, lagging deliveries, and higher prices, experts say.

.66 The fallout comes at a time of already-high demand for construction materials and equipment. Regional cement shortages are hurting contractors in many states. Availability of larger equipment, such as earthmoving machines, is tight. Nominal prices for highway diesel, averaging $2.59 per gallon, are at an all-time high. Each week brings a new record in diesel prices, according to the U.S. Department of Energy. And Hurricanes Katrina and Rita will push many of these costs much higher, according to Ken Simonson, chief economist for the Associated General Contractors of America.

.67 Heavy equipment dealers in the Gulf Coast area expect to see a run-up for construction machines, such as crawler dozers, excavators, and wheel loaders. The region's need for equipment over the next 12 months is going to be twice the normal demand, experts say.

.68 Machinery analysts have forecasted per-unit sales of construction equipment to increase by a hearty 8 percent to 10 percent this year. Hurricanes Katrina and Rita may push up next year's modest forecast of 2 percent to 5 percent.

.69 The crunch could tighten global supplies of construction machinery, whose demand is expected to rise to $106 billion by 2009 from last year's $81.4 billion, according to Freedonia Group Inc., a market research firm in Cleveland. U.S. machinery exports climbed a staggering 44 percent during this year's first half, according to the Milwaukee-based Association of Equipment Manufacturers.

.70 Ready-mix concrete prices are up 16 percent since they began to rise quickly late in 2003. Prices rose 0.9 percent in March and April but declined slightly in May and June. The price increases to date have been driven by sharply higher imports of cement at premium prices, strained capacity at U.S. cement plants, and bigger margins for ready-mix suppliers. Also, higher diesel and natural gas prices have contributed to cost increases at cement plants and ready-mix fleets.

.71 Cement was already in short supply in 32 states and the District of Columbia before the hurricanes and the disruption to ocean, barge, and rail transport from the storm, as well as the loss of power to cement plants in the storm's path, will cut further into cement supplies. At the same time, the urgent need to stabilize and rebuild roads, other infrastructure, and buildings will increase demand for cement and other materials.

.72 The construction industry has been urging the Commerce Department and the Southern Tier Cement Committee to reach immediate agreement on a way to allow Mexican cement into the Gulf states without the punitive 55 percent duty now in place.

.73 Hurricanes Katrina and Rita's impact on industry is also stretching far beyond oil refineries. The storms knocked out lumber mills as well. The Gulf Coast region is fertile ground for yellow pine, which is sold as plywood, oriented strand board, and pressure-treated lumber. Prices for yellow pine and related products have already gone up 10 percent. Hurricane Katrina boosted lumber prices overnight, and the storms will continue to increase construction costs in other, subtler ways—through fuel surcharges on deliveries, for instance. Experts say prices are likely to go even higher because of increased demand for lumber when the work of rebuilding Hurricane Katrina damage begins in earnest.

.74 On the brighter side, the buyers' market for labor is expected to continue into next year. June's 5 percent unemployment rate overstates the tightness in the labor market because labor-force growth has been unusually low recently. The missing workers are partly due to measurement error and partly due to the usual withdrawal from the labor force when jobs are hard to find. Monthly job gains are expected to rise slightly over the next year from the 180,000 during the spring, without any further decline in the unemployment rate. Rather, the unemployment rate is more likely to rise in the next few months. A stable unemployment rate requires about 60,000 people to reenter the labor force each month. Experience in similar economic conditions in the late 1990s suggests that this is likely.

> **Help Desk—**The *Engineering News Record* publishes detailed quarterly cost studies that track average prices for a wide variety of materials and labor classifications in major cities across the country. You can access summaries of the studies at the magazine's Web site at www.enr.com.

Doing Business With FEMA During Disaster Recovery

.75 Hurricanes Katrina and Rita caused massive destruction and damage that will require a multitude of services and products during the recovery process. The services of independent contractors are usually acquired through sealed bidding or negotiations; however, the Federal Emergency Management Agency (FEMA) accepts capability statements and informational packages. The following information should be included:

- Company name
- Business address
- Contact information
- Type of service or product offered
- Type of equipment
- Number of workers being provided
- Cost for service or product
- Whether the company is volunteering services

.76 FEMA also procures goods and services through the General Service Administration's Federal Supply Schedule (information available at www.gsa.gov/regions.htm) and identifies qualified small businesses through the U.S. Small Business Administration's Pro-net. Companies can register with Pro-Net on the SBA's Web site (www.sba.gov).

.77 In addition, state and local governments make purchases for disaster recovery services and products. Contractors should check the emergency management or other appropriate Web sites of the affected states for information.

> **Help Desk**—For more information about doing business with FEMA, visit www.fema.gov/ofm or call the FEMA Acquisitions Office at (202) 646-4006.

Legislative Issues and Developments

Transportation Act

.78 In July, Congress passed the Safe, Accountable, Flexible and Efficient Transportation Equity Act: A Legacy for Users (SAFETEA-LU), a measure that will provide more than $286 billion in funding for new highways, roads, airports, bridges, transit facilities, and other transportation-related projects.

.79 SAFETEA-LU reauthorizes federal aid for highways, mass transit, safety, and research programs through fiscal year 2009. The bill provides more than $50 billion for transit programs and $6 billion for transportation safety and contains a $15 billion highway bond plan.

.80 The legislation comes nearly two years after SAFETEA-LU's predecessor, TEA-21, expired in 2003. In the interim, Congress approved 12 extensions to ensure that states continued to receive funding.

Energy Bill

.81 Congress also voted in July to pass comprehensive energy legislation.

.82 The legislation touches nearly every sector of the energy industry, expanding oil and gas production and creating the first inventory of U.S. offshore oil and gas resources. Additionally, the bill provides tax incentives for renewable energy, nuclear power, and coal production; requires utilities to follow nationwide electric reliability rules; and provides incentives for energy efficiency and conservation measures.

.83 However, the final bill did not address a number of controversial items, including a provision that would have shielded manufacturers of the controversial gasoline additive methyl tertiary butyl ether (MTBE) from most product lawsuits associated with groundwater contamination, and the issue of drilling in the Arctic National Wildlife Refuge (ANWR) in Alaska.

.84 Republican leaders intend to pursue the ANWR proposal through the budget "reconciliation" process. Unlike most bills in the Senate, the budget measure cannot be filibustered and only needs a simple majority for passage.

Youth Employment Laws

.85 In July, the U.S. Department of Labor (DOL) unveiled a new national outreach campaign to increase awareness of the construction industry's youth employment laws.

.86 The Youth Working in Construction Campaign is part of the agency's ongoing YouthRules! initiative, a program launched by the DOL in 2002 to highlight federal and state rules concerning young workers and to educate parents, teens, employers, and educators about the types of jobs teens can hold and the number of hours they can work.

.87 As part of the campaign, the DOL is offering an electronic seminar presentation that describes prohibited equipment and activities and uses video clips depicting real-life examples of safe work practices. Additionally, the presentation discusses regulations implemented last year that expanded protections for young workers.

> **Help Desk**—To order a CD-ROM copy of the *Youth Working in Construction* video, visit the DOL's Wage and Hour Division Web site at www.wagehour.dol.gov. For more information about the jobs youths may perform and the number of hours they may work, contact the DOL at (866) 4USWAGE.

Current Accounting Issues and Developments

Accounting for Contracts

.88 Statement of Position (SOP) 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, sets forth recommendations on accounting for construction-type and certain production-type contracts in all industries. In addition, the AICPA's Audit and Accounting Guide *Construction Contractors* (the Guide) presents recommendations of the AICPA Construction Contractors Guide Committee on, and descriptions of, financial accounting and reporting principles and practice for construction contractors. In accounting for contracts, the basic accounting policy decision is the choice between the two generally accepted methods: the percentage-of-completion method, including units of delivery, and the completed-contract method. The Guide's recommendations on basic accounting policy are set forth in the sections "Percentage-of-Completion Method" and "Completed-Contract Method," which identify the circumstances appropriate to the methods, the basis of applying the methods, and the reasons for the recommendations. The recommendations apply to accounting for individual contracts and to accounting for other profit centers in accordance with the recommendations in the section on "Determining the Profit Center." As a result of evaluating individual contracts and profit centers, a contractor should be able to establish a basic policy that should be followed in accounting for most of his or her contracts. In accordance with the requirements of Accounting Principles Board (APB) Opinion No. 22, *Disclosure of Accounting Policies*, a contractor should disclose in the note to the financial statements on accounting policies the method or methods of determining earned revenue and the cost of earned revenue, including the policies relating to combining and segmenting, if applicable.

> **Help Desk**—AICPA Audit and Accounting Guide *Construction Contractors* (product no. 012585kk), with conforming changes as of May 1, 2005, has been updated to reflect the issuance of recently issued authoritative pronouncements. The Guide is available through the AICPA's reSOURCE Online and reSOURCE CD-ROM products, as well as through a loose-leaf subscription service. Paperback editions of Audit and Accounting Guides can be purchased as well. Subscriptions to AICPA reSOURCE, subscriptions to the loose-leaf service, and paperback copies of the Guide may be obtained by calling the AICPA Service Operations Center at (888) 777-7077, by faxing a request to (800) 362-5066, or by going online at www.cpa2biz.com.

Job Performance

.89 When projects are not completed on time, it is difficult for contractors to be profitable. Some contracts may even require that the contractor pay penalties if the job is not completed by a specified date. Jobs that are significantly behind their established timetable may require additional attention to determine that the original estimates of gross profit have not deteriorated (profit fade) and that the job has not incurred a loss (which should be recognized immediately).

.90 For contractors that are experiencing layoffs and increased turnover, it may require some time to find a competent replacement for key operational employees who leave the company before the job is completed.

The contractor may be forced to use less-experienced personnel in certain positions, including management, and that lack of experience can result in the job taking longer to complete and costing more than originally anticipated.

.91 A disruption in the supply of key materials can also affect the ability of the contractor to complete the project on time. During the past year, most construction materials were in adequate supply. However, the events of recent years have shown that an unexpected or continuing surge in demand for materials can quickly outpace supply and create shortages and delays. And cleaning up after Hurricanes Katrina and Rita could deplete some construction suppliers over the next year. Builders working far away from the Gulf Coast are likely to experience shortages, lagging deliveries, and higher prices. In addition, the lead time required for specifically fabricated items may affect the contractor's ability to deliver the project on time.

Job Status Indicators

.92 Keeping tabs on how jobs are progressing is crucial to a contractor's profitability. Presented here are four indicators (projected cost variance, over/under billings, cash flow, and scope change effectiveness index) that, when taken together, can reliably determine how a job is doing by integrating all of the financial variables that reveal and predict a job's performance. While these indicators do not indicate why a job is doing better or worse than planned, they will alert you to jobs in need of tighter management and more attention. However, before examining these indicators, it's important to establish consistent definitions for four common terms.

Original Budget

.93 The original budget (OB) is the cost budget associated with a job at the time the job is awarded, or as modified by the job's project manager before job inception. The OB must be compatible in form and function with the way incurred costs are recorded. Once established, the OB is not changed for any reason. It is broken down in accordance with the job's work breakdown structure.

Revised Budget

.94 The revised budget (RB) reflects the OB plus the cost budget associated with customer-requested scope changes. This is the most important budget pertaining to a particular job because it is the reference point. The scope changes referred to here are changes in work for which the contractor will be paid.

.95 There are several common situations that should not affect the RB:

- Savings or overruns due to subcontractor or vendor buyouts;
- Costs due to unexpected weather conditions or for any other occurrence, when such occurrences are not to be paid for by the customer; and
- Forced work orders, unless payment for the work is likely.

.96 One situation, however, that does affect the RB is a rearrangement of work (ROW)—a redistribution of resources to accomplish the original scope of work using a different methodology. To ensure that ROW transactions do not affect a job's revised budgeted margins, the sum of the rearrangements equals zero at the job (top) level, regardless of the changes made further down in the work breakdown structure. A contingency cost code is frequently used in conjunction with ROW transactions to ensure that they net to zero.

.97 There is often confusion about when the RB should be amended. By examining the steps in the scope change process, it is clear when the update should occur.

.98 *Step 1.* The customer requests a proposal for a scope change, which the contractor prepares and submits to the customer. At this point, the RB is not affected; however, the proposal is tracked so the contractor can identify the value, number, and content of outstanding proposals for any given job at any given time.

.99 *Step 2.* The customer either rejects the proposal or accepts it, perhaps even with modifications, and the contractor receives a Notice to Proceed. At this point the customer has not formally signed the scope change (in reality, the signed scope change may not follow for weeks or even months), but the contractor starts work anyway, thinking, "I don't have a signed scope change, so I'm not going to update the RB, even though I am proceeding with the work and incurring the associated costs."

.100 This is very dangerous. The job will always appear to be over-budget because the RB is too low. The RB should be updated at the time the Notice to Proceed is received. At the same time, your system should track unsigned scope changes that are affecting the RB so you can effectively monitor and manage those items. If the arrival of the Notice to Proceed alerts contractors to update the RB, it also frequently prompts contractors to ask, "How do I best record the change in contract amount associated with the Notice to Proceed transaction?" There are three commonly used methods.

1. Don't record the contract amount change at all until the scope change is signed.
2. Record the contract amount change without any margin until the scope change is signed.
3. Record the fully margined contract amount associated with the scope change when the Notice to Proceed is received.

.101 When using the four indicators discussed later, it is important to properly record the fully margined scope change and to keep the RB properly updated. The best way to do this is have three contract amount categories: original contract amount (OCA), revised contract amount (RCA), and forecast contract amount (FCA). The OCA corresponds to the OB. The RCA comprises the OCA plus additional contract amounts associated with all approved (signed) scope changes. The FCA comprises the RCA plus all unsigned scope changes/contract modifications with authorized Notices to Proceed. The difference between the FCA and the RCA (that is, unsigned scope changes for which there is a Notice to Proceed) should be continually managed so it will be reduced to zero before the job is completed.

Forecasts

.102 Forecasts are a project manager's best projection of hours, quantities, and costs at job completion, down to the most detailed level of the work breakdown structure. (Forecasts are normally furnished on a monthly basis.) In developing these forecasts, project managers integrate all available job information, as well as all scope changes for which a Notice to Proceed was received. Forecasts, when used, are typically the single most important piece of information in a contractor's management information system.

Estimated Cost at Completion

.103 Estimated cost at completion (ECAC) is a function of integrating budget and forecast information, as well as information contained in your information system, such as committed costs, incurred costs, and productivity (management information system data + forecast information). While it means nothing by itself, the ECAC is the basis for two of the four indicators: projected cost variance and over/underbillings.

The Four Indicators

.104 ***1. Projected Cost Variance (PCV).*** The formula is PCV = ECAC – RB. The PCV is the single most important indicator of job progress. On the first day of a job, this indicator should be zero. As a job progresses, this indicator becomes either positive (adverse, over budget) or negative (favorable, under budget). In one number, the PCV captures everything about how a job is progressing operationally (as opposed to financially) and easily indicates operational problems from the job level all the way down the work breakdown structure.

.105 This one indicator shows how the job costs will vary from the RB at job completion if action is not taken. The earlier in the job cycle that adverse variances are determined, the better the chances that appropriate action can remedy the situation. The PCV is normally calculated monthly and is formulated as of the end of the job, not as of the date that the calculation is made. Projecting to the end of the job is preferable because many costs not related to productivity (for example, committed costs and material costs) are much easier to evaluate as they relate to the total job at completion, rather than to fractional points in the job cycle.

.106 *2. Over/Underbillings (O/UB).* The formula is O/UB = Revenue – Billings. Unlike other industries, overbillings and underbillings are common in the construction industry. Contractors can capitalize on this to improve liquidity and to compensate for customer-withheld retention. It is common for lump-sum and unit-price work to "front-end load" billing schedules, so the billing-to-costs ratio is larger for work performed at the beginning of the job than for work performed later in the job cycle. In a practice called "unbalancing" (common in unit-price work), items with the potential for quantity overruns are priced with higher margins than items with little or no chance of overruns (or possible elimination from the contract). These practices should normally result in an overbilled position for a job, with over-billings typically largest in the early to midportion of the job cycle.

.107 Considering these factors, underbillings in a job should be a major warning to financial managers. Underbillings can and usually do occur where many (or even all) other financial indicators, including PCV, are favorable. As such, underbillings can be a telltale sign that everything is not copasetic. Underbillings usually occur because the operations staff has either (*a*) not updated the forecasts or (*b*) forecasted too low, resulting in an ECAC that is skewed too low and a percent complete that is skewed too high.

.108 Since the percent complete is too high, the billings resulting from that figure are also too high. The customer cannot be billed by those numbers, which leads to underbillings. In reality, the amount billed is probably consistent with the work that has been done, but the ECAC is not correct. An incorrect ECAC is a more serious problem than underbilling, per se; the corrected ECAC will reduce the job's revenue and associated gross margin. Due to these factors, underbillings are frequently a sign of serious problems.

.109 The O/UB indicator can sometimes be more important than PCV. In addition to possibly indicating an incorrect ECAC, O/UB relates to nonquantifiable factors, such as an unhappy customer, work falling behind schedule, or work of poor quality that must be redone, as well as just the normal lethargy project managers exhibit in submitting requisitions for payment. So, job un-derbillings should be investigated even if all other job metrics are favorable.

.110 *3. Cash Flow (CF).* CF is the ultimate reality check. There are numerous examples where PCV and O/UB were favorable, but the job was still a bust simply because the customer cannot (or will not) pay the bills. The first two indicators are based on internal factors. CF, on the other hand, is a measure of customer/client/supplier relationships. As such, it should be carefully and frequently monitored.

.111 *4. Scope Change Effectiveness Index (SCEI).* The formula is SCEI = (FCA – RB)/FCA (OCA – OB)/ OCA.SCEI is a ratio of revised contract budgeted margin to original contract budgeted margin. It indicates that both the contract amount and contract cost portion of the scope changes are properly processed. Unless special arrangements are made with the customer regarding scope change margin percentages (after the job has been awarded), this indicator is normally greater than one. If the SCEI is less than one, the scope changes are probably not being recorded correctly in the management information system.

.112 This indicator has nothing to do with job production, variances, or relationships with the customer. It simply determines if the scope changes are being properly entered into the system. The purpose of this indicator is to prevent inadvertent omission of the revenue portion of a scope change when the cost portion is processed. This is a frequent problem in the construction industry, resulting in what is commonly referred to as scope creep.

Guidance Related to Natural Disasters

.113 In September 2005, following the destruction caused by Hurricane Katrina, the AICPA issued Technical Practice Aid (TPA) section 5400.05, "Accounting and Disclosures Guidance for Losses from Natural Disasters—Nongovernmental Entities," to address some of the questions that arose in the aftermath of this disaster. This TPA identifies accounting literature, which gives guidance on the following accounting issues that may arise in accounting for losses from natural disasters:

- Classifying, in the statement of operations, losses from a natural disaster of a type that is reasonably expected to recur
- Recognizing an asset impairment loss related to a natural disaster
- Recognizing a liability for nonimpairment losses and costs related to a natural disaster
- Accounting for insurance recoveries to cover losses sustained in a natural disaster, and additional considerations related to business interruption insurance recoveries
- Fulfilling required disclosures regarding the impact of a natural disaster

Help Desk—This TPA can be accessed at www.aicpa.org/download/acctstd/Natural_disaster_TPA_5400.05.pdf.

Variable Interest Entities

.114 Financial Accounting Standards Board (FASB) Interpretation No. 46, *Consolidation of Variable Interest Entities*, issued in January 2003, affected the reporting of a large number of companies associated with special purpose entities (SPEs, entities established for a specific purpose). The concepts in FASB Interpretation No. 46 were very complex and far reaching. In December 2003, the FASB issued Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities* (FASB Interpretation No. 46(R)), which revised and clarified certain of the concepts in the original document.

.115 FASB Interpretation No. 46(R) interprets Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, which, for approximately half a century, was the principal authoritative literature governing when an investor should consolidate an in-vestee. ARB No. 51 concluded that consolidated financial statements are "usually necessary for fair presentation when one of the companies in the group directly or indirectly has a controlling interest in the other companies." FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, issued in October 1987, amended ARB No. 51 to remove one of the three exceptions provided in ARB No. 51 that allowed an investor to avoid consolidating a majority-owned investee. ARB No. 51, with certain exceptions, required consolidation of an investee if an investor had a controlling financial interest in the investee. In general, a controlling financial interest was exhibited by an ownership interest of more than 50 percent of the investee's voting stock.

.116 In 1990, to address the consolidation of SPEs for which voting rights were not considered substantive, the Emerging Issues Task Force (EITF) reached a consensus on Issue No. 90-15, "Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions." Issue 90-15 required a lessee to consolidate an SPE-lessor if all the following conditions were met:

- Substantially all the SPE's activities involved assets to be leased to the lessee.
- The lessee was exposed to the substantive risks and was entitled to substantially all the residual rewards of the leased assets and the SPE's financing arrangements.
- The SPE's owners had not made a substantive residual equity investment that would be at risk throughout the term of the lease.

.117 The consolidation of most SPEs was avoided based on the third condition not being met (in other words, the SPE's owners had made a substantive residual equity investment). As practice evolved, a "substantive residual equity investment" came to mean an amount equal to 3 percent of the fair value of the SPE's assets.

.118 Then the Enron scandal exploded. Enron had set up an elaborate array of entities to shift debt away from the company's books, while absorbing substantially all the risk associated with that debt either through guarantees of the debt or the SPE's assets. The extent of those guarantees came as a surprise to many investors.

.119 In response, the FASB issued Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, which requires a guarantor to recognize the fair value of its guarantee obligations as a liability and provide certain disclosures about the nature of guarantees it has provided, and FASB Interpretation No. 46 (which subsequently was replaced by FASB Interpretation No. 46(R)).

Importance in Construction

.120 FASB Interpretation No. 46(R) may have a significant impact on construction companies. Some of the more common arrangements that may be affected by FASB Interpretation No. 46(R) include the following:

- Real estate developers frequently form separate legal entities to own property to be developed. The purpose of the separate legal entity is to isolate the developer's other assets from the project to be developed in the event the project is unsuccessful.
- The owners of closely held construction contractors may establish separate legal entities to acquire equipment that is then leased to the contractor. Often, such entities are created for estate-planning purposes.
- Contractors may also form joint ventures to develop a project. Joint venture partners could include another party with unique capabilities in some facet of the project. In some circumstances, such as when the bid documents require that a prime contractor perform more than half of the work, two or more contractors may form a joint venture to become the prime contractor, to meet the contractual requirements.

.121 Each of these separate legal entities may meet the criteria in FASB Interpretation No. 46(R) to be a variable interest entity (VIE), which necessitates a careful consideration of the Interpretation's provisions.

.122 It is common in the construction industry for a contractor to report its interests in a joint venture by consolidating its proportionate interest in the venture. The AICPA Accounting and Audit Guide *Construction Contractors* (the Guide), issued in 1981, provided guidance on how to account for joint ventures. In addition, EITF Issue No. 00-1, "Investor Balance Sheet and Income Statement Display under the Equity Method for Investments in Certain Partnerships and Other Ventures," recognized the specialized, longstanding practice that had developed in the construction industry by permitting companies to continue consolidating their proportionate interests in investees in the construction industry. However, after the issuance of FASB Interpretation No. 46(R), companies can no longer take it for granted that pro-rata consolidation is appropriate.

Variable Interest Entities

.123 FASB Interpretation No. 46(R) introduced a number of new concepts into the literature. FASB Interpretation No. 46(R) does not define a VIE, but it does describe the characteristics of one. As described by FASB Interpretation No. 46(R), a VIE is an entity for which a controlling financial interest is provided through ownership of interests other than voting stock. Rather, a controlling financial interest arises out of the economics—a holder of variable interests that is either exposed to a majority of the VIE's expected losses or is entitled to a majority of its expected residual rewards is the party with a controlling financial interest, even if none of the interests is in voting common stock.

.124 FASB Interpretation No. 46(R) is complex. Judgment is called for in analyzing entities with which a company has business arrangements to determine if those entities are VIEs and, if so, whether consolidation is required.

.125 In applying FASB Interpretation No. 46(R), an investor and its related parties (which include the investor's officers, employees, and directors; parties that have a "close business relationship" with the investor; and parties that cannot sell, pledge, or exchange their interests in an entity without the investor's prior approval) must first determine whether they have a variable interest.

.126 Variable interests include, but are not limited to, equity investments; debt instruments; guarantees; beneficial interests; service contracts; leases, including guarantees or fixed-price purchase options; forward contracts; and options. In essence, almost any asset, liability, or off-balance-sheet contractual arrangement between parties could qualify as a variable interest. However, a variable interest is distinguished from other assets, liabilities, and off-balance-sheet contractual arrangements by virtue of the fact that a variable interest under FASB Interpretation No. 46(R) is one that absorbs the variability in the entity's return. For example, a party that guarantees the value of real estate held by a developer (or guarantees the developer's bank borrowings used to finance the real estate) has a variable interest because, through the guarantee, the guarantor will absorb any negative variability in returns on the real estate that result in the value of the real estate declining.

.127 If it is decided that a party has a variable interest and it is not immediately clear that the interest is so minor it could not possibly result in that party being required to consolidate the entity in which the variable interest is held, that party must determine whether the entity is a VIE. Paragraph 5 of FASB Interpretation No. 46(R) indicates that an entity is a VIE if any one of the following criteria is met:

1. The total equity investment at risk is insufficient to permit the entity to finance its activities without additional subordinated financial support provided by any parties, including equity holders. For this purpose, the total equity investment at risk:
   - *a.* Includes only equity investments in the entity that participate significantly in profits and losses, even if those investments do not carry voting rights.
   - *b.* Does not include equity interests that the entity issued in exchange for subordinated interests in other variable interest entities.
   - *c.* Does not include amounts provided to the equity investor directly or indirectly by the entity or by other parties involved with the entity (for example, by fees, charitable contributions, or other payments), unless the provider is a parent, subsidiary, or affiliate of the investor that is required to be included in the same set of consolidated financial statements as the investor.
   - *d.* Does not include amounts financed for the equity investor (for example, by loans or guarantees of loans) directly by the entity or by other parties involved with the entity, unless that party is a parent, subsidiary, or affiliate of the investor that is required to be included in the same set of consolidated financial statements as the investor.

2. As a group the holders of the equity investment at risk lack any one of the following three characteristics of a controlling financial interest:
   a. The direct or indirect ability through voting rights or similar rights to make decisions about an entity's activities that have a significant effect on the success of the entity. The investors do not have that ability through voting rights or similar rights if no owners hold voting rights or similar rights (such as those of a common shareholder in a corporation or a general partner in a partnership).
   b. The obligation to absorb the expected losses of the entity. The investor or investors do not have that obligation if they are directly or indirectly protected from the expected losses or are guaranteed a return by the entity itself or by other parties involved with the entity.
   c. The right to receive the expected residual returns of the entity. The investors do not have that right if their return is capped by the entity's governing documents or arrangements with other variable interest holders or the entity.
3. The equity investors as a group also are considered to lack characteristic 2(a) if (*a*) the voting rights of some investors are not proportional to their obligations to absorb the expected losses of the entity, their rights to receive the expected residual returns of the entity, or both and (*b*) substantially all the entity's activities (for example, providing financing or buying assets) either involve or are conducted on behalf of an investor that has disproportionately few voting rights. For purposes of applying this requirement, enterprises shall consider each party's obligations to absorb expected losses and rights to receive expected residual returns related to all that party's interests in the entity and not only to its equity investment at risk.

In some situations, it will be easy to determine if any of these conditions is met. In most circumstances, however, that will not be the case.

.128 The requirements of FASB Interpretation No. 46 were originally to be applied immediately to all VIEs created after January 31, 2003, and no later than the beginning of the period beginning after June 15, 2003 (July 1, 2003, for a calendar-year company that issues quarterly financial information that purports to comply with generally accepted accounting principles), to VIEs created before February 1, 2003. Because of concerns raised by constituents over the operationality of FASB Interpretation No. 46, the FASB delayed its effective date in October 2003 for those entities created before February 1, 2003. FASB Interpretation No. 46(R) modified the effective date provisions in FASB Interpretation No. 46 as follows.

.129 For public entities that are small business issuers, FASB Interpretation No. 46(R) must be applied to all VIEs no later than the end of the first reporting period that ends after December 15, 2004 (the year ending December 31, 2004, for calendar-year companies), including those VIEs to which FASB Interpretation No. 46 had already been applied (for example, those created after January, 31, 2003).

.130 For public entities that are not small business issuers, FASB Interpretation No. 46(R) must be applied to all VIEs no later than the end of the first reporting period that ends after March 15, 2004 (the quarter ending March 31, 2004, for calendar-year companies), including those VIEs to which FASB Interpretation No. 46 had already been applied.

.131 A nonpublic entity is required to apply FASB Interpretation No. 46(R) to all VIEs in which it holds variable interests by the beginning of the first reporting period beginning after December 2004, (January 1, 2005, for a calendar-year company). A nonpublic entity is required to apply FASB Interpretation No. 46(R) immediately to VIEs created after December 31, 2003.

.132 In addition, FASB Interpretation No. 46(R) required public companies to apply either FASB Interpretation No. 46 or FASB Interpretation No. 46(R) to entities that would have previously been evaluated under the accounting literature as SPEs by the end of the first reporting period ending after December 15, 2003.

.133 FASB Interpretation No. 46(R) expanded the consolidation requirements by requiring existing unconsolidated VIEs to be consolidated with their primary beneficiaries if the entities do not effectively disperse risk among the investing parties. As such, VIEs that effectively disperse risks will not be consolidated unless a single party holds an interest or combination of interests that effectively recombines risks that were previously dispersed.

Expected Losses

.134 If an entity is a VIE, the primary beneficiary entity and its related parties need to determine if they—or another investor—are exposed to a majority of the entity's "expected losses." If so, the party exposed to a majority of expected losses is required to consolidate the VIE. That party is referred to in FASB Interpretation No. 46(R) as the VIE's "primary beneficiary."

.135 If no investor is exposed to a majority of "expected losses," the enterprise and its related parties would need to determine if they are entitled to a majority of the entity's residual rewards. If so, the entity entitled to major rewards would be required to consolidate the entity.

.136 If the enterprise is not required to consolidate the VIE, it would account for its investment in the entity using whatever method is appropriate under other accounting literature. (For equity investments, appropriate accounting methods may include using the equity or cost method, or recording at fair value if the investment has a readily determinable fair value and the enterprise and its related parties do not exercise significant influence over the entity's activities. If the variable interest is based on guarantees or other contractual arrangements, disclosure is required.)

.137 Where significant investments do not result in consolidation, disclosure should include the nature of the investment, the exposure to losses, the purpose and size of the investment, and activities with the VIE.

.138 In determining whether an entity's equity is sufficient to cover "expected losses," it is important to understand that "expected losses" do not only arise in situations where an investor loses its stated invested principal.

.139 As used in FASB Interpretation No. 46(R), "expected losses" can arise when an investment under-performs expectations. For example, if the property held by a real estate limited partnership is expected to appreciate by 10 percent per year for the five-year life of the partnership, the partnership would incur "expected losses" for any possible scenario where appreciation could be less than 10 percent per year.

.140 So, if it were possible that the property could appreciate by 6 percent annually, the entity would need to have sufficient equity to "absorb" the opportunity cost related to the 4 percent difference between the expected return and the possible return.

Control of Entities' Activities

.141 Fees paid to any of the investors, for any reason, must be deducted from the equity invested when considering whether the equity is sufficient to absorb losses and whether the equity investors, as a group, control the activities of an entity.

.142 For example, if a developer is the general partner in a limited partnership and receives a fee at inception in excess of its investment, the limited partnership entity would be deemed to be a VIE. This is because FASB Interpretation No. 46(R) requires investors with equity in the entity to be able to control its activities to not be considered a VIE.

.143 In this example, the general partner—who is the only party with the right to control the ongoing activities of the partnership, the other partners being passive investors—does not have equity in the entity since the fees it received at inception exceeded its investment. That conclusion could require a limited partner to consolidate if the limited partner owns more than 50 percent of the limited partnership interests even though that limited partner's risks are limited to its accumulated and undistributed investment.

Conclusion

.144 As a result of FASB Interpretation No. 46, you should review your company's participations in VIEs to evaluate whether these entities should be consolidated. In many cases, real estate partnerships, LLCs, and other entities guaranteed by the operating entity (for example, the contractor) or its owner will have to be consolidated. To ensure compliance, review the full provisions of FASB Interpretation No. 46 when accounting for your company's partnerships and alliances.

.145 ***FASB Staff Positions.*** The FASB has issued and proposed several FASB Staff Positions (FSPs) related to Interpretation No. 46 that may be of interest to construction contractors. FSPs are available on the FASB Web site at www.fasb.org.

Asset Retirement Obligations

.146 Many construction contractors have mining operations or asphalt/concrete plants that have significant dismantling and restoration costs associated with retirement of the assets. FASB Statement No. 143, *Accounting for Asset Retirement Obligations*, addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. It applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development, and/or the normal operation of a long-lived asset, except for certain obligations of lessees. As used in FASB Statement No. 143, a legal obligation is an obligation that a party is required to settle as a result of an existing or enacted law, statute, ordinance, or written or oral contract or by legal construction of a contract under the doctrine of a promissory estoppel. FASB Statement No. 143 requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. If a reasonable estimate of fair value cannot be made in the period the asset retirement obligation is incurred, the liability shall be recognized when a reasonable estimate of fair value can be made. Upon initial recognition of a liability for an asset retirement obligation, an entity should capitalize an asset retirement cost by increasing the carrying amount of the related long-lived asset by the same amount as the liability. An entity should subsequently allocate that asset retirement cost to expense using a systematic and rational method over its useful life.

Recent Interpretation

.147 In March 2005, the FASB issued FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations—an interpretation of FASB Statement No. 143*. This Interpretation clarifies that the term *conditional asset retirement obligation* as used in FASB Statement No. 143 refers to a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the entity. The obligation to perform the asset retirement activity is unconditional even though uncertainty exists about the timing and/or method of settlement. Thus, the timing and/or method of settlement may be conditional on a future event. Accordingly, an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. The fair value of a liability for the conditional asset retirement obligation should be recognized when incurred—generally upon acquisition, construction, or development and/or through the normal operation of the asset. Uncertainty about the timing and/or method of settlement of a conditional asset retirement obligation should be factored into the measurement of the liability when sufficient information exists. FASB Statement No. 143 acknowledges that in some cases, sufficient information may not be available to reasonably estimate the fair value of an asset retirement obligation. This Interpretation also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation.

.148 Diverse accounting practices have developed with respect to the timing of liability recognition for legal obligations associated with the retirement of a tangible long-lived asset when the timing and/or method of settlement of the obligation are conditional on a future event. For example, some entities recognize the fair value of the obligation before the retirement of the asset with the uncertainty about the timing and/or method of settlement incorporated into the liability's fair value. Other entities recognize the fair value of the obligation only when it is probable the asset will be retired as of a specified date using a specified method or when the asset is actually retired. This Interpretation clarifies that an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation when incurred if the liability's fair value can be reasonably estimated. Questions also arose about when sufficient information may not be available to make a reasonable estimate of the fair value of an asset retirement obligation. This Interpretation clarifies when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation.

.149 This Interpretation is effective no later than the end of fiscal years ending after December 15, 2005 (December 31, 2005, for calendar-year enterprises). Retrospective application for interim financial information is permitted but is not required. Early adoption of this Interpretation is encouraged.

Accounting for Weather Derivatives

.150 Weather derivative contracts (that is, contracts indexed to climatic or geological variables) are relatively new; however, their market presence is rapidly growing. The construction industry is one of the market areas where the potential use of weather derivatives would likely expand. EITF Issue No. 99-2, "Accounting for Weather Derivatives," prescribes the accounting treatment for weather derivatives. The increased use of weather derivative contracts raises questions about whether such contracts should be accounted for under accrual accounting, under settlement accounting, under insurance accounting, marked to fair value through earnings at each reporting date, or under some other method. Most weather derivative contracts contain a terminal settlement provision based on a cumulative index (including the example degree-day swap and option contracts described in this Issue). Another issue to consider is whether the accounting for weather derivatives should vary based on the type of contract. Practice is diverse.

.151 In accordance with FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, contracts that are not exchange traded are not subject to the requirements of that Statement if settlement is based on a climatic or geological variable or on some other physical variable. Any derivative based on a physical variable that eventually becomes exchange traded will automatically become subject to the requirements of FASB Statement No. 133. EITF Issue No. 99-2 does not apply to contracts written by insurance companies that entitle the holder to be compensated only if, as a result of an insurable event, the holder incurs a liability or there is an adverse change in the value of a specific asset or liability for which the holder is at risk.

.152 This EITF addresses the following issues.

Issue 1. How should an entity account for a non-exchange-traded swap-based (or two-directional risk) weather derivative?

Issue 2. How should an entity account for a purchased non-exchange-traded option-based (or one-directional risk) weather derivative?

Issue 3. How should an entity account for a written non-exchange-traded option-based weather derivative?

.153 EITF Issue No. 99-2 explains that an entity that enters into a non-exchange-traded forward-based weather derivative in connection with nontrading activities should account for the contract by applying an "intrinsic value method." The intrinsic value method computes an amount based on the difference between the expected results from an up-front allocation of the cumulative strike and the actual results during a period, multiplied by the contract price (for example, dollars per heating degree day). The intrinsic value method first requires that the reporting entity allocate the cumulative strike amount to individual periods within the contract term. That allocation should reflect reasonable expectations at the beginning of the contract term of normal or expected experience under the contract. That allocation should be based on data from external statistical sources, such as the National Weather Service. The "intrinsic value," or "intrinsic value measure," of the contract at interim dates would then be calculated based on cumulative differences between actual experience and the allocation through that date. The initial allocation of the cumulative strike amount should not be adjusted over the term of the contract to reflect actual results.

.154 EITF Issue No. 99-2 further states that an entity that purchases a non-exchange-traded option-based weather derivative in connection with nontrading activities should amortize to expense the premium paid (or due) and apply the intrinsic value method described above to measure the contract at each interim balance sheet date. The premium asset should be amortized in a rational and systematic manner.

.155 Finally, EITF Issue No. 99-2 explains that all entities that sell or write a non-exchange-traded option-based weather derivative should initially recognize the premium as a liability and recognize any subsequent changes in fair value currently in earnings (the premium would not be amortized).

Exchanges of Nonmonetary Assets

.156 In December 2004, the FASB issued FASB Statement No. 153, *Exchanges of Nonmonetary Assets—an amendment of APB Opinion No. 29*. The guidance in APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, was based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. The guidance in that Opinion, however, included certain exceptions to that principle. Opinion No. 29 provided an exception to the basic measurement principle (fair value) for exchanges of similar productive assets. That exception required that some nonmonetary exchanges, although commercially substantive, be recorded on a carryover basis.

.157 FASB Statement No. 153 amends Opinion No. 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. According to FASB Statement No. 153, a nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange.

Impact on Contractors

.158 Because of the change in the accounting for exchanges of non-monetary assets, construction contractors are likely to see an increase in the historical cost of equipment over time. This increase in historical cost of equipment will result in higher depreciation expense, which may reduce margins on contracts. Likewise, higher depreciation may justify higher revenue on reimbursable cost type contracts. In addition, contractors must consider the immediate income effect for gain or loss recognition on any equipment transactions.

.159 FASB Statement No. 153 is effective for nonmonetary exchanges occurring in fiscal periods beginning after June 15, 2005.

Recent Accounting Pronouncements and Related Guidance

.160 Presented below is a list of recently issued accounting pronouncements and other guidance issued since last fall. For information on accounting standards issued subsequent to the publication of this Alert, please refer to the AICPA Web site at www.aicpa.org and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and the *Journal of Accountancy*.

FASB Statement No. 152 (December 2004)	*Accounting for Real Estate Time-Sharing Transactions—an amendment of FASB Statements No. 66 and 67* This FASB Statement amends FASB Statement No. 66, *Accounting for Sales of Real Estate*, to reference the financial accounting and reporting guidance for real estate time-sharing transactions that is provided in AICPA SOP 04-2, *Accounting for Real Estate Time-Sharing Transactions.* This Statement also amends FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, to state that the guidance for (*a*) incidental operations and (*b*) costs incurred to sell real estate projects does not apply to real estate time-sharing transactions. The accounting for those operations and costs is subject to the guidance in SOP 04-2.
FASB Statement No. 153 (December 2004)	*Exchanges of Nonmonetary Assets—an amendment of APB Opinion No. 29* This Statement amends APB Opinion 29, *Accounting for Nonmonetary Transactions*, to eliminate the exception for nonmonetary exchanges of similar productive assets, and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. Please refer to the "Exchanges of Nonmonetary Assets" section of this Alert for a brief description of this Statement.
FASB Statement No. 123(R) (December 2004)	*Share-Based Payment* This Statement is a revision of FASB Statement No. 123, *Accounting for Stock-Based Compensation*; it supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and its related implementation guidance. This Statement focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. It establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. It also addresses transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of those equity instruments.
FASB Statement No. 154 (May 2005)	*Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3* This Statement replaces APB Opinion No. 20, *Accounting Changes*, and FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*, and changes the requirements for the accounting for and reporting of a change in accounting principle. This Statement applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions.
FASB Interpretation No. 47 (March 2005)	*Accounting for Conditional Asset Retirement Obligations—an interpretation of FASB Statement No. 143* This Interpretation clarifies that *conditional asset retirement obligations* describes a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may not be under the entity's control. Please refer to the "Asset Retirement Obligations" section of this Alert for a brief description of this Interpretation.

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 FSPs. Some of the recently issued FSPs address issues relating to FASB Statements No. 143 and No. 150, among others; and FASB Interpretation No. 46(R).
AICPA TPA section 1200.06–.15 (February 2005) (Nonauthoritative)	"Accounting by Noninsurance Enterprises for Property and Casualty Insurance Arrangements That Limit Insurance Risk"
AICPA TPA section 5400.05 (September 2005) (Nonauthoritative)	"Accounting and Disclosures Guidance for Losses from Natural Disasters—Nongovernmental Entities" Please refer to the "Guidance Related to Natural Disasters" section of this Alert for a brief description of this TPA.
AICPA TPA 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 TPA 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"

.161 The summaries provided above are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standards and other guidance. You should visit the applicable Web site for complete information. You can obtain copies of AICPA standards and other guidance by contacting the Service Operations Center at (888) 777-7077 or online at www.cpa2biz.com.

.162 Some of the pronouncements listed above are already discussed in more detail in this Alert. Below is a brief discussion of two recently issued FSPs that that may have an impact on construction contractors.

FSP No. SOP 78-9-1, *Interaction of AICPA Statement of Position 78-9 and EITF Issue No. 04-5*

.163 This FASB Staff Position, issued in July 2005, amends SOP 78-9, *Accounting for Investments in Real Estate Ventures*.

.164 At the June 15-16, 2005, meeting, the EITF reached a consensus on 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." The consensus provides a framework for addressing when a general partner, or general partners as a group, controls a limited partnership or similar entity. The EITF acknowledged that the consensus in Issue No. 04-5 conflicts with certain aspects of SOP 78-9. The EITF agreed that the assessment of whether a general partner, or the general partners as a group, controls a limited partnership should be consistent for all limited partnerships, irrespective of the industry within which the limited partnership operates. Accordingly, the EITF requested and the FASB agreed to amend the guidance in SOP 78-9 to be consistent with the consensus in Issue No. 04-5.

.165 This FSP eliminates the concept of "important rights" in paragraph .09 of SOP 78-9 and replaces it with the concepts of "kick-out rights" and "substantive participating rights" as defined in EITF Issue No. 04-5. This FSP also amends paragraph .07 of SOP 78-9 to be consistent with revised paragraph .09. The FASB believes that the effect of the rights held by minority partners on the assessment of control, and therefore consolidation, of a general partnership should be the same as the evaluation of limited partners' rights in a limited partnership.

.166 For general partners of all new partnerships formed and for existing partnerships for which the partnership agreements are modified, the guidance in this FSP is effective after June 29, 2005. For general partners in all other partnerships, the guidance in this FSP is effective no later than the beginning of first reporting period in fiscal years beginning after December 15, 2005, and the application of either Transition Method A or Transition Method B, described in this FSP, is permitted.

FSP No. FAS 13-1, *Accounting for Rental Costs Incurred during a Construction Period*

.167 This FSP, issued in October 2005, addresses the accounting for rental costs associated with operating leases that are incurred during a construction period. This FSP does not address rental costs other than those associated with building and ground operating leases. This FSP also does not address whether a lessee that accounts for the sale or rental of real estate projects under FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, should capitalize rental costs associated with ground and building operating leases.

.168 This FSP provides that rental costs associated with ground or building operating leases that are incurred during a construction period shall be recognized as rental expense. The rental costs shall be included in income from continuing operations. A lessee shall follow the guidance in FASB Statement No. 13, *Accounting for Leases*, and FASB Technical Bulletin No. 85-3, *Accounting for Operating Leases with Scheduled Rent Increases*, in determining how to allocate rental costs over the lease term. This guidance does not change application of the maximum guarantee test in EITF Issue No. 97-10, "The Effect of Lessee Involvement in Asset Construction."

.169 The guidance in this FSP shall be applied to the first reporting period beginning after December 15, 2005. Early adoption is permitted for financial statements or interim financial statements that have not yet been issued. A lessee shall cease capitalizing rental costs as of the effective date of this FSP for operating lease arrangements entered into before the effective date of this FSP. Retrospective application in accordance with FASB Statement No. 154, *Accounting Changes and Error Corrections*, is permitted but not required.

On the Horizon

.170 You should keep abreast of accounting developments and upcoming guidance that may affect your company. You should check the appropriate standard-setting Web sites (listed below) for a complete picture of all accounting projects in progress. Presented below is brief information about certain projects that are expected to result in final standards in the near future. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing generally accepted accounting principles (GAAP).

.171 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 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

Help Desk—The AICPA's standard-setting committees publish exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To be added to the notification list for all AICPA exposure drafts, send your e-mail address to memsat@aicpa.org. Indicate "exposure draft e-mail list" in the subject header field to help process your submission more efficiently. Include your full name, mailing address and, if known, your membership and subscriber number in the message.

Project on Revenue Recognition

.172 Revenue usually is the largest single item in financial statements, and issues involving revenue recognition are among the most important and difficult that standard setters and accountants face. Because no comprehensive standard on revenue recognition exists, there is a significant gap between the broad conceptual guidance in the FASB's Concepts Statements and the detailed guidance in the authoritative literature. Most of the authoritative literature provides industry or transaction-specific implementation guidance, and it has been developed largely on an ad hoc basis and issued in numerous pronouncements with differing degrees of authority. Those pronouncements include APB Opinions, FASB Statements, AICPA Audit and Accounting Guides, AICPA SOPs, FASB Interpretations, EITF Issues, SEC Staff Accounting Bulletins (SABs), and the like. Each focuses on a specific practice problem and has a narrow scope, and the guidance is not always consistent across pronouncements.

.173 The SEC sought to fill the gap in the accounting literature with 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 Concepts Statement No. 5 (namely, 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 four basic criteria for revenue recognition in AICPA SOP 97-2, *Software Revenue Recognition*, should be a foundation for all basic revenue recognition principles. Those criteria are:

- Persuasive evidence of an arrangement exists.
- Delivery has occurred.
- The vendor's fee is fixed or determinable.
- Collectibility is probable.

.174 Some criticized SAB No. 101 on the basis that the criteria in SOP 97-2 were developed for a particular industry and that broader application of those criteria was neither contemplated nor intended. They asserted that that guidance may not be appropriate for certain recognition issues, including some that the EITF has considered. Others noted that a SAB is designed to provide the SEC staff's interpretive responses and not to change GAAP. For that reason, SABs are issued without an invitation for comment. Critics argued that SAB No. 101 had in fact changed GAAP by promulgating changes in industry practice without the full due process and deliberation that characterize the FASB's decision-making process. Even though the SEC guidance for revenue recognition applies only to SEC registrants, the work done in developing and implementing SAB No. 101 has focused attention on revenue recognition issues and will be very useful in this project.

.175 In response to these issues, the FASB has undertaken a project to develop a comprehensive statement on revenue recognition that is conceptually based and framed in terms of principles. The FASB is partnering with the International Accounting Standards Board (IASB) on this project.

.176 The planned comprehensive revenue recognition Statement will (*a*) eliminate the inconsistencies in the existing authoritative literature and accepted practices, (*b*) fill the voids that have emerged in revenue recognition guidance in recent years, and (*c*) provide a conceptual basis for addressing issues that arise in the future.

Proposed FASB Statements, Interpretations, and Other Guidance

Proposed FASB Statement The Hierarchy of Generally Accepted Accounting Principles

.177 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, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles (AICPA, *Professional Standards*, vol. 1). 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 AU section 411, subject to certain modifications. The proposed Statement would be effective for fiscal periods beginning after September 15, 2005. Readers should be alert for the issuance of a final Statement, which is expected in the third quarter of 2005.

Proposed FASB Statements Business Combinations, *and* Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries

.178 In these proposed Statements, the FASB plans to revise the existing guidance on the application of the purchase method. The following are among the main proposals:

1. That all acquisitions of businesses be measured at the fair value of the business acquired.
2. That substantially all of the assets acquired and liabilities assumed of the acquired business be recognized and measured at their fair values at the acquisition date.
3. That entities that follow U.S. GAAP and international standards apply substantially the same accounting requirements for their business combinations.

.179 Issuance of the exposure drafts on business combinations, purchase method procedures, and noncontrolling interests are expected. The FASB's goal is to issue the two final Standards in the third quarter of 2006. The target effective date for the two proposed Statements is for fiscal years beginning on or after December 15, 2006.

Proposed FASB Statements Accounting for Transfers of Financial Assets, Accounting for Servicing of Financial Assets, *and* Accounting for Certain Hybrid Financial Instruments

.180 The exposure draft, *Accounting for Transfers of Financial Assets*, is a revision of a June 2003 exposure draft, *Qualifying Special-Purpose Entities and Isolation of Transferred Assets*, and would amend FASB Statement

No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The proposed Statement seeks to (*a*) clearly specify the circumstances that require the use of a qualifying SPE in order to derecognize all or a portion of financial assets, (*b*) provide additional guidance on permitted activities of qualifying SPEs, (*c*) eliminate the prohibition on a qualifying SPE's ability to hold passive derivative financial instruments that pertain to beneficial interests held by a transferor, and (*d*) revise the initial measurement of interests related to transferred financial assets held by a transferor. The effective dates associated with this proposed Statement vary; refer to the exposure draft for further information.

.181 The exposure draft, *Accounting for Servicing of Financial Assets*, would also amend Statement No. 140. The proposed Statement would (*a*) require all separately recognized servicing rights to be initially measured at fair value, if practicable; (*b*) permit an entity to choose between two measurement methods for each class of separately recognized servicing assets and liabilities; and (*c*) require additional disclosures for all separately recognized servicing rights. The proposed Statement would be effective for transactions occurring in the earlier of the first fiscal year beginning after December 15, 2005, or fiscal years that begin during the fiscal quarter in which the Statement is issued.

.182 The proposed Statement, *Accounting for Certain Hybrid Financial Instruments*, would amend FASB Statement No. 140 and FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Specifically, the proposed Statement would (*a*) permit fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, (*b*) clarify which interest-only strips and principal-only strips are not subject to the requirements of Statement 133, (*c*) establish a requirement to evaluate beneficial interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, (*d*) clarify that concentrations of credit risk in the form of subordination are not embedded derivatives, and (*e*) eliminate restrictions on a qualifying SPE's ability to hold passive derivative financial instruments that pertain to beneficial interests that are themselves or that contain a derivative financial instrument. The proposed Statement would be effective after the earlier of fiscal years beginning after December 15, 2005, or fiscal years that begin during the fiscal quarter in which the Statement is issued.

.183 Readers should be alert for the issuance of final Statements, which is expected in the first quarter of 2006. See the FASB Web site at www.fasb.org for complete information.

Proposed FASB Statement Fair Value Measurements

.184 In June 2004, the FASB published an exposure draft of a proposed Statement, *Fair Value Measurements*, which seeks to establish a framework for measuring fair value that would apply broadly to financial and nonfinancial assets and liabilities, improving the consistency, comparability, and reliability of the measurements. The fair value framework would clarify the fair value measurement objective and its application under authoritative pronouncements that require fair value measurements. The exposure draft would replace any current guidance for measuring fair value in those pronouncements and would expand current disclosures. Readers should be alert for the issuance of a final Statement, which is expected in the first quarter of 2006. Refer to the FASB Web site at www.fasb.org for complete information.

Proposed FASB Statement Earnings per Share—an amendment of FASB Statement No. 128

.185 This proposed Statement would amend the computations guidance in FASB Statement No. 128, *Earnings per Share*, for calculating the number of incremental shares included in diluted shares when applying the Treasury stock method. Also, this proposed Statement would eliminate the provisions of FASB Statement No. 128 that allow an entity to rebut the presumption that contracts with the option of settling in either cash or stock will be settled in stock. In addition, this proposed Statement would require that shares that will be issued upon conversion of a mandatorily convertible security be included in the weighted-average number of ordinary shares outstanding used in computing basic earnings per share from the date when conversion becomes mandatory. Readers should be alert for the issuance of a final Statement, which is expected to be released in the third quarter of 2005.

Proposed FASB Interpretation Accounting for Uncertain Tax Positions

.186 In July 2005, the FASB published an exposure draft of a proposed Interpretation, *Accounting for Uncertain Tax Positions*, which seeks to reduce the significant diversity in practice associated with recognition and measurement in the accounting for income taxes. It would apply to all tax positions accounted for in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. Specifically, the exposure draft requires that a tax position meet a "probable recognition threshold" for the benefit of the uncertain tax position to be recognized in the financial statements.

.187 This threshold is to be met assuming that the tax authorities will examine the uncertain tax position. The exposure draft also contains guidance with respect to the measurement of the benefit that is recognized for an uncertain tax position, when that benefit should be derecognized, and other matters. The effective date of the proposed Interpretation would be as of the end of the first fiscal year ending after December 15, 2005. A final Interpretation is expected to be released in the fourth quarter of 2005.

Proposed FASB EITF Issues

.188 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.

Proposed FASB Staff Positions

.189 A number of proposed FASB Staff Positions are in progress addressing issues related to FASB Statements No. 13, No. 123(R), and No. 140, and FASB Interpretation No. 45. Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/proposed_fsp.shtml for complete information.

AICPA Resource Central

.190 The following publications deliver valuable guidance and practical assistance.

- Audit and Accounting Guide *Construction Contractors* (product no. 012585kk). The Audit and Accounting Guide as of May 1, 2005, summarizes applicable practices and delivers "how-to" advice for handling almost every type of financial statement. It describes relevant matters, conditions, and procedures unique to the construction industry, and illustrates treatments of financial statements and reports to caution auditors and accountants about unusual problems. This Audit and Accounting Guide is available now as a CD-ROM or Online subscription.

- Checklist Supplement and Illustrative Financial Statements *Construction Contractors* (product no. 008925kk). Developed by AICPA's Accounting and Auditing Publications staff as a supplement to *Corporations Checklists and Illustrative Financial Statements* (product no. 008935kk), this practice aid is invaluable to anyone who prepares financial statements and reports for construction contractors.

- *CPA's Guide to Accounting, Auditing and Tax for Construction Contractors* (2004 Paperback) (product no. 091014kk). Here's the definitive resource—complete with information on the specialized requirements that affect contractors—that is perfect for CPAs in public practice and in the construction industry. Based on the AICPA's best-selling CPE self-study course, this newly revised guide covers everything from GAAP accounting methods to auditing and review services performed by outside CPAs and important tax rules for contractors.

- *Accounting Trends and Techniques—2005* (product no. 009897kk). It is the must-have resource for any CPA who frequently creates or uses financial reports. Filled with current reporting techniques and methods used by the nation's top organizations, this 650-page AICPA bestseller will provide guidance you need to improve your accounting preparation and procedures.

- Practice Aid *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* (product no. 006701kk). Authoritative guidance on cash- and tax-basis financial statements is rather vague and leaves a great deal to professional judgment. Section One of this publication provides nonauthoritative, practical guidance on preparing and reporting on cash- and tax-basis financial statements. Section Two includes example financial statements, disclosures, and other engagement practice aids. The Appendix provides an example checklist to be used for cash- and tax-basis financial statements.

AICPA reSOURCE: Online Accounting and Auditing Literature

.191 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's 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 and Techniques*. To subscribe to this essential online service for accounting professionals, go to cpa2biz.com.

Educational Courses

.192 The AICPA has developed a number of continuing professional education (CPE) courses that are valuable to CPAs working in the construction industry. Those courses include:

- *Construction Contractors: Accounting, Auditing and Tax* (product no. 736429kk). 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. 731991kk). Delve beyond the basics of many issues the construction industry brings to the accounting profession. 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.

- *Construction Contractors Strategic Briefing* (CD-ROM of Webcast originally presented on November 4, 2004) (product no. 780034kk). This course provides a strategic look at what's important in the area of construction contractors. The program addresses the current economic and industry environment, the regulatory environment, current accounting developments, current auditing developments, and what's on the horizon that could affect this industry segment.

- *Real Estate Accounting and Auditing* (product no. 730604kk). This course provides an in-depth study of the unique requirements that apply at each stage of the real estate life cycle. It gives practical, how-to-do-it coverage of accounting considerations related to the development, ownership, and operation of real estate assets.

.193 Accountants in the construction industry, as well as in other industries, may also find the following courses helpful:

- *FASB Review for Industry* (2005-2006 edition) (product no. 730562kk). Comprehensive coverage of recent FASB, AcSEC, IASB, and EITF pronouncements is provided in this course geared to the specific interests of the CPA in corporate management.

- *Accounting Update: A Review of Recent Activities* (2005 Edition) (product no. 732761kk). This course keeps you current and shows you how to apply the most recent financial accounting and reporting standards. Highlights include FASB Interpretation No. 46 on variable interest entities, fair value concepts and measurements, and the revised FASB Statement No. 123 on share-based payment.

- *AICPA's Annual Accounting and Auditing Update Workshop* (2005 edition) (product no. 736181kk, text; also available in video and DVD formats with a manual). 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.
- *Accounting for Income Taxes: Applying SFAS No. 109* (product no. 732790kk). No other area in accounting is as far reaching, and requires knowledge of a vast number of topics in financial and tax accounting, as accounting for deferred taxes. This course addresses the application of this complex standard to many common differences between financial accounting and tax compliance. You will gain a sound knowledge of the theory of deferred taxes and how this theory can be applied to practical situations. Many practical examples are included to illustrate the theory, and the information is presented so you will be able to apply this theory to any other situation that you may encounter.
- *The AICPA's Guide to Business Consolidations, Goodwill and Other Consolidation Issues* (product no. 735129kk). Learn how FASB Statements No. 141 and No. 142 have changed the rules for business combinations and goodwill accounting. Develop standards for applying purchase accounting and how to allocate the acquired entity now that it's the only game in town under FASB Statement No. 141. Identify variable interest entities' impact under FASB Interpretation No. 46(R). Learn how FASB Statement No. 142 deals with goodwill from initial recognition to the annual impairment review requirements.

.194 For a listing of additional courses available please download the *Fall/Winter 2005 AICPA CPE Catalog* at http://media.cpa2biz.com/Publication/05_fall_winter_FINAL.pdf. You can also check at www.cpa2biz.com/CPE/default.htm for availability of a more recent catalog.

Online CPE

.195 AICPA InfoBytes, offered exclusively through CPA2Biz.com, is the AICPA's flagship online learning product. Selected as one of *Accounting Today's* top 100 products for 2003, AICPA InfoBytes now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 ($369 nonmembers) for a new subscription and $119 ($319 nonmembers) for the annual renewal. Divided into one- and two-credit courses that are available 24/7, AICPA InfoBytes offers hundreds of hours of learning in a wide variety of topics. To register or learn more, visit www.cpa2biz.com/infobytes.

Webcasts

.196 Stay plugged in to what's 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 on the discussion. If you can't make the live event, each Webcast is archived and available on CD-ROM.

CFO Quarterly Roundtable Series

.197 The CFO Roundtable Webcast Series—brought to you each calendar quarter—is designed to cover 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

.198 The SEC Quarterly Update Webcast Series—brought to you each calendar quarter—showcases the profession's leading experts on what's "hot" at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and CorpFin activities, these hard-hitting sessions will keep you "plugged-in" to what's important. A must for both 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 Satisfaction Center

.199 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.

Technical Hotline and Ethics Hotline

.200 Do you have a complex technical question about GAAP, other comprehensive bases of accounting (OCBOA), or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with their answer. You can reach the Technical Hotline at (888) 777-7077.

.201 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.

Conferences

.202 Among the many interesting conferences the AICPA offers, there is one that might interest you. Held late each fall, the AICPA National Construction Industry Conference presents a comprehensive program revealing latest trends and developments in the construction industry. The conference offers a national perspective and addresses the newest trends in conducting business, among other topics.

.203 For additional information, contact CPA2Biz at its Web site, www.cpa2biz.com.

Web Sites[1]

AICPA Online and CPA2Biz

.204 Here is a unique opportunity to stay abreast of matters relevant to the CPA profession! AICPA Online, at www.aicpa.org, informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, www.cpa2biz.com offers you all the latest AICPA products, including more than 15 Audit Risk Alerts, more than 20 Audit and Accounting Guides, the professional standards, and CPE courses.

.205 *Construction Contractors Industry Developments* will be published annually. As you encounter accounting or industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Alert would also be appreciated. You may e-mail these comments to ymishkevich@aicpa.org or write to:

Yelena Mishkevich
AICPA
Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881

[1] Additional helpful Web sites are presented in the Appendix.

.206

Appendix

Helpful Web Sites

Here are some useful Web sites that may provide valuable information. In addition to these Web sites, be sure to review those listed in the "On the Horizon" section of this Alert.

General Web Sites of Interest

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
AuditNet	Electronic communications among audit professionals	www.auditnet.org
CPAnet	Links to other Web sites of interest to CPAs	www.cpalinks.com/
Accountant's Home Page	Resources for accountants and financial and business professionals	www.computercpa.com/
U.S. Tax Code Online	A complete text of the U.S. Tax Code	www.fourmilab.ch/ustax/ustax.html
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
Ask Jeeves	Search engine that uses a user-friendly question format and provides simultaneous search results from other search engines (e.g., Excite, Yahoo, AltaVista)	www.askjeeves.com
Governmental Accounting Standards Board	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org
Society of Industrial and Office Realtors	Industrial and office real estate information	www.sior.com
Engineering News Record	Source of important information for owners, contractors, and design and engineering professionals	www.enr.com

(continued)

Name of Site	*Content*	*Internet Address*
Construction.com	A McGraw-Hill company that unifies the resources of Dodge, Sweets, *Architectural Record*, ENR, and Regional Publications and includes market analysis and forecasting, industry trends, and insights	www.construction.com
Associated Builders and Contractors	A national association representing all specialties within the construction industry and primarily comprising firms that perform work in the industrial and commercial sectors of the industry	www.abc.org
Associated General Contractors of America	An organization of qualified construction contractors and industry-related companies	www.agc.org
Construction Financial Management Association	The only nonprofit organization dedicated to serving the construction financial professional	www.cfma.org
Construction Industry Compliance Assistance Center	The source for plain language explanations of environmental rules for the construction industry	www.cicacenter.org
Construction Owners Association of America	A focal point and voice for the interests of owners in the construction industry	www.coaa.org
Contractor's License Reference Site	Information about state license requirements, with search functions to find out if a contractor is licensed in a particular state	www.contractors-license.org/index.html
Home Builders Institute	Dedicated to the advancement and enrichment of education and training programs serving the needs of the housing industry	www.hbi.org
National Association of Home Builders	A trade association that helps promote the policies that make housing a national priority	www.nahb.org
National Association of the Remodeling Industry	Focusing on educating both trade professionals and remodeling-ready homeowners through a variety of formats including education, training, publications, and programs	www.nari.org
Disaster Contractors Network	Facilitating information sharing and resource matching among government, the construction community, and home and business owners before, during, and after disasters strike	www.dcnonline.org

[*The next page is 8311*.]

AAM Section 8100

Investment Companies Industry Developments—2006/07

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

NOTICE TO READERS
INVESTMENT COMPANIES INDUSTRY DEVELOPMENTS—2006/07

This Audit Risk Alert, prepared by the AICPA staff, is intended to provide auditors of financial statements of investment companies with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform.

This publication is an *Other Auditing Publication* as defined in 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 Statements on Auditing Standards (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.

Maryann Kasica, CPA
Technical Manager
Accounting and Auditing Publications

Acknowledgments

The AICPA staff wishes to thank Brian Gallagher, Richard Grueter, Gregory M. Levy, Aaron Masek, Brent D. Oswald, Irina Portnoy, and Maryna P. Tully for their assistance and contributions in the review of this Audit Risk Alert.

How This Alert Helps You

.01 This Audit Risk Alert helps you plan and perform your investment companies industry audits. The knowledge delivered by this Alert assists you in achieving a more robust understanding of the business and economic environment in which your clients operate. This Alert is an important tool in helping you identify the significant risks that may result in the material misstatement of your client's financial statements. Moreover, this Alert delivers information about emerging practice issues and information about current accounting, auditing, and regulatory developments.

.02 If you understand what is happening in the investment companies industry, and you can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert assists you in making considerable strides in gaining that industry knowledge and understanding it.

.03 This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2006/07* (product no. 022337kk).

.04 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, *Illegal Acts by Clients*, is referred to as AU section 317 of the AICPA *Professional Standards*.

> **Help Desk—**See the AICPA Audit Risk Alert *SEC and PCAOB Alert—2006/07* (product no. 022497kk) for a thorough discussion of recent Securities and Exchange Commission (SEC) and Public Company Accounting Oversight Board (PCAOB) developments.
>
> **Help Desk—**AICPA Audit Risk Alerts can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

Economic and Industry Developments[1]

.05 AU section 311A, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1) and AU section 311 (AICPA, *PCAOB Standards and Related Rules*), among other matters, provide guidance for auditors regarding the specific procedures to be considered in planning an audit. AU section 311A.07 (AICPA, *Professional Standards*, vol. 1) and AU section 311.07 (AICPA, *PCAOB Standards and Related Rules*), state that the auditor should obtain a knowledge of matters that relate to the nature of the entity's business, its organization, and its operating characteristics, and consider matters affecting the industry in which the entity operates, including, among other matters, economic conditions as they relate to the specific audit. For audits of financial statements for periods beginning on or after December 15, 2006, refer to AU section 311 (AICPA, *Professional Standards*, vol. 1). Also, paragraph 2.140 in the Audit and Accounting Guide *Investment Companies*[2] states that economic conditions in the jurisdictions in which funds invest may affect the auditor's assessment of inherent risk for assertions in investment companies' financial statements. Factors that auditors should consider include local rates of inflation, government stability, and local tax rules. Discussed below are recent developments for you to consider as you plan and perform your audits. Auditors should consider whether the current economic and business environment increases the risk for misstatement of reported investment results in order to achieve performance expectations, exceed benchmarks, earn performance-based fees, and/or gain competitive advantage.

.06 The AICPA general *Audit Risk Alert—2006/07*(product no. 022337kk) discusses current business and economic developments, along with risks and issues, and some of the audit considerations associated with those developments. That Alert generally discusses developments of broad interest to auditors. You will need to identify those developments that could have implications for your investment company client audits.

.07 Among the economic developments in 2006 that may be of particular interest for investment companies are:

- After continuing to raise the target federal funds rate through June of 2006 to 5.25 percent, the Federal Reserve kept the rate unchanged through the remainder of 2006. After moving higher earlier in 2006, yields on 10-year Treasury notes fell in the latter part of 2006, then moved higher again during January 2007.
- The Dow Jones Industrial Average reached a new high in 2006, closing over 12,000 for the first time. The performance of foreign stock markets generally exceeded that of the U.S. stock markets.

---

[1] Refer to the full text of the accounting and auditing standards and other guidance discussed in this Alert, as well as the full text of any rules, releases, or publications that are discussed in this Alert. Be alert for updates, amendments, or other changes and developments. The brief summaries provided in this Alert are for informational purposes only.

[2] References in this section of this Alert to the Audit and Accounting Guide *Investment Companies* are to the May 1, 2006, edition of that Guide.

Emerging markets performed particularly well. In U.S. dollar terms, foreign stock market performance was further enhanced by the strengthening value of many foreign currencies relative to the U.S. dollar.

- Funds that are focused on energy-related investments may be negatively affected by volatility in the energy markets in 2006 and price declines during recent months for crude oil and natural gas.
- The housing market is slowing. Consider its effect, combined with the effects of the increases in interest rates in 2006, as discussed above, on mortgage lending and the many businesses that are dependent on the housing market. For example, if your investment company clients invest in collateralized mortgage obligations or other mortgage-backed securities, consider whether the value and performance of those investments may be affected by an increase in mortgage delinquencies and foreclosures. The Audit Risk Alert *Bank, Credit Union, and Other Depository and Lending Institution Industry Developments—2006/07* (product no. 022297kk) provides further discussion about mortgages, including nontraditional mortgage products, noting that some mutual fund managers are cutting back on investments in mortgage-backed securities.
- There was significant buyout and merger activity and a number of public companies announced they were going private. Massive amounts of debt, in the form of both bank loans and bonds, are normally needed to finance the deals. High-yield debt funds, bank loan funds, and hedge funds often are purchasers of such debt. In some instances, the values of debt previously issued by the public company going private and held by various fixed-income funds decrease significantly upon the announcement of the going-private transaction, in consideration of the leverage being added to the issuer's capital structure.

Redemption Fees

.08 The SEC adopted new rules and rule amendments in 2005 and 2006 for investment companies and advisers that address mutual fund redemption fees. The rulemaking is discussed in the "Regulatory Developments" section of this Alert. Be alert for any changes to your clients' operating, accounting, and reporting procedures to comply with new regulations. Investment companies with multiple class structures may have boards that have approved charging redemption fees to address market timing. You may need to consider if the client has appropriately applied redemption fees in the multiple-class structure.

Financial Instruments

.09 Your clients in the investment companies industry may be purchasers or writers of complex financial instruments, including derivative financial instruments that are based on interest rates, to meet their investment objectives and to provide investors with the returns they seek. Chapter 3 of the Audit and Accounting Guide *Investment Companies* provides brief descriptions about certain financial instruments used by investment companies. The discussion "Investments" in the "Audit and Accounting Issues and Developments" section of this Alert lists sources of auditing and accounting guidance that may be helpful when auditing financial instruments.

.10 Financial instruments other than those described in Chapter 3 of the Guide have come into increased use by investment companies. Two of those types of financial instruments, Treasury inflation protected securities (TIPS) and credit default swaps, are briefly discussed below.

.11 TIPS are a specialized form of indexed securities issued by the U.S. government. TIPS pay a coupon rate of interest and index their contractual principal based on a recognized measure of inflation, but cannot decrease below their original par value. Foreign governments and some private concerns have issued securities with similar, though not necessarily identical, terms. Example 25: Inflation Bond, in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, paragraph 191, illustrates the application of FASB Statement

No. 133 to investments in TIPS. Under the guidance, the indexing of the contractual principal is a derivative that is considered clearly and closely related to the host debt instrument and should not be separated from the host. Since an investment company is required to remeasure investments at fair value with changes in fair value recorded through earnings, an investment company would not bifurcate the embedded derivative regardless of whether it is clearly and closely related to the host contract. See paragraph 12(b) of FASB Statement No. 133.

.12 A credit default swap (also known as credit derivative) is a form of swap contract. Under the terms of a credit default swap, one party agrees to make payments, usually ratably over the swap term but occasionally including an up-front payment, in exchange for the agreement by the counterparty to pay an agreed-upon value (usually par) for a debt instrument of a specified issuer, should the issuer enter into an event of default (as specified in the contract) during the swap term. Investment companies may purchase credit default swaps ("purchase protection") to hedge existing holdings, and may write swaps ("offer protection") as a means of creating a synthetic debt position in an underlying issuer with a term equal to that of the swap. They may also purchase or write swaps as a means to speculate on changes in creditworthiness of particular issuers. FASB Emerging Issues Task Force (EITF) Issues No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities," and No. 03-11, "Reporting Realized Gains and Losses on Derivative Instruments That Are Subject to FASB Statement No. 133 and Not 'Held for Trading Purposes' as Defined in Issue No. 02-3," provide accounting and financial reporting guidance for swaps, including credit default swaps.

Mergers of Funds

.13 Mergers and acquisitions of investment advisers increased substantially in 2006. There has been a similar upswing in the numbers of mergers of investment companies during 2006, as advisers consolidate investment company offerings, a typical result of adviser mergers, and other advisers continue efforts to eliminate funds that are not successful in the marketplace. You can find guidance about fund mergers in the section "Business Combinations" in Chapter 8 of the Audit and Accounting Guide *Investment Companies*. Paragraph 8.34 in the Guide states that a registration statement on SEC Form N-14 is filed in connection with a fund merger. Form N-14 contains information about the companies involved in the transaction, historical financial statements, pro forma financial statements, and additional pro forma financial information. Form N-14 instructions and Article 11 of Regulation S-X, as well as prior SEC "Dear CFO" letters,[3] may assist in understanding the requirements for pro forma financial statements and additional pro forma financial information in merger proxy statement and prospectus filings.

Hedge Fund Use of Side Pocket Arrangements

.14 Many hedge funds have adopted or expanded their use of side pocket arrangements. Side pockets are used typically to segregate investments in illiquid or restricted securities. Ownership of the side pocket is attributed on a pro rata basis to investors in the general fund at the time the side pocket arrangement is adopted. Subsequent investors in the general fund do not participate in the side pocket's performance. Investors with side pocket ownership cannot redeem their side pocket investments. Generally, side pocket investments are only liquidated upon a sale or other disposition of the investment, and only at the time of such a realization event does the general partner of the hedge fund generally take any performance fee or allocation.

.15 Side pocket arrangements raise a number of considerations for auditors. Management's determination of the fair value of the underlying investments may be subject to greater judgment than the fair value determination for other investments. Consider the controls over the valuation process and the expertise and

[3] You can obtain certain Securities and Exchange Commission (SEC) Division of Investment Management staff letters to the chief financial officers of investment company registrants and their independent public accountants on the SEC Web site at www.sec.gov/divisions/investment.shtml.

knowledge of those determining fair values. You can find auditing guidance that may assist you when auditing valuation of investments in Chapter 2 in the Audit and Accounting Guide *Investment Companies*. Also, be alert for the adoption or expanded use of side pocket arrangements and determine whether they are properly accounted for and disclosed in the financial statements, as, for example, when auditing accruals and expenses for performance fees and incentive allocations, and financial highlights disclosures in the financial statements, particularly total return and expense ratios. Consider the particular circumstances of the client to identify the specific accounting and auditing issues.

Performance Fees

.16 Performance-based advisory fees continue to be a focus of regulatory scrutiny for registered investment companies. In September 2006, the SEC announced the settlement of five enforcement actions for the computation of performance-based advisory fees in a manner contrary to the requirements of the Investment Advisers Act of 1940 (Advisers Act).[4]

.17 Be alert for changes to investment advisory contracts and the computation of performance-based advisory fees. Fund management and boards of directors may have intensified their scrutiny of the procedures used by registered investment companies to compute performance-based advisory fees for conformity with related laws and regulations. Refer to Rules 205-1 and 205-2 under the Advisers Act that govern performance-based compensation under advisory contracts. Consider the guidance in AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards,* vol. 1; AICPA, *PCAOB Standards and Related Rules*), on the auditor's responsibilities when a possible illegal act is discovered. The term "illegal acts" for purposes of AU section 317 (AICPA, *Professional Standards,* vol. 1; AICPA, *PCAOB Standards and Related Rules*), refers to violations of laws or governmental regulations. AU section 317.08 (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), provides guidance for inquiries of management concerning the client's compliance with laws and regulations. AU section 317.10 (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), provides guidance for consulting with the client's legal counsel or other specialists about the application of relevant laws and regulations to the circumstances and the possible effects on the financial statements.

New Pronouncements and Other Guidance[5]

Recent Auditing and Attestation Pronouncements and Related Guidance

.18 Presented below is a list of auditing, attestation, and related guidance issued since the writing of last year's Alert.[6] The AICPA general *Audit Risk Alert—2006/07* (product no. 022337kk) presents brief information about selected guidance listed. Guidance of particular interest for the investment companies industry is discussed in this section of this Alert. 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/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/ and the PCAOB Web site at www.pcaobus.org (applicable to audits conducted in accordance with PCAOB Standards).

.19 As a reminder, SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards,* vol. 1, AU sec. 339), which was discussed in last year's Alert, is effective for audits of periods ending on or after December 15, 2006.

---

[4] You can obtain the SEC releases regarding the administrative proceedings, dated September 7, 2006, on the SEC Web site at www.sec.gov/litigation/admin.shtml.

[5] See footnote 1 in this Alert.

[6] This list of standards and other guidance in this section of the Alert includes guidance that may not apply to investment companies.

.20 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 Audit and Attest Standards Team and available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Opinion/.

SAS Nos. 104 through 111	See the discussion "The Risk Assessment Standards" in this section of the Alert.
SAS No. 112	*Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325) See the discussion "SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit*" in this section of the Alert.
SAS No. 113	*Omnibus—2006* SAS No. 113 amends SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150); SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316); SAS No. 101, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1, AU sec. 328); SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341); SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342); SAS No. 1, section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1, AU sec. 560); and SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333).
SAS No. 114	*The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380) SAS No. 114 supersedes SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380A), as amended. SAS No. 114 amends SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341A), as amended, and SAS No. 108, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311).
Statement on Standards for Attestation Engagements (SSAE) No. 14	*SSAE Hierarchy* SSAE No. 14 (AICPA, *Professional Standards*, vol. 1, AT sec. 50), identifies the body of attestation literature and clarifies the authority of attestation publications issued by the AICPA and others.

Conforming Amendments	Chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting" (AICPA, *Professional Standards*, vol. 1, AT sec. 501) of SSAE No. 10, *Attestation Standards: Revision and Recodification*
Statement of Position (SOP) 06-1	*Reporting Pursuant to the Global Investment Performance Standards* See the discussion "SOP 06-1, *Reporting Pursuant to the Global Investment Performance Standards*" in this section of the Alert.
Audit Guide	*Assessing and Responding to Audit Risk in a Financial Statement Audit*
AICPA Technical Practice Aid (TPA) 8100.01 (nonauthoritative)	"Determining the Effective Date of a New Statement on Auditing Standards for Audits of a Single Financial Statement"
AICPA TPA 8100.02 (nonauthoritative)	"Determining the Effective Date of a New Statement on Auditing Standards for Audits of Interim Periods"
AICPA TPA 9510.03 (nonauthoritative)	"Reporting on New York State Medicaid Cost Reports"
AICPA Practice Aid for Auditors (nonauthoritative)	*Alternative Investments—Audit Considerations* See the discussion "Practice Aid *Alternative Investments—Audit Considerations*" in this section of the Alert.
PCAOB Auditing Standard No. 4	*Reporting on Whether a Previously Reported Material Weakness Continues to Exist* (Applicable to audits conducted in accordance with PCAOB Standards)
PCAOB Conforming Amendment to AT section 101	*Conforming Amendments to PCAOB Auditing and Related Professional Practice Standards Resulting from the Adoption of the Auditing Standard No. 4—Reporting on Whether a Previously Reported Material Weakness Continues to Exist* (Applicable to audits conducted in accordance with PCAOB Standards)
PCAOB Staff Questions and Answers	*Adjustments to Prior-Period Financial Statements Audited By a Predecessor Auditor* (Applicable to audits conducted in accordance with PCAOB Standards) See the discussion "PCAOB Staff Questions and Answers" in this section of the Alert.

(continued)

PCAOB Staff Questions and Answers	*Auditing the Fair Value of Share Options Granted to Employees* (Applicable to audits conducted in accordance with PCAOB Standards)
COSO document	*Internal Control Over Financial Reporting—Guidance for Smaller Public Companies*

Auditing Standards Available on AICPA and PCAOB Web Sites

.21 The standards and interpretations promulgated by the Auditing Standards Board (ASB) are available free of charge by visiting the AICPA Audit and Attest Standards Team's page on the AICPA Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/. Members and nonmembers alike can download the auditing, attestation, and quality control standards by choosing a section of the codification. 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.

> **Help Desk—**See the AICPA publication *AICPA Professional Standards* (product no. 005106kk) for AICPA professional standards applicable to nonpublic companies. *PCAOB Standards and Related Rules* (product no. 057199kk), developed by the AICPA, offers a comprehensive source of PCAOB Standards.

.22 The PCAOB has published its interim standards for audits conducted in accordance with PCAOB Standards on its Web site (www.pcaobus.org).

> **Help Desk—**See the AICPA Audit Risk Alert *SEC and PCAOB Alert—2006/07* (product no. 022497kk) for a thorough discussion of recent PCAOB developments including an update on new PCAOB pronouncements and other issuances.

The Risk Assessment Standards

.23 The ASB issued eight SASs that provide extensive guidance concerning the auditor's assessment of the risks of material misstatement in a financial statement audit, and the design and performance of audit procedures whose nature, timing, and extent are responsive to the assessed risks. Additionally, the SASs establish standards and provide guidance on planning and supervision, the nature of audit evidence, and evaluating whether the audit evidence obtained affords a reasonable basis for an opinion regarding the financial statements under audit. The following table lists the eight SASs, and their effect 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)	Amends SAS No. 1, section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230), as amended

SAS No. 105, *Amendment to Statement on Auditing Standards No. 95*, Generally Accepted Auditing Standards (AICPA, *Professional Standards*, vol. 1, AU sec. 150)	Amends SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150), as amended
SAS No. 106, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1, AU sec. 326)	Supersedes SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326A), as amended
SAS No. 107, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312)	Supersedes SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312A), as amended
SAS No. 108, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311)	Supersedes SAS No. 1, section 310, *Appointment of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1, AU sec. 310), as amended, and supersedes SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311A), as amended
SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314)	Together with SAS No. 110, supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended
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)	Supersedes "Substantive Tests Prior to the Balance-Sheet Date" of SAS No. 45, *Omnibus Statement on Auditing Standards—1983* (AICPA, *Professional Standards*, vol. 1, AU sec. 313), as amended; 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), as amended
SAS No. 111, *Amendment to Statement on Auditing Standards No. 39*, Audit Sampling (AICPA, *Professional Standards*, vol. 1, AU sec. 350)	Amends SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350), as amended

.24 The SASs emphasize the linkage between understanding the entity, assessing risks, and the design of further audit procedures. The SASs introduce the concept of risk assessment procedures, which are deemed necessary to provide a basis for assessing the risk of material misstatement. Risk assessment procedures along with further audit procedures, which consist of tests of controls and substantive tests, provide the audit evidence to support the auditor's opinion on the financial statements. According to the SASs, the auditor should perform risk assessment procedures to gather information and gain an understanding of the entity and its environment, including its internal controls; these procedures include inquiries, analytical procedures, and inspection and observation. Assessed risks and the basis for those assessments should be documented; therefore, auditors may no longer default to maximum control risk for an entity's risk assessment without documenting the basis for that assessment. The SASs also require auditors to consider and document how the risk assessment at the financial statement level affects individual financial statement assertions, so that auditors may tailor the nature, timing, and extent of their audit procedures to be responsive to their risk assessment. It is anticipated that generic audit programs will not be appropriate for all audit engagements, as risks vary between entities.

.25 The SASs are effective for audits of financial statements for periods beginning on or after December 15, 2006; earlier application is permitted. In most cases, implementation of the SASs will result in an overall increased work effort by the audit team, particularly in the year of implementation. 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.

.26 The AICPA has published the Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk) and the Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (product no. 012456kk) to assist in the implementation of the risk assessment standards.

SAS No. 112, Communicating Internal Control Related Matters Identified in an Audit

.27 SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), 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*. SAS No. 112 applies whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion). SAS No. 112 defines the terms *significant deficiency* and *material weakness*. SAS No. 112 requires that auditors (1) evaluate identified control deficiencies and determine whether these deficiencies, individually or in combination, are significant deficiencies or material weaknesses, and (2) 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.

.28 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 and/or review of the preparation of financial statements.
- 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.

.29 SAS No. 112 is effective for audits of financial statements for periods ending on or after December 15, 2006. Earlier implementation is permitted. The AICPA has published the Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk) to assist in the implementation of SAS No. 112.

SOP 06-1, Reporting Pursuant to the Global Investment Performance Standards

.30 The CFA Institute (formerly known as the Association for Investment Management and Research [AIMR®]) developed the AIMR Performance Presentation Standards (AIMR-PPS® standards) and the

Global Investment Performance Standards (GIPS® standards)[7] (collectively, the performance standards). Although compliance with the performance standards is voluntary, an investment management firm's claim of compliance with the performance standards is widely regarded as providing a competitive advantage. As of January 1, 2006, the AIMR-PPS standards converged with the GIPS standards and the AIMR-PPS standards no longer exist as a separate set of standards.[8]

.31 AICPA SOP 06-1, *Reporting Pursuant to the Global Investment Performance Standards*, provides guidance to practitioners for engagements to examine and report on aspects of a firm's compliance with the GIPS standards (a verification engagement); and on engagements to examine and report on the performance presentation of specific composites (a performance examination). Such examination engagements should be performed pursuant to AT section 101, *Attest Engagements* (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*). AT section 101 (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*) permits the practitioner to report either on the assertions or directly on the subject matter to which the assertions relate.

.32 Illustrative attest reports, an example engagement letter, and an example representation letter are presented in the appendixes of SOP 06-1, including:

- Appendix A, "Example Engagement Letter: Verification and Performance Examination"
- Appendix B, "Example Management Representation Letter: Verification and Performance Examination"
- Appendix C, "Illustrative Attest Reports: Verification"
- Appendix D, "Illustrative Attest Reports: Verification and Performance Examination"
- Appendix F, "Illustrative Attest Reports: Successor Practitioner Report—Verification and Performance Examination"

.33 SOP 06-1 was issued in April 2006 and is effective upon issuance. SOP 06-1 supersedes SOP 01-4, *Reporting Pursuant to the Association for Investment Management and Research Performance Presentation Standards*.

Practice Aid Alternative Investments—Audit Considerations

.34 Investment companies, including funds of funds, may have investments for which a readily determinable fair value is not available. Such investments may be structured as limited partnerships, limited liability corporations, trusts, and corporations. They can include private investment funds that meet the definition of an investment company in the Audit and Accounting Guide *Investment Companies*, such as hedge funds, private equity funds, real estate funds, venture capital funds, commodity funds, offshore fund vehicles, and funds of funds, as well as bank common/collective trust funds.

.35 The Practice Aid *Alternative Investments—Audit Considerations* addresses the challenges associated with auditing such investments, referred to in the Practice Aid as alternative investments, focusing on the

---

[7] The phrase "Association for Investment Management and Research Performance Presentation Standards" is abbreviated in this Alert as the AIMR-PPS standards. The phrase "Global Investment Performance Standards" is abbreviated in this Alert as the GIPS standards. For information on the appropriate use of the AIMR-PPS and/or GIPS registered trademark, see the CFA Institute Web site www.cfainstitute.org.

[8] Investment management firms (referred to as "firms" in Statement of Position (SOP) 06-1, *Reporting Pursuant to the Global Investment Performance Standards*; see paragraph 9 of SOP 06-1 regarding the definition of a "firm") may continue to claim compliance with the AIMR-PPS standards on presentations that include performance through December 31, 2005. Once a firms performance presentation includes results for periods that begin after December 31, 2005, the firm may no longer claim compliance with the AIMR-PPS standards. All firms that previously claimed compliance with the AIMR-PPS standards are granted reciprocity for GIPS compliance for periods prior to January 1, 2006.

existence and valuation assertions associated with alternative investments. You can obtain the Practice Aid on the AICPA Web site at www.aicpa.org. Certain guidance in the Practice Aid is briefly discussed below.

.36 The auditor's consideration of the existence assertion would typically include confirming with the fund manager the investor entity's interest in the fund. In Appendix 1 of the Practice Aid, you will find an example confirmation for alternative investments. If a confirmation request is not returned to the auditor or details of the underlying investments are not otherwise provided, the auditor performs alternative procedures that are directed toward assessing the existence of the alternative investments. Depending upon the significance of the alternative investments to the investor's financial statements, it may be necessary for the auditor to perform additional alternative audit procedures, which may include:

- Observing management site visits or telephone calls to investee funds.
- Reviewing executed partnership, trust, limited liability corporation, or similar agreements.
- Inspecting other documentation supporting the investor's interest in the fund.
- Reviewing periodic statements from the fund or trustee.
- Vouching relevant cash receipts and disbursements.

.37 Management's responsibility for the valuation of alternative investment amounts as presented in the financial statements cannot under any circumstances be outsourced or assigned to a party outside of the investor entity's management. When alternative investments are accounted for at fair value, the valuation assertion may involve significant judgment by management in the assessment of the fair value of the investment. The auditor's consideration of the valuation assertion typically begins with understanding the process used by the investor entity's management to develop fair value estimates and the established controls relative to those estimates. An auditor may test management's fair value estimate as of the balance sheet date by using one or more of the following approaches:

- Confirm the alternative investment.
- Review and test the investor entity's significant assumptions and the underlying data in its valuation or its analysis of the assumptions and data obtained from the fund manager.
- Reconcile to audited financial statements as of the same date.
- Review transactions at or near the balance sheet date.

.38 If management estimates the fair value of a significant portion of the alternative investments as of an interim date, management needs a robust process and strong internal control over the roll-forward period to the balance sheet date. The auditor tests both the estimation process as of the interim date and the roll-forward process.

.39 As the inherent uncertainty in management's estimate of fair value increases, as well as the significance of the alternative investments to the financial statements, auditors may consider including an emphasis of matter paragraph in the auditor's report, such as the emphasis of matter paragraph illustrated in the Practice Aid, tailored for the specific facts and circumstances. Such paragraphs are not required and are included solely at the auditor's discretion.

.40 If the auditor is unable to obtain sufficient appropriate audit evidence to support the financial statement assertions, it will be necessary to qualify or disclaim an opinion on the financial statements due to a scope limitation. AU section 508.22–.26, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), provides guidance in determining the appropriate form of opinion. Scope limitations related to the sufficiency of evidence are different from situations in which the auditor concludes that the financial statements are materially misstated due to departures from generally accepted accounting principles (GAAP) related to inadequate disclosure of uncertainties inherent in the investment valuations, failure to apply a valuation method required by GAAP, or valuations that are not supported or are not reasonable. If the potential affect of a GAAP departure is material to the investor entity financial statements taken as a whole, the auditor issues a qualified opinion or an adverse opinion as described in AU section 508.35–.49 (AICPA *Professional Standards*, vol. 1).

PCAOB Staff Questions and Answers

.41 The PCAOB staff issued Questions and Answers *Adjustments to Prior-Period Financial Statements Audited By a Predecessor Auditor*. Topics addressed in the document include:

- How a predecessor auditor dates a report on reissued financial statements if the predecessor auditor audits the adjustments to the prior-period financial statements.
- Successor auditor responsibility with regard to adjustments if the predecessor auditor audits the adjustments made to prior-period financial statements.
- Factors relevant to a successor auditor to determine whether to audit only the adjustments to prior-period financial statements or whether a reaudit of the financial statements is necessary.

.42 Reporting examples are provided with certain answers. You can obtain the Questions and Answers on the PCAOB Web site at www.pcaobus.org.

Recent Independence and Ethics Pronouncements

.43 See the AICPA *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 including an update on new independence and ethics pronouncements. Also, see the discussion "Registration of Hedge Fund Advisers" in the "Securities and Exchange Commission Developments" section of this Alert.

Recent Accounting Pronouncements and Related Guidance

.44 Presented below is a list of accounting pronouncements and other guidance issued since the writing of last year's Alert.[9] The AICPA general *Audit Risk Alert—2006/07* (product no. 022337kk) presents brief information about selected guidance listed. Guidance of particular interest for the investment companies industry is discussed in this section of this Alert. For information on accounting standards and other accounting guidance 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 of Financial Accounting Standards No. 155	*Accounting for Certain Hybrid Financial Instruments* (an amendment of FASB Statements No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*)
FASB Statement No. 156	*Accounting for Servicing of Financial Assets* (an amendment of FASB Statement No. 140)

(continued)

[9] The list of pronouncements and other guidance in this section of the Alert includes guidance that may not apply to investment companies.

FASB Statement No. 157	*Fair Value Measurements* See the discussion "FASB Statement No. 157, *Fair Value Measurements*" in this section of the Alert.
FASB Statement No. 158	*Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* (an amendment of FASB Statements No. 87, *Employers' Accounting for Pensions*, No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, and No. 132 (revised 2003), *Employers Disclosures' about Pensions and Other Postretirement Benefits*)
FASB Interpretation No. 48	*Accounting for Uncertainty in Income Taxes* (an interpretation of FASB Statement No. 109, *Accounting for Income Taxes*) See the discussion "FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*" in this section of the Alert.
FASB Emerging Issues Task Force (EITF) Issues Go to www.fasb.org/eitf/ for a complete list of EITF Issues.	• Issue No. 05-1, "Accounting for the Conversion of an Instrument That Became Convertible upon the Issuer's Exercise of a Call Option" • Issue No. 05-7, "Accounting for Modifications to Conversion Options Embedded in Debt Instruments and Related Issues" (modified) • 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" • Issue No. 06-2, "Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43" • Issue No. 06-3, "How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation)" • Issue No. 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements" • Issue No. 06-5, "Accounting for Purchases of Life Insurance—Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4"

	• Issue No. 06-6, "Debtor's Accounting for a Modification (or Exchange) of Convertible Debt Instruments" • Issue No. 06-7, "Issuer's Accounting for a Previously Bifurcated Conversion Option in a Convertible Debt Instrument When the Conversion Option No Longer Meets the Bifurcation Criteria in FASB Statement No. 133" • Issue No. 06-8, "Applicability of the Assessment of a Buyer's Continuing Investment under FASB Statement No. 66 for Sales of Condominiums" • Issue No. 06-9, "Reporting a Change in (or the Elimination of) a Previously Existing Difference between the Fiscal Year-End of a Parent Company and That of a Consolidated Entity or between the Reporting Period of an Investor and That of an Equity Method Investee"
FASB Staff Positions (FSPs) Go to www.fasb.org/ fasb_staff_positions/ for a complete list of FSPs.	• FSP No. FAS 13-2, "Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease Transaction" • FSP No. FAS 123(R)-4, "Classification of Options and Similar Instruments Issued as Employee Compensation That Allow for Cash Settlement upon the Occurrence of a Contingent Event" • FSP No. FAS 123(R)-5, "Amendment of FASB Staff Position FAS 123(R)-1" • FSP No. FAS 123(R)-6, "Technical Corrections of FASB Statement No. 123(R)" • FSP No. FAS 126-1, "Applicability of Certain Disclosure and Interim Reporting Requirements for Obligors for Conduit Debt Securities" • FSP No. FIN 46(R)-6, "Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R)" • FSP No. FTB 85-4-1, "Accounting for Life Settlement Contracts by Third-Party Investors" • FSP No. AUG AIR-1, "Accounting for Planned Major Maintenance Activities" • FSP No. EITF 00-19-2, "Accounting for Registration Payment Arrangements" See the discussion "FSP No. FTB 85-4-1, 'Accounting for Life Settlement Contracts by Third-Party Investors'" in this section of the Alert.

(continued)

AICPA TPA 1400.29 (nonauthoritative)	"Consolidated Versus Combined Financial Statements Under FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities*"
AICPA TPA 1400.30 (nonauthoritative)	"Stand-Alone Financial Statements of a Variable Interest Entity"
AICPA TPA 1400.31 (nonauthoritative)	"GAAP Departure for FIN No. 46(R)"
AICPA TPA 1400.32 (nonauthoritative)	"Parent-Only Financial Statements and Relationship to GAAP"
AICPA TPA 1500.06 (nonauthoritative)	"Application of FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities*, to Income Tax Basis Financial Statements"
AICPA TPA 2130.36 (nonauthoritative)	"Impact on Cash Flows on a Group of Loans Accounted for as a Pool in Accordance With SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*, if There Is a Confirming Event, and One Loan Is Removed as Expected"
AICPA TPA 2130.37 (nonauthoritative)	"Impact on Cash Flows on a Group of Loans Accounted for as a Pool in Accordance With SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*, if There Is a Confirming Event, One Loan Is Removed From the Pool, and the Investor Decreases Its Estimate of Expected Cash Flows"
AICPA TPA 2210.28 (nonauthoritative)	"Accounting for Certain Liquidated Damages"
AICPA TPA 5700.01 (nonauthoritative)	"Income Tax Accounting for Contributions to Certain Nonprofit Scholarship Funding Organizations"
AICPA TPAs 6910.21 through 6910.24 (nonauthoritative)	See the discussion "Nonauthoritative TPAs for Investment Companies" in this section of the Alert.

FASB Statement No. 157, Fair Value Measurements[10]

.45 FASB Statement No. 157, *Fair Value Measurements*, establishes a framework for measuring fair value in GAAP and requires expanded disclosures about fair value measurements. FASB Statement No. 157 applies under other accounting pronouncements that require or permit fair value measurement and does not require any new fair value measurements. FASB Statement No. 157 emphasizes that fair value is a market-based measurement. Appendix D of FASB Statement No. 157 lists Accounting Principles Board and FASB pronouncements that refer to fair value.

[10] See footnote 2 of this Alert.

.46 *Fair value* is defined in FASB Statement No. 157, paragraph 5, 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. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities. The definition of fair value also should be applied to instruments measured at fair value that are classified in stockholders' equity. A fair value measurement is for a particular asset or liability and should consider attributes specific to the asset or liability.

.47 A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability, which is the market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity. In the absence of a principal market, a fair value measurement assumes a sale of an asset or transfer of a liability occurs in the most advantageous market, which is the market in which the asset would be sold with a price that maximizes the amount received or the liability transferred with a price that minimizes the amount paid. Transaction costs are not an attribute of the asset or liability and are accounted for according to the provisions of other accounting pronouncements and not as an adjustment of the price.

.48 A fair value measurement for an asset assumes the highest and best use of the asset by market participants. The highest and best use of the asset establishes the in-use or in-exchange valuation premise used to measure the fair value of the asset. A fair value measurement for a liability assumes that the liability is transferred to a market participant at the measurement date. The nonperformance risk (the risk that the obligation will not be fulfilled) relating to the liability is the same before and after its transfer. A reporting entity considers the effect of its credit risk on the fair value of the liability in all periods in which the liability is measured at fair value.

.49 At initial recognition of an asset or a liability, the reporting entity determines whether the transaction price represents fair value, considering factors specific to the transaction and the asset or liability. FASB Statement No. 157 nullifies the guidance in footnote 3 of 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."

.50 Valuation techniques consistent with the market approach, income approach, and/or cost approach that are appropriate in the circumstances and for which sufficient data are available are used to measure fair value. A single valuation technique will be appropriate in some cases and multiple valuation techniques will be appropriate in others. Valuation techniques shall be consistently applied. A change in the valuation technique may be appropriate and revisions in valuations resulting from a change are accounted for as a change in accounting estimate.

.51 The fair value hierarchy established by FASB Statement No. 157 prioritizes the inputs to valuation techniques used to measure fair value into three broad levels:

1. *Level 1 inputs*. Quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. A quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available, with exceptions.
   - — If the reporting entity holds a large number of similar assets or liabilities that are required to be measured at fair value, a quoted price in an active market might be available but not readily accessible for each asset or liability individually. Fair value may be measured using an alternative pricing method such as matrix pricing.
   - — A quoted price in an active market might not represent fair value, for example, if significant events occur after the close of a market but before the measurement date. Reporting entities should establish and consistently apply a policy for identifying those events that might affect fair value measurements.

In either case, any alternative pricing methods used do not necessarily constitute Level 1 inputs. As discussed in FASB Statement No. 157, paragraph 25, the use of an alternative pricing method renders the fair value measurement a lower level measurement.

2. *Level 2 inputs*. Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. 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, and market-corroborated inputs.

3. *Level 3 inputs*. Unobservable inputs that are developed based on the best information available in the circumstances, which might include the reporting entity's own data.

.52 Level 1, Level 2, and Level 3 inputs based on bid and ask prices shall use the price within the bid-ask spread that is most representative of fair value in the circumstances. FASB Statement No. 157 does not preclude using mid-market pricing or other pricing conventions as a practical expedient. Bid-ask spread pricing methods appropriate under SEC Accounting Series Release 118 are appropriate under FASB Statement No. 157. See paragraph C91 of FASB Statement No. 157.

.53 FASB Statement No. 157, paragraph 27, prohibits the use of a blockage factor to value positions in financial instruments, which can be traded on an active market, 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. The quoted price shall not be adjusted because of the size of the position in a financial instrument relative to trading volume. The guidance applies for positions in financial instruments (including blocks) held by all entities, including investment companies within the scope of the Audit and Accounting Guide *Investment Companies*. "Standstill" provisions on current accounting practice permitted under the Audit and Accounting Guide *Investment Companies* for measurement of blocks for certain investment companies are discussed in the "Notice to Readers" section and in footnote 20 to Chapter 2, "Investment Accounts," in the Guide.

.54 The expanded disclosures about fair value measurement are provided in FASB Statement No. 157, paragraphs 32 through 35. Reporting entities are required to disclose information that enables financial statement users to assess the inputs used to develop fair value measurements. Reporting entities are encouraged, but not required, to combine fair value information disclosed under FASB Statement No. 157 with the fair value information disclosed under other accounting pronouncements, if practicable.

.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. Earlier application is encouraged, provided the reporting entity has not issued financial statements, including interim financial statements, for that fiscal year. An investment company within the scope of the Audit and Accounting Guide *Investment Companies* shall apply FASB Statement No. 157 retrospectively, as of the beginning of the fiscal year in which FASB Statement No. 157 is initially applied, to a position held in a financial instrument that trades in an active market and that was measured at fair value using a blockage factor prior to initial application of FASB Statement No. 157. At initial application, a difference between the carrying amounts and the fair values of those instruments is recognized as a cumulative-effect adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that fiscal year, presented separately. FASB Statement No. 154, *Accounting Changes and Error Corrections*, disclosure requirements for a change in accounting principle do not apply.

FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes

.56 FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, an Interpretation of FASB Statement No. 109, *Accounting for Income Taxes*, 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. Guidance is provided on derecognition, classification, interest and penalties, unrecognized tax benefits, accounting in interim periods, disclosures, and transition. FASB Interpretation No. 48 applies to registered investment companies whose tax liability is subject to 100 percent credit for dividends paid and potentially subject to income taxes.

.57 A two-step process that separates recognition from measurement is required. In the first step, an enterprise determines whether a tax position has met the recognition threshold. The enterprise determines whether it is more likely than not, based on the technical merits, that the position will be sustained upon examination, including resolution of any related appeals or litigation processes. *More likely than not* in FASB Interpretation No. 48 means a likelihood of more than 50 percent. Presume that the tax position will be examined by the relevant taxing authority that has full knowledge of all relevant information. The second step is measuring a tax position that meets the recognition threshold. A tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information. Measurement of a tax position that meets the more-likely-than-not recognition threshold shall consider the amounts and probabilities of the outcomes that could be realized upon ultimate settlement using the facts, circumstances, and information available at the reporting date. Previously recognized tax positions are derecognized in the first period in which it is no longer more likely than not that the tax position would be sustained upon examination. Use of a valuation allowance is not an appropriate substitute for the derecognition of the 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 FASB Interpretation No. 48.

.58 When tax law requires payment of interest on an underpayment of income taxes, interest expense is recognized in the first period the interest would begin accruing according to the provisions of the relevant tax law. If a tax position does not meet the minimum statutory threshold to avoid payment of penalties, an expense for the amount of statutory penalty is recognized in the period in which the enterprise claims or expects to claim the position in the tax return. If penalties were not recognized when the position was initially taken, the expense is recognized in the period in which the enterprise's judgment about meeting the minimum statutory threshold changes.

.59 If the more-likely-than-not recognition threshold is not met in the period for which a tax position is taken or expected to be taken, the benefit of the tax position is recognized in the first interim period that meets any one of three conditions:

1. The more-likely-than-not recognition threshold is met by the reporting date.
2. The tax matter is ultimately settled through negotiation or litigation.
3. The statute of limitations for the relevant taxing authority to examine and challenge the tax position has expired.

.60 Previously recognized interest and penalties associated with tax positions that subsequently meet one of the three conditions are derecognized in the period that condition is met.

.61 Required disclosures include the policy on classification of interest and penalties, a tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the period, and the total amounts of interest and penalties recognized in the statement of operations and in the statement of financial position.

.62 FASB Interpretation No. 48 is effective for fiscal years beginning after December 15, 2006. Earlier adoption is permitted as of the beginning of the enterprise's fiscal year, provided the enterprise has not issued financial statements, including interim financial statements, for that fiscal year.

.63 The AICPA "Practice Guide on Accounting for Uncertain Tax Positions Under FIN 48" presents a summary of FASB Interpretation No. 48, as well as related accounting, auditing, and tax issues. You can obtain the Practice Guide on the AICPA Web site at www.aicpa.org.

.64 The December 22, 2006, SEC staff "Letter to ICI re: Implementation of FASB Interpretation No. 48" provides the investment companies industry with guidance for applying FASB Interpretation No. 48. The letter is available on the SEC Web site at www.sec.gov/divisions/investment/letter_mutual_fund_fin_48.htm. A brief discussion of the SEC staff letter is presented below. See also the discussion "SEC Staff Reviews of Financial Statements" in the "Regulatory Developments" section of this Alert.

.65 The informal guidance of the taxing authority is often an important form of evidence when assessing the technical merits of a tax position. The provisions of FASB Interpretation No. 48 permit, and necessitate, the consideration of such informal guidance. Pursuant to paragraph 7(b) of FASB Interpretation No. 48, administrative practices and precedents of the taxing authority should be considered in a fund's analysis. Funds can, and should, consider the taxing authority's practice of addressing fund industry issues on a prospective basis as part of the administrative practices and precedents of the taxing authority. When performing this analysis pursuant to paragraph 7(a) of FASB Interpretation No. 48, a fund must presume that the tax position will be examined by a taxing authority that has knowledge of all relevant information. FASB Interpretation No. 48 should not be read to limit the types or forms of evidence that may be considered.

FSP No. FTB 85-4-1, "Accounting for Life Settlement Contracts by Third-Party Investors"

.66 FSP No. FTB 85-4-1, "Accounting for Life Settlement Contracts by Third-Party Investors," provides initial and subsequent measurement guidance and financial statement presentation and disclosure guidance for investments by third-party investors in life settlement contracts. Transactions in which a broker facilitates settlement transactions between the policy owner and the investor, and transactions that do not involve a broker, are addressed.

.67 An investor may elect to account for investments in life settlement contracts using either the investment method or the fair value method. Elections are irrevocable and are made on an instrument-by-instrument basis. Investments that are remeasured at fair value are reported by investors on the face of the statement of financial position separately from those accounted for under the investment method. Investment income from investments in life settlement contracts that are remeasured at fair value and investment income from those life settlement contracts accounted for under the investment method are reported separately on the face of the income statement. Cash receipts and cash payments related to life settlement contracts are classified pursuant to FASB Statement No. 95, *Statement of Cash Flows*, based on the nature and purpose for which the life settlements were acquired.[11] FSP No. FTB 85-4-1 requires certain disclosures, including disclosure of the investor's accounting policy for life settlement contracts and disclosures for the fiscal period of adoption.

.68 FSP No. FTB 85-4-1 shall be applied to fiscal years beginning after June 15, 2006. Earlier application is permitted as of the beginning of the investor's fiscal year, provided that the investor has not yet issued its first quarter financial statements for that fiscal year.

Nonauthoritative TPAs for Investment Companies

.69 AICPA TPA 6910.21, "Recognition of Premium/Discount on Short Positions in Fixed-Income Securities," provides that when recognizing interest expense on short positions, an investment company should recognize all economic elements of interest, including premium and discount. Chapter 2 in the Audit and

[11] Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale*, exempts investment companies meeting certain conditions from the requirements of FASB Statement No. 95, *Statement of Cash Flows*.

Accounting Guide *Investment Companies* requires that investment companies amortize premiums and discounts on their investments, referring to long positions, but is silent as to whether similar accounting is required for short positions.

.70 AICPA TPA 6910.22, "Presentation of Reverse Repurchase Agreements," provides that investment companies should present liabilities for reverse repurchase agreements in their financial statements at amounts payable. A reverse repurchase agreement denominated in a currency that differs from the reporting currency should be translated at the current exchange rate.

.71 AICPA TPA 6910.23, "Accounting Treatment of Offering Costs Incurred by Investment Partnerships," provides that an investment partnership that continually offers its interests should defer offering costs incurred prior to the commencement of operations and then amortize them to expense over the period that it continually offers its interests, up to a maximum of 12 months. The straight-line method of amortization should generally be used. If the offering period terminates earlier than expected, the remaining deferred balance should be charged to expense.

.72 AICPA TPA 6910.24, "Meaning of Continually Offer Interests," provides guidance for how an investment partnership should determine if it continually offers its interests.

Audit and Accounting Issues and Developments[12]

Investments in Inverse Floaters

.73 Your investment company clients may make investments in municipal inverse floaters. They have been widely used by mutual funds and other investment companies over many years under various names: tender option bonds, RITES, RIBs, and DRIVERS, among others. Some of these investments are initiated with a transaction involving the transfer of municipal bonds from the investment company client. Consider whether these transfers of municipal bonds should be accounted for as secured borrowings rather than sales according to FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

Audit and Accounting Guide *Investment Companies*

.74 The Audit and Accounting Guide *Investment Companies* is updated periodically with conforming changes to reflect the issuance of new authoritative pronouncements and regulatory developments. The most recent update of the Guide was prepared to reflect conforming changes as of May 1, 2006 (product no. 012625kk). Conforming changes to the 2006 edition of the Guide include:

- Update of Chapter 7 to discuss the guidance in FSP Nos. 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 financial statement presentation and disclosure guidance in FSP Nos. AAG INV-1 and SOP 94-4-1 is effective for financial statements for annual periods ending after December 15, 2006. Investment portfolio disclosures resulting from the adoption of the FSP are discussed in "Investments" in this section in this Alert. When implementing the guidance in FSP Nos. AAG INV-1 and SOP 94-4-1, note that paragraph 11 requires disclosure of a reconciliation between the beginning and ending balance of the amount presented on the statement of assets and liabilities that represents the difference between net assets reflecting all investments at fair value and net assets for each period in which a statement of changes in net assets is presented. To be considered within the scope of FSP Nos. AAG INV-1 and SOP 94-4-1 as of the effective date and thereafter, any portion of the investment company's net assets

[12] See footnote 1 in this Alert.

attributable to a particular plan investee that is not held in trust in a qualified employer-sponsored defined-contribution plan for the benefit of participants is not permitted to increase after January 15, 2006, except for reinvestment of income earned.

- Addition of footnote 32 to paragraph 7.85 to inform readers that the AICPA has released nonauthoritative TPAs 6910.16 through 6910.20 that address nonregistered investment partnership financial statement presentation and disclosures.

- Addition of paragraph 11.07 (for nonregistered investment companies) and paragraph 11.11 (for registered investment companies) to illustrate the optional wording that may be added to reports in accordance with AU section 9508.85–.88, "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 section 9508.85–.88 (AICPA, *Professional Standards*, vol. 1), provides for audits of nonissuers an example of additional language that may be added to an auditor's standard report to explain that an audit includes consideration of internal control over financial reporting as a basis for designing audit procedures but not for the purpose of expressing an opinion on the effectiveness of internal control over financial reporting.

- Presentation in paragraph 11.19 of the revised illustrative report that the AICPA Investment Companies Expert Panel developed to replace the illustrative "Report on Internal Control Required by The SEC Under Form N-SAR."

- Addition of a new section, "Reporting Pursuant to the Global Investment Performance Standards," to Chapter 11 to reflect the guidance in SOP 06-1. The new section replaces the section "Reporting Pursuant to the Association for Investment Management and Research Performance Presentation Standards." See the related discussion "SOP 06-1, *Reporting Pursuant to the Global Investment Performance Standards*" in the "New Pronouncements and Other Guidance" section of this Alert.

- Addition of new Appendix G, "References to AICPA Technical Practice Aids."

.75 The Guide is an interpretive publication. It is the ASB'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 where none exists. See the "Notice to Readers" in the Guide, AU section 120, *Defining Professional Requirements in Statements on Auditing Standards* (AICPA, *Professional Standards*, vol. 1), and AT section 20, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (AICPA, *Professional Standards*, vol. 1).

Investments[13]

Significance to the Overall Audit

.76 An investment company's securities portfolio typically comprises substantially all its net assets. Accordingly, the audit of an investment company's investment accounts is a significant portion of the overall audit because of the relative significance of those accounts and of the related income accounts. Auditors may identify changes to the operations and procedures for investment valuation. In particular, investment companies may have implemented operational and procedural changes for valuing investments in foreign securities following the focus in recent years by the SEC and by investors on market timing in funds investing overseas.

Guidance for Auditing Investments

.77 In the table that follows, you will find brief summaries of selected auditing guidance for consideration when auditing investment accounts.

---

[13] See footnote 2 in this Alert.

Paragraphs 2.99 through 2.183 of the Audit and Accounting Guide *Investment Companies*	Guidance on auditing procedures for investment accounts. Among the matters discussed are the principal objectives in auditing the investment accounts, consideration of internal control, and examination of transactions and detail records, including portfolio transactions with affiliates and the valuation of investments. The auditing procedures in paragraph 2.142 specify that the auditor should review such relevant investment company documents as the latest prospectus, statement of additional information, certificate of incorporation, bylaws, and minutes of the board of directors' and shareholders' meetings to gain an understanding of the investment company's investment objectives and restrictions, and consider whether management has a program to prevent, deter, or detect noncompliance with the investment company's investment restrictions. The auditor should also consider whether the program has identified noncompliance with the stated investment restrictions and test the operation of the program to the extent considered necessary. An investment company's failure to comply with its stated investment restrictions may be considered a possible illegal act that may have an indirect effect on the financial statements of the fund. See paragraphs 2.128 and 2.142 regarding the SEC requirement in Rule 38a-1 for appointment of a chief compliance officer responsible for administering and for reviewing annually an investment company's policies and procedures designed to prevent violation of federal securities laws. Chief compliance officers were required in 2006 to provide the first reports on the operation of the policies and procedures to fund boards.
Paragraphs 5.55 through 5.87 of the Audit and Accounting Guide *Investment Companies*	Audit considerations for complex capital structures including master-feeder funds and funds of funds.
AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*)	AU section 317 (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), prescribes the nature and extent of the consideration an independent auditor should give to the possibility of illegal acts by a client in an audit of financial statements in accordance with generally accepted auditing standards (GAAS) and provides guidance on the auditor's responsibilities when a possible illegal act is detected. Auditors may also be required, under certain circumstances, pursuant to the Private Securities Litigation Reform Act of 1995 (codified in Section 10A(b)1 of the

(continued)

	Securities Exchange Act of 1934), to make a report to the SEC relating to an illegal act that has a material effect on the financial statements. See paragraph 2.142 in the Audit and Accounting Guide *Investment Companies*.
AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*)	AU section 328 (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*) provides guidance on auditing fair value measurements and disclosures. AU section 328.23 (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*) states that based on the auditor's assessment of the risk of material misstatement, the auditor should test the entity's fair value measurements and disclosures. Substantive tests of the fair value measurements may involve (*a*) testing management's significant assumptions, the valuation model, and the underlying data, (*b*) developing independent fair value estimates for corroborative purposes, or (*c*) reviewing subsequent events and transactions.
AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*)	AU section 329 (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*) 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. For significant risks of material misstatement, AU section 329.09 (AICPA, *PCAOB Standards and Related Rules*), provides that it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient. The Audit Guide *Analytical Procedures* (with conforming changes as of May 1, 2006) (product no. 012556kk) provides practical guidance to auditors on the effective use of analytical procedures.
AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*) and the companion Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (with conforming changes as of May 1, 2006) (product no. 012526kk)	AU section 332 (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*) provides guidance to auditors in planning and performing auditing procedures for assertions about derivative instruments, hedging activities, investments in debt and equity securities, and investments accounted for under Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*. The companion Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, provides practical guidance for implementing AU section 332 (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*).

AU section 9332.01–.04, "Auditing Investments in Securities Where a Readily Determinable Fair Value Does Not Exist" (AICPA, *Professional Standards*, vol. 1)	AU section 9332.01–.04 (AICPA, *Professional Standards*, vol. 1) provides guidance for auditors of nonissuers regarding the adequacy of audit evidence, with respect to the existence and valuation assertions in AU section 332 (AICPA, *Professional Standards*, vol. 1), 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, but 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 (AICPA, *Professional Standards*, vol. 1), an auditor typically would satisfy the existence assertion through either 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. AU section 9332.01–.04 (AICPA, *Professional Standards*, vol. 1), provides illustrative examples of information auditors may receive in a third-party confirmation (in the aggregate or on a security-by-security basis), and interpretative guidance for auditors about the adequacy of audit evidence provided in those examples.
Practice Aid *Alternative Investments—Audit Considerations*	The Practice Aid is discussed in the "Recent Auditing and Attestation Pronouncements and Related Guidance" section of this Alert.
AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*)	AU section 336 (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*) provides guidance for auditors who use the work of a specialist in performing an audit in accordance with generally accepted auditing standards. The examples listed in AU section 336.07 (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), of the types of matters that the auditor may decide require him or her to consider using the work of a specialist include valuations of complex financial instruments and restricted securities.

(continued)

AU section 9508.76–.84, "Effect on Auditor's Report of Omission of Schedule of Investments by Investment Partnerships That Are Exempt From Securities and Exchange Commission Registration Under the Investment Company Act of 1940" (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*)	AU section 508.41, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), addresses the effect of inadequate disclosure of information essential for fair presentation of the financial statements on the auditor's report. AU section 508.42 (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*) provides an example of a report qualified for inadequate disclosure, assuming that the auditor has concluded that it is not practicable to present the required information and the effects are such that the auditor has concluded an adverse opinion is not appropriate. AU section 9508.81 (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*) states that the example in AU section 508.42 (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*) does not change the requirement in AU section 508.41 (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*) for the auditor to issue a qualified or adverse opinion and also to provide the missing information, if practicable. If financial statements of an investment partnership that is exempt from SEC registration do not include the required Schedule of Investments disclosures and it is practicable for the auditor to determine them or any portion thereof, AU section 9508.81 (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*) states that the auditor should include the information in his or her report expressing the qualified or adverse opinion. AU section 9508.82 (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*) states that ordinarily it would be practicable for the auditor to obtain and present the information about investments constituting more than 5 percent of net assets. However, due to the need to categorize the investments, the auditor might be in the position of preparer of financial information and, therefore, would not include the schedule in his or her report.

Accounting for Investments

.78 In the table that follows, you will find brief summaries of selected accounting guidance for consideration when auditing investment accounts.

Paragraph 1.33 in the Audit and Accounting Guide *Investment Companies* (the Guide)	The fair value of an investment is the amount at which the investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. The best evidence of fair value is the quoted market price in an active market. In the absence of a quoted market

	price, amounts representing estimates of fair values using methods applied consistently and determined in good faith by the board of directors should be used. FASB Statement No. 157 was issued in 2006 and defines fair value. FASB Statement No. 157 is discussed in the "Recent Accounting Pronouncements and Related Guidance" section of this Alert.
Paragraphs 2.19 through 2.98, and paragraph 2.179, in the Guide	Accounting guidance including methods of valuing investments, defaulted debt securities, expenditures in support of defaulted debt securities, lending of portfolio securities, and accounting for foreign investments. As discussed in paragraph 2.179, for items valued using a valuation model, the auditor should determine whether the investment company client has made appropriate disclosures about the method(s) and significant assumptions used to estimate the fair values of such investments. As discussed in paragraph 2.34, in December 2003, the SEC adopted Rule 38a-1 under the Investment Company Act of 1940. In the adopting release, the SEC stated that Rule 38a-1 requires registered investment companies and business development companies (referred to in the release as "funds") to adopt policies and procedures that require the fund to monitor for circumstances that may necessitate the use of fair value prices; establish criteria for determining when market quotations are no longer reliable for a particular portfolio security; provide a methodology or methodologies by which the fund determines the current fair value of the portfolio security; and regularly review the appropriateness and accuracy of the method used in valuing securities, and make any necessary adjustments. In April 2004, the SEC adopted rules requiring investment companies offering their shares on Forms N-1A and N-3 to provide a brief explanation in their prospectuses of the circumstances under which they will use fair value prices and the effects of using fair value pricing. FASB Statement No. 157 establishes a framework for measuring fair value in GAAP and prohibits the use of a blockage factor. FASB Statement No.157 is discussed in the "Recent Accounting Pronouncements and Related Guidance" section of this Alert.
Chapter 3 in the Guide	Chapter 3 discusses pronouncements that provide accounting and financial statement presentation guidance for various types of financial instruments.

(continued)

Paragraphs 7.14 through 7.19 in the Guide	Guidance for reporting the Schedule of Investments. Chapter 7 of the May 1, 2006, edition of the Guide was updated with conforming changes to reflect the issuance of FSP Nos. AAG-INV-1 and SOP 94-4-1. FSP Nos. AAG-INV-1 and SOP 94-4-1 requires that investment companies disclose, for fully benefit-responsive investment contracts, as part of the schedule of investments, the fair value of each investment contract, including separate disclosure of the fair value of the wrapper contract and the fair value of each of the corresponding underlying investments, if held by the fund, in that investment contract. Major credit ratings of the issuer or wrapper provider for each investment contract are disclosed as part of the schedule of investments.
FASB EITF Issues No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities," and No. 03-11, "Reporting Realized Gains and Losses on Derivative Instruments That Are Subject to FASB Statement No. 133 and Not 'Held for Trading Purposes as Defined in Issue No. 02-3'"	See the highlights of the March 10, 2004, meeting of the Investment Companies Expert Panel, available on the AICPA Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel_investco.htm. The Regulatory Update section notes that the SEC staff believes that for investment companies, all fair value adjustments for interest rate swap contracts and other derivative contracts should be reflected in unrealized appreciation/depreciation and realized gains and losses upon a realization event, including periodic payments. Periodic payments under interest rate swaps and other derivative contracts are not reported as adjustments to investment income. See the highlights of the December 2, 2003, meeting of the Investment Companies Expert Panel for information about the financial statement presentation of realized gains and losses and unrealized gains and losses by investment companies.
SEC *Codification of Financial Reporting Policies* Section 404.02, *Accounting for Interest Collected on Defaulted Bonds* Section 404.03, *Accounting, Valuation, and Disclosure of Investment Securities* Section 404.04, *Restricted Securities* Section 404.05, *Money Market Funds*	See Sections 404.03 and 404.04 for guidance on accounting, valuation, and disclosure of investment securities and on restricted securities, including the factors to be considered in, and the responsibilities for and methods used for, the valuation of securities for which market quotations are not readily available.
Regulation S-X, Article 6 and Article 12	Rules 6.03, 6.04, 6.05, 12-12, 12-12A, 12-12B, 12-12C, 12-13, and 12-14 apply to registered investment companies. Small Business Investment Companies (SBICs) are covered in Article 5. Part 107 of the Small Business Administration (SBA) rules and

	regulations includes guidance on proper techniques and standards for valuing portfolios for purposes of regulatory reporting to the SBA.
SEC Division of Investment Management staff interpretive letters:[14] — Letter from Douglas Scheidt, associate director and chief counsel, SEC Division of Investment Management, to Craig S. Tyle, Investment Company Institute, December 8, 1999 (1999 Letter). — Letter from Douglas Scheidt, associate director and chief counsel, SEC Division of Investment Management, to Craig S. Tyle, Investment Company Institute, April 30, 2001 (2001 Letter).	The 1999 Letter clarified that market quotations for portfolio securities are not readily available when the exchanges or markets on which those securities trade do not open for an entire day, and that funds accordingly must price those securities based on a determination of fair value; provided additional guidance regarding the process of fair value pricing; described certain factors that funds should consider when pricing portfolio securities at fair value; and discussed the obligations of fund boards of directors for pricing portfolio securities at fair value and measures that boards may take when discharging those responsibilities. The 1999 Letter reaffirmed that SEC Accounting Series Releases No. 113 and No. 118 continue to represent the views of the SEC on securities valuation. The 2001 Letter stated the SEC staff's views on the obligations of funds and their directors under the Investment Company Act of 1940 to determine in good faith the fair value of the funds' portfolio securities when market quotations are not readily available, as well as other topics, such as the valuation of securities traded on foreign exchanges and the inappropriate use of fair value pricing for securities for which market quotations are readily available.
SEC Release No. IC-26418, *Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings*	Requires investment companies offering their shares on Forms N-1A and N-3 to provide a brief explanation in their prospectuses of the circumstances under which they will use fair value prices and the effects of using fair value pricing.

Investment Strategies Achieved by Funds Investing in Other Funds[15]

.79 A recent development in the investment companies industry is the increase in the number of registered funds that invest in another fund as regulations evolve to permit such investment activity. Funds might achieve their investment strategy by investing most of their investable assets in another fund or other funds, commonly referred to as a *fund of funds structure*. Fund of funds structures may provide for consolidation and greater efficiency in investment of a certain asset class.

.80 Accounting and auditing guidance for funds of funds is found in Chapter 5, "Complex Capital Structures," in the Audit and Accounting Guide *Investment Companies*. Consider whether recent industry developments regarding the use of funds of funds may indicate the existence of auditing issues in addition to those addressed in that guidance. Some examples of additional audit issues to consider are:

[14] You can obtain these documents on the SEC Web site at www.sec.gov.

[15] See footnote 2 in this Alert.

- To the extent an investor fund invests in a number of nonaffiliated investment companies, what audit procedures should the auditor perform on investee fund financial information that is included in the investor fund financial statements?
- What procedures should an auditor of a fund of registered funds perform when auditing the valuation of the underlying funds that are managed by an affiliated entity, especially if the year-ends differ or the affiliated funds are audited by another firm?
  - — How are audit procedures for auditors of nonissuers affected by AU section 9332.01–.04 (AICPA, *Professional Standards*, vol. 1)?
  - — Can the audited financial statements of the investee funds be utilized as audit evidence to the extent the fiscal years of the investee funds and the investor fund correspond?
- Are there concerns for a principal auditor if most of the assets of the investor fund are invested in investee funds that are audited by other audit firms?
- For a registered fund of funds in which the investee fund shares are held by a transfer agent, should the wording of the audit opinion that refers to the confirmation process be modified? What are the audit considerations if the transfer agent and the investee funds are affiliated with the investor fund?

.81 See the discussion "Securities and Exchange Commission Developments" in this Alert for information about recent rulemaking for fund of funds investments.

Regulatory Developments[16]

.82 In this section of the Alert, we briefly summarize selected regulatory developments since the writing of last year's Alert that have particular interest for auditors and their clients in the investment companies industry. See the "Information Sources" table at the end of this Alert for a list of some Web sites that can provide additional information on regulatory developments.

Securities and Exchange Commission Developments[17]

.83 The complete text of SEC final rules discussed in this section of this Alert, rules adopted subsequent to the writing of this Alert, proposed rules, and other information about SEC regulations and developments can be obtained from the SEC Web site at www.sec.gov.

Final Rules

.84 Brief summaries about final rules released by the SEC since the writing of last year's Alert and that are of particular interest for the investment companies industry are provided in this section of the Alert.

- *Rulemaking for EDGAR System* (Releases No. IC-26990A, No. 33-8590A, and No. 34-52052A). Last year's Alert discussed a final SEC rule (see SEC Release No. IC-26990) that expands the information that certain investment company filers are required to submit to the SEC through the Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system. The SEC made technical corrections in 2006 to Part 232 of Regulation S-T. Effective date: February 8, 2006. The final rule was published in the February 14, 2006, *Federal Register*.
- *Technical Amendments to Form ADV, Form ADV-W, Form ADV-H, Form ADV-E* (Release No. IA-2504). The SEC issued technical amendments to Form ADV, Form ADV-W, and Form ADV-E to reflect the addition of the U.S. Virgin Islands to the group of states with investment adviser statutes. Technical

[16] See footnote 1 in this Alert.

[17] See footnote 2 in this Alert.

amendments to Form ADV and Form ADV-H update the SEC mailing address. Effective date: April 7, 2006. The final rule was published in the April 6, 2006, *Federal Register*.

- *Fund of Funds Investments* (Releases No. IC-27399 and No. 33-8713). Historically, Section 12(d) of the Investment Company Act of 1940 (the 1940 Act) limits a registered investment company's ability to invest in other investment companies. Except for a limited number of registered funds that receive exemptive orders from the SEC, such fund of funds structures have been limited to unregistered investment companies. Section 12(d) was amended in 1996 to permit registered investment companies to invest in other investment companies provided that both the investor and investee funds were part of the same group of investment companies (affiliated funds). See paragraph 5.22 in the Audit and Accounting Guide *Investment Companies*. In 2006, the SEC adopted the following three new rules under Section 12(d):

  — *Rule 12d1-1: Exemptions for investments in money market funds.* Rule 12d1-1 provides exemption from Section 12(d)(1), Section 17(a), Section 57, and Rule 17d-1 under the 1940 Act, and is designed to permit cash sweep arrangements. If specified conditions are satisfied, investment companies, including business development companies and other closed-end investment companies, are permitted to invest an unlimited amount of uninvested cash in shares of money market funds in the same fund complex or a different fund complex, rather than directly in short-term investments. The investment would have to be consistent with the fund's investment objectives and policies. The acquired fund may be an unregistered money market fund that operates like a money market fund registered under the 1940 Act. The final rule permits unregistered funds to invest their cash in shares of a registered money market fund and eliminates most conditions included in SEC exemptive orders. One condition that was retained precludes the acquiring fund from paying a sales load, distribution fee, or service fee on acquired fund shares. Effective date: July 31, 2006.

  — *Rule 12d1-2: Exemptions for investment companies relying on Section 12(d)(1)(G) of the Act*. Rule 12d1-2 codifies and expands three types of relief provided for affiliated funds of funds. First, Rule 12d1-2(a)(1) permits an affiliated fund of funds to acquire securities of funds that are not part of the same group of investment companies, subject to Section 12(d)(1)(A) or Section 12(d)(1)(F) limits. Second, Rule 12d1-2(a)(2) provides an exemption from Section 12(d)(1)(G) of the 1940 Act to permit an affiliated fund of funds to invest, consistent with the fund's investment policies, directly in securities not issued by a fund. Third, Rule 12d1-2(a)(3) permits an affiliated fund of funds to invest in affiliated or unaffiliated money market funds in reliance on Rule 12d1-1. The investor fund must comply with the conditions in Rule 12d1-1. Effective date: July 31, 2006.

  — *Rule 12d1-3: Exemptions for investment companies relying on Section 12(d)(1)(F) of the Act*. A registered investment company relying on Section 12(d)(1)(F) to invest all its assets in other registered investment companies is allowed under Rule 12d1-3 to charge sales loads greater than 1 percent, provided that the aggregate sales load any investor pays does not exceed the limits on sales loads in Rule 2830 of the Conduct Rules of the National Association of Securities Dealers for funds of funds. Effective date: July 31, 2006.

  The SEC amended Form N-1A,[18] Form N-2,[19] Form N-3,[20] Form N-4,[21] and Form N-6[22] to require disclosures about acquired fund expenses in the fee table. The disclosures are required for all new registration statements and all post-effective amendments that are annual updates to effective registration statements on those forms filed on or after January 2, 2007. The final rule was published in the June 27, 2006, *Federal Register*.

---

[18] See Form N-1A, Item 3. Risk/Return Summary: Fee Table.

[19] See Form N-2, Item 3. Fee Table and Synopsis.

[20] See Form N-3, Item 3. Synopsis or Highlights.

[21] See Form N-4, Item 3. Synopsis.

[22] See Form N-6, Item 3. Risk/Benefit Summary: Fee Table.

- *Executive Compensation and Related Person Disclosure* (Releases No. IC-27444A and No. 33-8732A). The SEC amended the required disclosures for executive and director compensation,[23] related person transactions,[24] director independence and other corporate governance matters,[25] and security ownership of officers and directors,[26] in proxy and information statements, periodic and current reports, and other filings with the SEC.[27] The amendments change the persons covered by disclosure requirements, and the threshold for disclosure in proxy and information statements and registration statements, of certain interests, transactions, and relationships of directors, raising it from $60,000 to $120,000.[28] Amended disclosures generally have to be provided in plain English. Information that registered investment companies (other than business development companies) previously were required to provide under Item 7 of Schedule 14A is now required by Item 22(b) of Schedule 14A. Conforming amendments were made to Form N-CSR to add cross references to Item 407 of Regulation S-K and to Item 22(b)(15) of Schedule 14A. Business development companies are required to apply the same disclosure requirements for executive compensation that were adopted for operating companies in Item 402 of Regulation S-K.[29] This includes providing a Compensation Discussion and Analysis, and Summary Compensation Table, and covering the same persons as operating companies in compensation disclosure. Disclosure of compensation of members of the advisory board or certain affiliated persons is no longer required in registration statements. Business development companies are also not required to include compensation from the "fund complex" in proxy and information statements and registration statements. Effective date: November 7, 2006. Registered investment companies have to comply with the disclosure requirements in initial registration statements and post-effective amendments that are annual updates to effective registration statements on Form N-1A, Form N-2 (except those filed by business development companies), and Form N-3, and in any new proxy or information statements that are filed on or after December 15, 2006. For business development companies, Form 10-K compliance is required for fiscal years ending on or after December 15, 2006. For proxy and information statements, compliance is required for any new proxy or information statement filed on or after December 15, 2006. The final rule was published in the September 8, 2006, *Federal Register*. The SEC requested additional comment about proposed compensation disclosures for up to three additional highly compensated employees. See Release No. 33-8735.

- *Mutual Fund Redemption Fees* (Release No. IC-27504). Funds are required by Rule 22c-2 under the 1940 Act, which was adopted in 2005, to enter into written agreements with their financial intermediaries that require the intermediaries to provide the funds with access to information about certain shareholder identity and transaction information, regardless of whether the fund imposes a redemption fee. Each fund determines when it should receive that information.[30] The compliance date for Rule 22c-2 was October 16, 2006. The SEC revised Rule 22c-2 in 2006. The definition of "financial intermediary" was amended to limit the types of intermediaries with which funds must enter into shareholder information agreements by excluding from that definition any entity that the fund treats as an "individual investor" for purposes of the fund's policies intended to eliminate or reduce

---

[23] See Item 402 of Regulation S-K. In December 2006, the SEC issued interim final rules together with a request for further comments. See SEC Release No. 33-8765.

[24] See Item 404 of Regulation S-K.

[25] See new Item 407 of Regulation S-K.

[26] See Item 403 of Regulation S-K.

[27] See the release for a complete list of amendments.

[28] See Schedule 14A, Item 22(b)(7), Item 22(b)(8), and Item 22(b)(9); Form N-1A, Item 12(b)(6), Item 12(b)(7), and Item 12(b)(8); Form N-2, Item 18.9, Item 18.10, and Item 18.11; and Form N-3, Item 20(h), Item 20(i), and Item 20(j).

[29] Business development companies are required to respond to Item 11 of Form 10K, Items 7, 8, and 22(b) of Schedule 14A, and new Item 18.14 of Form N-2. Business development companies no longer have to respond to Schedule 14A, Item 22(b)(13) and to Form N-2, Item 18.13.

[30] The requirements of Rule 22c-2 do not apply to (1) money market funds, (2) funds that issue securities that are listed on a national securities exchange, and (3) funds that affirmatively permit short-term trading and prominently disclose in the prospectus that short-term trading of fund shares is permitted and may result in additional costs to the fund, unless those funds elect to impose a redemption fee. See Rule 22c-2(b).

dilution of the value of fund shares (that is, frequent trading and redemption fee policies). The exclusion does not apply if a fund has not established frequent trading policies. Such funds would need to identify the shareholder accounts that are financial intermediaries. The amendments clarify the application of Rule 22c-2 to chains of intermediaries and the effect of a fund's failure to obtain an agreement with any of its intermediaries. Effective date: December 4, 2006. The compliance date by which funds must enter into shareholder information agreements with intermediaries was extended to April 16, 2007. The date by which funds must be able to request and promptly receive shareholder identity and transaction information pursuant to shareholder information agreements was extended to October 16, 2007.

- *Definition of Eligible Portfolio Company under the Investment Company Act of 1940* (Release No. IC-27538). The SEC expanded the definition of "eligible portfolio company" as part of the requirement for business development companies to invest at least 70 percent of total assets in certain specified types of companies (the 70 percent basket), with the adoption of new Rule 2a-46 and new Rule 55a-1 under the 1940 Act. New Rule 2a-46 defines eligible portfolio company to include all private domestic operating companies and those public domestic operating companies whose securities are not listed on a national securities exchange. Domestic operating companies with securities traded on the over-the-counter bulletin board and through Pink Sheets LLC qualify as eligible portfolio companies. Rule 55a-1 allows business development companies to make 70 percent basket follow-on investments in companies that met the definition of eligible portfolio company under Rule 2a-46 at the time of the business development company's initial investment(s) in them but not at the time of the follow-on investment, subject to certain conditions. Effective date: November 30, 2006. The SEC reproposed a rule for comment (see Release No. IC-27539) that would expand the definition of eligible portfolio company to include certain companies that list their securities on a national securities exchange.

- *Amendments to the Tender Offer Best-Price Rules* (Releases No. IC-27542 and No. 34-54684). The SEC amended the third-party and issuer tender offer best-price rules[31] to address the uncertainty resulting from divergent court interpretations that have employed an integral-part test or bright-line test to determine best-price rule violations, and to diminish a regulatory disincentive against structuring transactions as tender offers. Under the amendments, the best-price rules apply only to the consideration offered and paid for securities tendered in a tender offer, and not to compensatory arrangements. Consideration offered and paid according to employment compensation, severance, or other employee benefit arrangements with security holders of the subject company are not prohibited if certain requirements are met. Under an accompanying non-exclusive safe harbor, arrangements approved by certain independent directors of either the subject company's or the bidder's board of directors, or a committee performing similar functions, are not prohibited by the third-party and issuer tender offer best-price rules. A director of a registered closed-end investment company is considered to be independent if the director is not an interested person of the investment company, as defined in Section 2(a)(19) of the 1940 Act. Effective date: December 8, 2006.

- *Internet Availability of Proxy Materials* (Releases No. IC-27671 and No. 34-55146). The SEC amended its proxy rules under Section 14 of the Securities Exchange Act of 1934 (the 1934 Act) to allow companies, through a "notice and access" model, to furnish proxy materials on an Internet Web site and provide shareholders with a Notice of Internet Availability of Proxy Materials before the meeting date. A soliciting person other than the company may follow the notice and access model. Effective date: March 30, 2007.

Self-Regulatory Organization Rulemaking

.85 You can refer to the SEC Web site at www.sec.gov to obtain information about self-regulatory organization (SRO) rules approved by the SEC.

[31] See Rule 13e-4 and Rule 14d-10 under the Securities Exchange Act of 1934.

Interpretative Release

.86 The SEC released an Interpretation, *Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934* (see Release No. 34-54165), with request for comment, to provide interpretive guidance on money managers' use of client assets to pay for research and brokerage services in light of evolving technologies and industry practices under the safe harbor that is codified as Section 28(e) of the 1934 Act. Money managers include investment advisers. Conduct not protected by Section 28(e) may constitute a breach of fiduciary duty as well as a violation of federal securities laws, including the Investment Advisers Act of 1940 (Advisers Act), and the 1940 Act. The Interpretation replaces Section II and Section III of the interpretive guidance on Section 28(e) previously issued by the SEC in 1986. Effective date: July 24, 2006. Market participants may continue to rely on the SEC's prior interpretations of Section 28(e) until January 24, 2007.

Registration of Hedge Fund Advisers

.87 The requirements in Rule 203(b)(3) under the Advisers Act for SEC registration of advisers to certain private investment pools (hedge funds) became effective February 1, 2006.[32] In the June 23, 2006, decision in *Philip Goldstein, Kimball & Winthorp, Inc., and Opportunity Partners, L.P., v. Securities and Exchange Commission*, the U.S. Court of Appeals for the District of Columbia Circuit invalidated the hedge fund registration rule. The SEC did not seek an en banc review of the decision or petition the U.S. Supreme Court for a writ of certiorari (appeal the decision).[33] SEC Chairman Christopher Cox's "Testimony Concerning the Regulation of Hedge Funds" before the U.S. Senate Committee on Banking, Housing, and Urban Affairs has information about SEC initiatives for hedge funds.[34] The Investment Adviser Registration Depository (IARD) homepage has SEC Staff Guidance for interim completion of Form ADV pending IARD reprogramming to reverse Form ADV amendments that were vacated.[35] Also, see the August 10, 2006, SEC no-action letter to ABA Subcommittee on Private Investment Entities and the August 28, 2006, SEC no-action letter to Deloitte & Touche LLP.[36] The August 28, 2006, no-action letter provides certain independence transition relief for hedge funds that are managed by advisers that registered under Rule 203(b)(3) and did not choose to subsequently withdraw their registrations and accountants that audit the hedge fund financial statements for the purpose of complying with custody Rule 206-4(2) under the Advisers Act.

Investment Company Governance

.88 In 2004, the SEC amended the 10 Exemptive Rules under the 1940 Act to require that investment companies relying on those Exemptive Rules satisfy certain governance standards.[37] The amendments require that funds relying on the Exemptive Rules have boards of directors with (1) no less than 75 percent independent directors and (2) an independent chair. The Chamber of Commerce of the United States of America challenged the two requirements. In response to a remand order by the U.S. Court of Appeals for the District of Columbia Circuit in *Chamber of Commerce of the United States of America v. Securities and Exchange Commission*, the SEC considered further two deficiencies in the rulemaking that the Court identified. On June 29, 2005, by a 3-2 vote, the SEC readopted the two corporate governance requirements.[38] The Chamber of Commerce of the United States of America responded with another request to stay implementation of the requirements, which was granted by the U.S. Court of Appeals for the District of Columbia Circuit in August 2005.

---

[32] See SEC Release No. IA-2333 on the SEC Web site at www.sec.gov/rules/final/ia-2333.htm.

[33] See SEC Release No. 2006-135 on the SEC Web site at www.sec.gov/news/press/2006/2006-135.htm.

[34] You can obtain the testimony on the SEC Web site at www.sec.gov/news/testimony/2006/ts072506cc.htm.

[35] You can obtain the SEC Staff Guidance on the SEC Web site at www.sec.gov/divisions/investment/iard.shtml.

[36] You can obtain the no-action letters on the SEC Web site at www.sec.gov.

[37] See Release No. IC-26520 at www.sec.gov/rules/final/ic-26520.htm.

[38] See Release No. IC-26985 on the SEC Web site at www.sec.gov/rules/final/ic-26985.pdf for the SEC response to the remand.

.89 On April 7, 2006, the U.S. Court of Appeals for the District of Columbia Circuit vacated the two corporate governance requirements but withheld its mandate for 90 days. The SEC released a request for additional comment, *Investment Company Governance*, published in the June 19, 2006, *Federal Register*, seeking comment about the proposed rule amendments, with comments due on or before August 21, 2006. In December 2006, the SEC reopened the comment period for the amendments, to permit public comment on two papers prepared by the Office of Economic Analysis on the fund governance provisions. See Release No. IC-27600.[39]

Staff Accounting Bulletin No. 108

.90 On September 13, 2006, the 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.

.91 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.

.92 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.

.93 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 the SAB. 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.

.94 See the related discussion "Proposed FASB Guidance for Quantification of Misstatements" in the "On the Horizon" section of this Alert.

CCOutreach Program

.95 The SEC Office of Compliance Inspections and Examinations and the Division of Investment Management jointly sponsor the CCOutreach program to enable better communication of the SEC and SEC staff with mutual fund and investment adviser chief compliance officers. For information about the program visit the SEC Web site at www.sec.gov.

---

[39] You can obtain the release on the SEC Web site at www.sec.gov/rules/proposed/proposedarchive/proposed2006.shtml.

SEC Staff Reviews of Financial Statements

.96 Disclaimer: Below is a summary of financial statement review comments given by the SEC Staff (the Staff) to investment company registrants. These comments were compiled by the AICPA Investment Companies Expert Panel and have not been approved or endorsed by the SEC or its Staff.

- *Consolidation by Investment Companies.* Rule 6-03(c)(1) of Regulation S-X provides guidance relating to consolidation by registered investment companies. It states ". . . statements of the registrant may be consolidated only with the statements of subsidiaries which are investment companies." The May 1, 2006, edition of the Audit and Accounting Guide *Investment Companies* (the Guide), paragraph 7.05, states that consolidation is appropriate when "the investment company has an investment in an operating company that provides services to the investment company, for example, an investment adviser or transfer agent. In those cases, the purpose of the investment is to provide services to the investment company rather than to realize a gain on the sale of the investment." The Staff has indicated that they interpret S-X 6-03(c)(1) generally to prohibit the consolidation by a registered investment company of any entities other than registered investment companies.

  The Staff have raised particular concerns about consolidation of entities providing services to registered investment companies, because the resulting mixing of fair value accounting and historical accounting may distort the investment company's reported performance. The Staff have indicated that, pursuant to written requests citing specific facts and circumstances, they have not objected to consolidation of nonregistered investment companies that are wholly owned (or substantially wholly owned) by a registered investment company and, in certain cases, operating companies providing all or substantially all of their services or operations to a registered investment company and/or its portfolio companies. The Staff recommends that registrants seek preapproval when a registered investment company intends to consolidate an entity other than another registered investment company.

- *Fund of Funds Rule.* According to the newly adopted Fund of Funds rule, which can be found at www.sec.gov/rules/final/2006/33-8713.pdf, the prospectus fee table must contain a new line item called "Acquired Fund Fees and Expenses" (AFFE). The AFFE discloses the percentage of indirect expenses incurred by the acquiring fund when investing in one or more acquired funds, or, if less than one basis point, such percentage may be included in the "other expenses" line item within the expense table. The Staff commented that any acquiring fund investing in an acquired fund must include this disclosure, including funds that invest in exchange traded funds and money market funds. The AFFE disclosure is required only in the prospectus fee table and is not required in the expense example or the financial highlights table contained in shareholder reports. However, funds are permitted to explain the differences between the expense ratios in a footnote to their respective fee table schedules.

- *Certifications Contained in Form N-CSR.* The Staff have noted outdated certifications by the principal executive and principal financial officer contained in Form N-CSR. Such certifications are required by Rule 30a-2(a) under the Investment Company Act of 1940 (the 1940 Act). In particular, some Form N-CSR certifications did not address the effectiveness of the registrant's disclosure controls and procedures as defined in Rule 30a-3(c) under the 1940 Act. Registrants should ensure they are using the most current certifications contained in Form N-CSR.

- *Fund Mergers.* Some registrants define their expenses relating to fund mergers as extraordinary. Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions,* defines extraordinary expenses as those that meet two criteria: unusual in nature and are infrequent in occurrence. The Staff believes that merger-related expenses are not extraordinary expenses as they are not unusual or infrequent as defined in APB Opinion No. 30, and thus are not eligible for exclusion from prospectus fee tables (see, for example, Form N-1A, Item 3, Instruction 3(c)(ii)). If agreements between funds and advisers established expense caps excluding "extraordinary" expenses without further definition of the term, the Staff encourages registrants to revisit whether merger-related expenses were inappropriately defined as "extraordinary" and thereby excluded from the expense cap calculation. If management and the board intended to exclude merger-related expenses from expense caps, such exclusion should be stipulated contractually.

- *Organization Costs in Seed Financial Statements for a Closed-End Fund.* The initial filing of Form N-2 for a closed-end fund that is not a series of a larger trust generally requires an audited "seed-capital" statement of assets and liabilities with accompanying notes and in certain cases, an audited statement of operations. To the extent a closed-end fund incurs organization expenses that are not paid for and assumed by the fund sponsor or another party, the fund must present these expenses in the statement of operations for the period from the organization date through the end of the reporting period.[40] Under certain arrangements, the sponsor or another party agrees to pay for and assume only those organization and offering costs incurred by the fund which exceed a specified ceiling expressed as a per share amount. For example, an arrangement might state that the adviser will reimburse the fund for organization expenses and offering costs in excess of $0.03 per share. Although the actual amount of the organization expenses that will be borne by the fund will not be known until the initial offering has been completed, AICPA Statement of Position (SOP) 98-5, *Reporting on the Costs of Start-Up Activities*, requires organization expenses to be expensed as incurred. Offering costs, however, should be deferred and charged to paid-in capital upon the sale of shares.[41] In order to comply with SOP 98-5 when an arrangement similar to that described above exists, the sponsor may contribute additional capital to ensure the net assets do not fall below $100,000 after the fund records the organization expenses.

- *Delayed Implementation of FASB Interpretation No. 48 for NAV Calculations.* The SEC staff would not object if a fund implements FASB Interpretation No. (FIN) 48 in its net asset value per share (NAV) calculation as late as its last NAV calculation in the first required financial statement reporting period for its fiscal year beginning after December 15, 2006.[42] Calendar year-end funds, for example, are the first group of funds required to implement FIN 48 and could implement FIN 48 as late as their June 29, 2007 (the last business day of the semi-annual reporting period) NAV calculation and the effects of FIN 48 would be reflected in the fund's semi-annual financial statements contained in its Form N-CSR filing. Similarly, funds that have fiscal years ending February 28, 2007, are required to implement FIN 48 in their NAV calculation no later than August 31, 2007. Funds that have a fiscal year end of November 30, 2007, would be the last group of funds required to implement FIN 48. Therefore, those funds would have until May 30, 2008 (the last business day of the semi-annual reporting period) to implement FIN 48 in their NAV calculation.

  Help Desk—See the AICPA Audit Risk Alert *SEC and PCAOB Alert—2006/07* (product no. 022497kk) for a thorough discussion of recent SEC developments including an update on new SEC final rules and other issuances. See the "On the Horizon" section of this Alert for information about selected proposed SEC rules that may be especially relevant to the investment companies industry.

Commodity Futures Trading Commission Developments

.97 Investment partnerships that are commodity pools subject to the regulations of the Commodity Exchange Act of 1974 are required to comply with the financial reporting requirements of Part 4 of the Commodity Futures Trading Commission (CFTC) Regulations.[43] The complete text of the CFTC final rules discussed in this section of the Alert, rules adopted subsequent to the writing of this Alert, and information

---

[40] See letter from Kenneth V. Domingues, Chief Accountant, Division of Investment Management, SEC, to Chief Financial Officer (December 30, 1998) discussing "Organization Costs For Open-end Investment Companies."

[41] See paragraph 8.24 of the Guide.

[42] See letter from Conrad Hewitt, Chief Accountant and Barry Miller, Associate Director, Division of Investment Management to Mr. Paul Schott Stevens, President of the Investment Company Institute, dated December 22, 2006.

[43] Rule 4.13 and Rule 4.5 under the Commodity Exchange Act of 1974 provide for exemptions from registration under that Act.

about proposed rules, the annual letters to commodity pool operators (CPOs), and other CFTC regulations and developments can be obtained from the CFTC Web site at www.cftc.gov.

Final Rules

.98 The CFTC published the final rule *Commodity Pool Operator Electronic Filing of Annual Reports* in the February 22, 2006, *Federal Register*. It amends the following Part 4 rules for CPOs, effective March 24, 2006:

- Rule 4.7(b)(2) was amended to clarify that the account statement provided to pool participants be presented and computed in accordance with generally accepted accounting principles.
- Rule 4.7(b)(3) and Rule 4.22(c) were amended to require that registered CPOs file their commodity pool annual reports electronically with the National Futures Association (NFA) through the NFA's established electronic filing procedures.
- Rule 4.22(d) was amended to specifically state that Rule 1.16(g) is applicable to CPOs with respect to notifications of changes in independent accountants engaged for certifying commodity pool financial statements. The notification may be made solely to the NFA.
- Rule 4.22(f)(1)(ii)(B) was amended to clarify that the term "segregation" in Rule 4.22(f)(1) refers to the Rule 4.20(c) prohibition on commingling of funds of a commodity pool with the assets of any other person.
- Rule 4.22(g)(2) and Rule 4.22(g)(3) were amended to require that notifications concerning CPOs' elections of fiscal years for commodity pools other than the calendar year or subsequent changes in fiscal year-ends be solely filed with the NFA.
- Rule 4.22(h) was amended to require that the oath or affirmation on annual reports filed with the NFA must be made using electronic filing procedures.
- Rule 4.22(j) was deleted and a provision was added to Rule 4.23(a) to require that CPOs maintain in their books and records a manually signed oath or affirmation for all annual reports and account statements, and records of key financial balances submitted to the NFA.

CFTC Staff "Dear CPO" Letter

.99 On February 17, 2006, the Division of Clearing and Intermediary Oversight of the CFTC issued a letter to assist registered CPOs with preparing and filing annual financial reports required by the Commodity Exchange Act.[44] Regulatory changes affecting CPOs and reminders about requirements in response to observed common deficiencies in prior years' annual reports that are discussed in the letter include:

- Due dates of commodity pool financial filings—late filings
- Amendments to Part 4[45]
- Compliance with U.S. GAAP
- Requests for limited relief from U.S. GAAP compliance for certain offshore commodity pools
- Initial annual reports and final annual reports
- Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity

---

[44] The February 17, 2006, Commodity Futures Trading Commission (CFTC) staff "Dear CPO" Letter is available on the CFTC Web site at www.cftc.gov/files/tm/tmcpoannualguidanceletter2005.pdf. Similar letters issued in prior years are also available on the CFTC Web site at www.cftc.gov.

[45] See the discussion "Final Rules" earlier in this section of the Alert for more information about the Part 4 amendments.

- Implementation of FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*

- Reminder regarding availability of annual report information under the Freedom of Information Act

  Help Desk—See the AICPA Audit Risk Alert *Securities Industry Developments—2006/07* (product no. 022387kk) for more information about CFTC regulations and the CFTC staff "Dear CPO" letter, and for a discussion about the commodities industry.

SEC/CFTC Joint Final Rule

.100 The SEC and CFTC issued joint final rules, Application of the Definition of Narrow-Based Security Index to Debt Securities Indexes and Security Futures on Debt Securities, published in the July 13, 2006, Federal Register. Rule 6h-2 under the Securities Exchange Act of 1934 (the 1934 Act) was adopted and Rule 41.21 under the Commodity Exchange Act was amended to modify applicable statutory listing standards to permit trading of security futures based on individual debt securities that are notes, bonds, debentures, or evidences of indebtedness and indexes composed of such securities. New Rule 41.15 under the Commodity Exchange Act and new Rule 3a55-4 under the 1934 Act exclude from the statutory definition of narrow-based security index any debt securities index that satisfies certain criteria. Futures on narrow-based security indexes are subject to joint SEC and CFTC regulation. Futures on debt securities satisfying the criteria for exclusion are subject to regulation by the CFTC. Effective date: August 14, 2006.

Financial Crimes Enforcement Network Developments

.101 The complete text of the final rule and Frequently Asked Questions document discussed in this section of the Alert and other information about Financial Crimes Enforcement Network (FinCEN) developments can be obtained from the FinCEN Web site at www.fincen.gov.

Final Rule

.102 FinCEN issued a final rule, *Requirement That Mutual Funds Report Suspicious Transactions*, published in the May 4, 2006, *Federal Register*, that amends the Bank Secrecy Act regulations. Mutual funds are required to file Suspicious Activity Reports (SARs) on suspicious transactions that involve or aggregate at least $5,000 in funds or other assets. The reporting requirement is uniform with the requirements already established for other financial institutions. Four categories of transactions are specified that require reporting. Filing a single joint report is permitted in certain circumstances, such as when individual mutual funds are part of a complex and more than one mutual fund is obligated to report the same transaction or transactions. Effective date: June 5, 2006. The requirements apply to transactions occurring after October 31, 2006.

.103 FinCEN issued guidance in a Frequently Asked Questions format to assist mutual funds with applying the suspicious transaction reporting requirements.

Pension Protection Act of 2006

.104 The Pension Protection Act of 2006 (the Act) was signed into law on August 17, 2006. This comprehensive pension reform legislation aims to strengthen the federal pension insurance program and to expand and encourage participation and enrollment in retirement plans. The Act establishes, among other matters, a safe harbor to encourage automatic enrollment arrangements for defined contribution plans, allows plan fiduciaries to give investment advice to participants, makes permanent significant tax retirement savings incentives enacted under prior law, and includes provisions for default investments when a participant fails to exercise an investment election. The provisions of the Act are effective in phases, with some rules in effect in 2007 and others in 2008. For technical explanations of the provisions of the Act prepared by the staff of the Joint Committee on Taxation, visit www.house.gov/jct/x-38-06.pdf.

On the Horizon[46]

.105 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 of the accounting and auditing projects in progress. The AICPA general *Audit Risk Alert—2006/07*(product no. 022337kk) presents brief information about selected projects that may have a broad interest and are expected to result in final standards in the near future. Brief information about projects that are especially relevant to the investment companies industry is presented in this section of this Alert.

.106 Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS.

> **Help Desk—**See the AICPA Audit Risk Alert *SEC and PCAOB Alert—2006/07* (product no. 022497kk) for information about proposed SEC rules and PCAOB auditing standards on the horizon.

.107 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 (Note that for audits of public companies, the Public Company Accounting Oversight Board sets auditing standards.)	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/
Public Company Accounting Oversight Board	www.pcaobus.org
AICPA Accounting Standards Executive Committee	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/
Financial Accounting Standards Board	www.fasb.org
Professional Ethics Executive Committee	www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/

Accounting Pipeline

Proposed FASB Statement—Fair Value Option

.108 The FASB released an exposure draft of a proposed FASB Statement, *The Fair Value Option for Financial Assets and Financial Liabilities*. The proposed Statement would permit an entity to irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and financial liabilities, including debt liabilities, on a contract-by-contract basis, with changes in fair value recognized in earnings as those changes occur. The availability of that election is referred to as the fair value option. Separate presentation or parenthetical disclosure on the face of the statement of financial position would be required of assets and liabilities that are subsequently measured at fair value pursuant to the fair value option and assets and liabilities subsequently measured using another measurement attribute. The proposed Statement requires disclosures that include qualitative disclosure about the nature of significant changes in fair value

[46] See footnote 1 of this Alert.

of the financial liabilities during a period. Cash receipts and cash payments related to financial assets and liabilities measured pursuant to the fair value option would be classified in the statement of cash flows based on the nature and purpose for which the related financial assets and financial liabilities were acquired or incurred.

.109 An issuer that elects the fair value option for its debt liabilities would be required under the proposed Statement to report changes in the fair values of those liabilities, including deterioration in an issuer's own creditworthiness, as gains and losses in earnings and to provide the qualitative disclosure about the nature of significant changes in fair value during a period.

.110 At its October 18, 2006, meeting, the FASB tentatively decided that if financial assets that have been reported at fair value (with changes included in earnings) because of the nature of the subsidiary that has been holding those assets are transferred to another entity within the consolidated reporting entity for which such fair value accounting is not required, the fair value option may be elected on the date of the transfer.[47]

.111 The FASB project to consider the fair value option has two phases. The proposed FASB Statement was prepared for Phase 1 of the project. Phase 2 will address creating a fair value option for selected nonfinancial assets and liabilities. For additional updated information about the project visit the FASB Web site at www.fasb.org/project/fv_option.shtml.

Proposed FASB Statement—Derivative Disclosures

.112 The FASB released an exposure draft of a proposed FASB Statement, *Disclosures about Derivative Instruments and Hedging Activities*. The proposed Statement would amend FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, to require expanded disclosures about the effects of derivatives on an entity's financial position, how an entity uses derivatives, and how derivatives and related hedged items are accounted for. The proposed Statement, among other things, would require inclusion of a discussion about the primary risks that derivative instruments are intended to modify; disclosure about the notional amounts related to reported derivative instruments; the location and fair value amounts of derivative instruments reported in the statement of financial position; the location and amount of gains and losses reported on derivative instruments and related hedged items in the statement of financial performance and the statement of financial position, if applicable, at the end of the reporting period, as well as for derivative instruments and related hedged items that existed during the reporting period but are no longer held at the end of the reporting period; disclosures about contingent features in derivative instruments; and disclosure about counterparty credit risk, both on a gross basis and net of collateral received. For additional updated information about the project visit the FASB Web site at www.fasb.org/project/derivative_disclosures.shtml. The exposure draft of the proposed FASB Statement can be obtained on the FASB Web site at www.fasb.org.

FASB Project—Applying FASB Interpretation No. 46(R) to Investment Companies

.113 The FASB has a project to reconsider the temporary deferral of the effective date of FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, an interpretation of Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, for investment companies that are not subject to SEC Regulation S-X, Rule 6-03(c)(1) but currently account for their investments according to the

---

[47] You can obtain the October 18, 2006, FASB meeting minutes on the FASB Web site at www.fasb.org/board_meeting_minutes/10-18-06_fvo.pdf. Interaction between the proposed FASB Statement for the fair value option and the proposed SOP, *Clarification of the Scope of the Audit and Accounting Guide* Audits of Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*, was also discussed at the September 13, 2006, FASB meeting. Those meeting minutes can be obtained on the FASB Web site at www.fasb.org/board_meeting_minutes/09-13-06_acsec_fspfin46r-d.pdf. The proposed SOP, discussed later in this section of this Alert, would change current practice regarding which entities can be accounted for as investment companies. Certain financial and nonfinancial assets will need to be transferred out of investment company subsidiaries into other entities within the consolidated reporting entity prior to the SOP effective date.

specialized industry guidance in the Audit and Accounting Guide *Investment Companies*. See paragraph 36 of FASB Interpretation No. 46(R). The deferral does not extend to investments made after March 27, 2002, that are held by an investment company that is not a separate legal entity, unless those investments were acquired pursuant to an irrevocable binding commitment that existed prior to March 28, 2002.

.114 On November 22, 2006, the FASB released proposed FSP FIN 46(R)-d, "Application of FIN 46(R) to Investment Companies," which would amend FASB Interpretation No. 46(R), paragraph 4(e), to extend the current scope exception to encompass all investment companies subject to the Audit and Accounting Guide *Investment Companies*.[48] For additional updated information about the project visit the FASB Web site at www.fasb.org/project/application_fin46-r_investment_companies.shtml.

Proposed FASB Guidance for Quantification of Misstatements

.115 At the December 19, 2006, FASB meeting, the FASB reached a decision to issue guidance for nonregistrants for quantifying current-year misstatements that arise from the carryover or reversal of prior-year uncorrected misstatements. The guidance would require the dual method approach illustrated in SAB No. 108. See the related discussion "Staff Accounting Bulletin No. 108" in the "Securities and Exchange Commission Developments" section of this Alert. For updated information about the project, visit the FASB Web site at www.fasb.org.

Proposed AcSEC SOP, **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**

.116 The proposed SOP, *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*, provides specific conditions for determining whether an entity is within the scope of the Audit and Accounting Guide *Investment Companies*. Entities that meet those conditions would be required to apply the provisions of the Guide in presenting their financial statements. Entities that do not meet those conditions would be prohibited from applying the provisions of the Guide. At its September 13, 2006, meeting, the FASB met with representatives of AcSEC and discussed final clearance of the SOP. The FASB did not object to issuance of the final SOP.[49]

.117 The Guide includes "standstill" provisions on current accounting practice. Until the project to clarify the scope of the Guide is finalized, an entity should consistently follow its current accounting policies for determining whether the provisions of the Guide apply to investees of the entity or to subsidiaries that are controlled by the entity. Further, the FASB has expressed its view that an investment company (other than a separate account of an insurance company as defined in the Investment Company Act of 1940) must be a separate legal entity to be within the scope of the Guide. (See the FASB Action Alert No. 02-14, April 3, 2002.) Accordingly, the specialized accounting principles in the Guide should be applied to an investment made after March 27, 2002, only if the investment is held by an investment company that is a separate legal entity. Investments acquired prior to March 28, 2002, or those acquired after March 27, 2002, pursuant to an irrevocable binding commitment that existed prior to March 28, 2002, should continue to be accounted for in accordance with the entity's existing policy for such investments. For further discussion of this matter, see the FASB staff announcement in the EITF Topic D-74, *Issues Concerning the Scope of the AICPA Audit Guide on Investment Companies*.

[48] You can obtain the November 1, 2006, FASB meeting minutes, providing further discussion about the proposed FSP, on the FASB Web site at www.fasb.org/board_meeting_minutes/11-01-06_fspfin46r-d.pdf.

[49] You can obtain the September 13, 2006, FASB meeting minutes on the FASB Web site at www.fasb.org/board_meeting_minutes/09-13-06_acsec_fspfin46r-d.pdf.

.118 The August 15, 2006 "discussion draft" of this proposed SOP that was sent to the FASB, which is briefly discussed below, is available as of the writing of this Alert on the AICPA Web site at www.aicpa.org/download/acctstd/investment_cos_scope_SOP71.pdf.

.119 AcSEC concluded that the proposed SOP's conditions for inclusion or exclusion of entities from the scope of the Guide should be based on the nature of the entity's activities. Further, AcSEC concluded that certain entities subject to regulatory requirements should automatically be within the scope of the Guide.

.120 Entities that meet the definition of an "investment company" as provided in paragraph 5 of the discussion draft and entities regulated by the 1940 Act or similar requirements as described in paragraphs 9 and 10 of the discussion draft would apply the accounting principles and reporting requirements in the Guide (investment company accounting) to their separate financial statements. The definition of an investment company is based on characteristics that AcSEC believes distinguish investment companies from entities that benefit from the operations of investees in ways other than through current income, capital appreciation, or both. Entities that are within the scope of FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, would not be within the scope of the Guide. Similarly, entities that are within the scope of the AICPA Audit and Accounting Guide *Employee Benefit Plans* would not be within the scope of the Guide. The discussion draft does not provide specific requirements for real estate investment trusts (REITs). REITs would be subject to the same provisions of the proposed SOP as other entities. Entities that are neither entities regulated by the 1940 Act or similar requirements as described in paragraphs 9 and 10 of the discussion draft nor an investment company under the definition in paragraph 5 of the discussion draft would not apply investment company accounting.

.121 Visit the AICPA Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/Scope_Clarification_Investment_Companies_Guide-SOP.htm to obtain updated information about the status of the exposure draft and project.

AICPA Real Estate Investment Funds Project

.122 In connection with the issuance of the proposed SOP discussed above, which would provide specific conditions for determining whether an entity is within the scope of the Audit and Accounting Guide *Investment Companies*, the real estate funds project was initiated to establish consistency in implementation of the Guide for affected entities. The AICPA decided to develop for the Guide an additional nonauthoritative chapter on real estate funds that is expected to provide guidance on, among other things:

- The definition of a real estate investment.
- Balance sheet presentation of investments, including the applicability of a consolidation approach to the financial statement presentation.
- Income statement presentation of net investment income, including the applicability of recognizing rental revenue, expenses, or other accrual basis earnings in net investment income (versus the dividend income principle noted in the Guide).
- Accounting for third-party real estate financing.
- Other financial statement presentation and disclosure matters.

.123 The proposed nonauthoritative chapter would only provide guidance on applying existing GAAP to real estate funds and would not change existing GAAP.

.124 Visit the AICPA Web site at www.aicpa.org for updated information about the status of the project. You can obtain AcSEC meeting agendas, materials, and highlights that include discussions and tentative conclusions about the real estate funds project at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/.

Proposed Technical Practice Aids for Investment Companies

.125 TIS section 6910 in the "Technical Questions and Answers" section of *Technical Practice Aids* includes questions and answers (Q&As), commonly referred to as TPAs, specifically pertaining to investment companies. The AICPA staff continues to consider nonauthoritative TPAs on practice matters for investment companies and new TPAs have been proposed. Visit the AICPA Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/ for updated information about the issuance of TPAs.

Auditing and Attestation Pipeline—Nonpublic

Proposed SOP—Compliance Controls at Service Providers

.126 In December 2003, the SEC adopted Rule 38a-1 under the Investment Company Act of 1940 (1940 Act) and Rule 206(4)-7 under the Investment Advisers Act of 1940 (Advisers Act) requiring both registered investment companies and registered investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violation of federal securities laws. Both funds and advisers are required to appoint chief compliance officers responsible for administering these policies and procedures, and to review the policies and procedures annually for adequacy and effectiveness of implementation. Among other things, the designation of a chief compliance officer of a registered investment company is required to be approved by the investment company's board of directors, and the chief compliance officer is to report directly to the board of directors and meet in executive session with independent directors at least annually. See SEC Release No. IC-26299 under the 1940 Act and SEC Release No. IA-2204 under the Advisers Act.

.127 The AICPA has a project in connection with the adoption of Rule 38a-1 and Rule 206(4)-7 to develop an SOP that would provide practitioners with performance and reporting guidance when examining the suitability of the design and operating effectiveness of controls over compliance at entities that provide services (service providers), such as transfer agents, record keepers, administrators, and custodians, to funds and investment advisers (user organizations). Compliance controls at service providers may affect or be part of the user organization's internal control over compliance. For updated information about the development of the exposure draft, entitled *Attestation Engagements That Address Aspects of Internal Control Directed at Compliance Objectives at Entities That Provide Services to Investment Companies, Investment Advisers, or Other Service Providers*, visit the AICPA Web site at www.aicpa.org.

Auditing and Attestation Pipeline—Public

Revised Auditing Standard on Internal Control Over Financial Reporting

.128 On December 19, 2006, the PCAOB released Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit of Financial Statements*, that would supersede Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements*. Investment companies, other than business development companies, generally are exempt from the requirement for issuers to include in their annual reports an assessment on the company's internal control, along with the auditor's report on that assessment. The proposed standard, among other matters, would revise the definitions of "significant deficiency" and "material weakness" as well as the "strong indicators" of a material weakness that are provided in Auditing Standard No. 2. The revised illustrative report in paragraph 11.19 of the Audit and Accounting Guide *Investment Companies*, which is discussed in the "Audit and Accounting Issues and Developments" section of this Alert, incorporates certain definitions described in Auditing Standard No. 2 that may be revised by the proposed standard.

SEC Proposed Rules

.129 The following are some of the proposed SEC rules that were released and not final as of the writing of this Alert, and that may be particularly relevant to the investment companies industry:

- *Exemption from Shareholder Approval for Certain Subadvisory Contracts* (Releases No. 33-8312, No. 34-48683, and No. IC-26230). The proposed rule would, under certain conditions, permit an adviser to serve as subadviser to an investment company without shareholder approval.

- *Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles* (Releases No. IA-2756 and No. 33-8766). The proposed new rules would prohibit advisers to pooled investment vehicles, including hedge funds, from making false or misleading statements or otherwise defrauding investors or prospective investors in the pooled investment vehicles, and revise the definition of "accredited investor" as it relates to natural persons.

- *Amendments to Rules Governing Pricing of Mutual Fund Shares* (Release No. IC-26288). The proposed rule would amend Rule 22c-1 under the 1940 Act to require that all purchase and redemption orders be received by the registered investment company, a single transfer agent designated by the registered investment company, or a registered clearing agency, no later than the time at which the investment company prices its securities.

- *Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds* (Releases No. IC-26341, No. 33-8358, and No. 34-49148). The proposed rule would amend Form N-1A to require improved disclosure regarding sales loads and revenue-sharing payments. The SEC subsequently released *Point of Sale Disclosure Requirements and Confirmation Requirements for Transactions in Mutual Funds, College Savings Plans, and Certain Other Securities, and Amendments to the Registration Form for Mutual Funds* (Releases No. IC-26778, No. 33-8544, and No. 34-51274), requesting comment about whether to adopt modified or additional disclosure requirements for Form N-1A beyond those originally proposed. The release also asks for comment about what disclosures, if any, should be added to Forms N-3, N-4, and N-6 with respect to revenue-sharing payments.

- *Definition of Nationally Recognized Statistical Rating Organization* (Releases No. IC-26834, No. 33-8570 and No. 34-51572). The proposed rule would define the term nationally recognized statistical rating organization (NRSRO) and provide interpretations of that definition for purposes of SEC rulemaking. Credit rating agencies would be provided with information to better understand whether they qualify as an NRSRO.

- *Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations* (Release No. 34-55231). The proposed rules would implement provisions of the Credit Rating Agency Reform Act of 2006, enacted on September 29, 2006. That Act requires registration of credit rating agencies with the SEC and subjects the agencies to regulation of various aspects of their business, although not their rating methodologies.

.130 Visit the SEC Web site at www.sec.gov to get the full text of these proposed rules and interpretation and for information about other proposed SEC rules.

Resource Central

AICPA Products and Publications

.131 In addition to the AICPA publications already discussed in this Alert, the following are some of the AICPA products and publications that may also be of interest to auditors of investment companies. To order these and other AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Service Center Operations at (888) 777-7077.

Checklist Supplement and Illustrative Financial Statements for Investment Companies

.132 The *Checklist Supplement and Illustrative Financial Statements for Investment Companies* (August 2006 edition) (product no. 008946kk) is a nonauthoritative financial accounting and reporting practice aid that is updated annually. The 2006 edition was expanded to include the illustrative financial statements for management investment companies that have multiple classes of shares or master-feeder structures, the illustrative financial statements for a unit investment trust, and the illustrative financial statements for variable annuity separate accounts registered as unit investment trusts, as illustrated in the Audit and Accounting Guide *Investment Companies*. The checklist should be used in conjunction with the *Checklists and Illustrative Financial Statements for Corporations* (November 2006 edition) (product no. 008937kk).

Audit and Accounting Manual

.133 The *Audit and Accounting Manual* (revised as of July 1, 2006) (product no. 005135kk) 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.

AICPA reSOURCE

.134 With AICPA reSOURCE you can access accounting and auditing materials online with the AICPA Library or the AICPA Library + FASB Library. You can custom-tailor your subscription by choosing titles you use most often. To subscribe or to learn more about AICPA reSOURCE, go online at www.cpa2biz.com.

AICPA Industry Expert Panel—Investment Companies

.135 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.

Education Courses

.136 The AICPA has developed a number of continuing professional education (CPE) courses that are valuable to CPAs working in the investment companies industry, many of them available for both group study and self-study.

Online CPE

.137 To register or learn more visit www.cpa2biz.com.

Hotlines

Accounting and Auditing Technical Hotline

.138 The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077. For more information visit the AICPA Web site at www.aicpa.org.

Ethics Hotline

.139 Members of the AICPA Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call (888) 777-7077. Send email inquiries to ethics@aicpa.org.

American Institute of Certified Public Accountants—Web Site

.140 AICPA Online (www.aicpa.org) is the AICPA's Web site on the Internet. The site offers users the opportunity to stay abreast of developments in accounting, auditing, and professional ethics. AICPA 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.

Other Helpful Web Sites

.141 Further information on matters addressed in this Audit Risk Alert is available through various publications and services offered by a number of organizations. Some of those organizations are listed in the "Information Sources" table at the end of this Alert.

. . . .

.142 This Audit Risk Alert replaces the *Investment Companies Industry Developments—2005/06* Audit Risk Alert. The *Investment Companies Industry Developments* Audit Risk Alert is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Alert would also be appreciated. You may e-mail these comments to mkasica@aicpa.org or write to:

Maryann Kasica, CPA
AICPA
Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881

Information Sources

.143

Organization	*Web site*
American Institute of Certified Public Accountants Telephone: (888) 777-7077 (Service Center Operations)	www.aicpa.org
CFA Institute	www.cfainstitute.org
Commodity Futures Trading Commission Headquarters Office: Three Lafayette Centre 1155 21st Street, NW Washington, DC 20581 Telephone: (202) 418-5000	www.cftc.gov
Financial Accounting Standards Board Order Department: 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116 Telephone: (800) 748-0659	www.fasb.org
Financial Crimes Enforcement Network (FinCEN)	www.fincen.gov
Investment Company Institute 1401 H Street, NW Washington, DC 20005	www.ici.org
Public Company Accounting Oversight Board Washington Office: 1666 K Street, NW Washington, DC 20006-2803 Telephone: (202) 207-9100	www.pcaobus.org
Stable Value Investment Association	www.stablevalue.org
U.S. Securities and Exchange Commission SEC Headquarters: 100 F Street, NE Washington, DC 20549 Publications Unit: Telephone: (202) 551-4040 SEC Public Reference Room: Telephone: (202) 551-8090	www.sec.gov
U.S. Small Business Administration	www.sba.gov

[*The next page is 8355*.]

AAM Section 8110

Securities Industry Developments—2006/07

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

NOTICE TO READERS
SECURITIES INDUSTRY DEVELOPMENTS—2006/07

This Audit Risk Alert is intended to provide auditors of financial statements of broker-dealers in securities with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. Because securities broker-dealers often deal in commodity futures or function as commodity pool operators, this 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 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.

Yelena Mishkevich, CPA
Technical Manager
Accounting and Auditing Publications

Acknowledgements

The AICPA staff would like to thank the Stockbrokerage and Investment Banking Expert Panel for its assistance in development and review of this Audit Risk Alert. The AICPA staff is especially grateful to the following people for their significant contributions:

Ronald Carletta
Ann Cheeseman
Richard C. Flowers
Al Goll
Matthew Hughey
G. Victor Johnson
Lawrence Kaplan
Andrew Labadie
Anthony Lucarelli
Mark Ramler
Lawrence Rosenberg
George Simeone
Samuel Telzer
Shannon Warren

How This Alert Helps You

.01 This Audit Risk Alert helps you plan and perform the audits of your securities industry clients. The knowledge delivered by this Alert assists you in achieving a more robust understanding of your client's business and economic environment. This Alert is an important tool in helping you identify the significant risks that may result in the material misstatement of your client's financial statements. Moreover, this Alert delivers information about emerging practice issues and current accounting, auditing, and regulatory developments.

.02 If you understand what is happening in the securities industry and can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert assists you in making considerable strides in gaining that industry knowledge and understanding.

.03 This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2006/07* (product no. 022337kk).

Economic and Industry Developments

Economic Developments

.04 In 2006, the U.S. economy has shown signs of cooling down. Real gross domestic product (GDP) grew 1.6 percent in the third quarter, which was below the 2.6 percent growth registered in the second quarter and the exceptional 5.6 percent growth in the first quarter. According the updated economic forecast issued by the White House on November 21, 2006 for the whole year, GDP is expected to increase 3.1 percent, which is below the 3.3 percent growth registered in 2005. Furthermore, economic growth is expected to slow down in 2007 to 2.9 percent.

.05 The federal funds rate incrementally increased 75 basis points throughout 2006 to 5.25 percent as a result of the Federal Reserve combating inflation. However, since late June, the Fed has kept its target federal funds rate steady.

.06 Please refer to the AICPA general *Audit Risk Alert—2006/07* for an in-depth discussion of the United States economic and business environment. For up-to-date information, you may also wish to refer to Web sites of the Federal Reserve branches at www.federalreserve.gov/otherfrb.htm. Also, the Boston branch publishes monthly a report on stock market activity which practitioners in the securities industry may find particularly helpful.

The Securities Industry

.07 Notwithstanding the economic slowdown, the stock market has performed well in 2006. On October 19, 2006, the Dow Jones Industrial Average (DJIA) closed above the 12,000 level for the first time and since then has continued its stellar performance, posting one record close after another. On November 17, 2006 the Standard & Poor's 500 Index (S&P 500) crossed the 1400 mark for the fist time in six years. The National Association of Securities Dealers Automated Quotation (NASDAQ) composite index has also been increasing and it has more than doubled since its October 2002 low of 1114.11.

.08 2006 is expected to be an exceptional year for the securities industry. According to the Securities Industry and Financial Markets Association (SIFMA),[1] for the first half of 2006, US securities industry profits reached $15.3 billion, the best half-year performance in six years. The SIFMA estimates that the industry profits reached $7.25 billion in 3Q'06, down only slightly from the $7.5 billion earned in 2Q'06 and $7.82 billion reported in 1Q'06. For the year 2006 as a whole, the SIFMA expects profits to top $28.5 billion, $10.9 billion higher than in 2005, and easily surpassing the industry's second best annual performance of $25.3 billion set in 1999, but still short of the record $31.6 billion earned in 2000. Total revenues in 2006 are expected to top $414.8 billion, an increase of 28.9 percent from the 2005 results. More importantly, net revenues (total revenues net of interest expense) are forecast to reach $211.5 billion, up 13.9 percent from last year's level.

.09 For more information, please refer to the September and November 2006 issues of the SIFMA Research Reports (Vol. VII, No. 10 and Vol. I, No. 1, respectively), which can be accessed at www.sia.com/research/html/research_reports.html.

---

[1] SIFMA was formed as a result of the merger between the Securities Industry Association and the Bond Market Association.

The Commodities Industry

.10 Global futures and options contract volume has continued to increase through 2005 and into 2006. In the first eight months of 2006, volume on U.S. futures exchanges reached three billion contracts, a 34 percent increase from the same period in 2005. The volume of contracts traded on foreign exchanges increased 18.5 percent compared to the first eight months of 2005. These changes are primarily attributable to increased trading volume in interest rate and equity products.

.11 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 from approximately $105 billion as of June 30, 2005, to more than $137 billion as of June 30, 2006, an increase of more than 30 percent.

.12 The U.S. futures industry, in addition to the increasing volume and customer participation, has also experienced other significant changes through 2005 and into 2006. In October 2006, the Chicago Mercantile Exchange (CME) and the Chicago Board of Trade (CBOT), the two largest contract markets designated by the CFTC, announced merger plans, subject to appropriate regulatory and stockholders' approval. The new CME/CBOT combined organization, to be called CME Group, Inc., would be U.S.-based and devoted to derivatives trading and clearing.

Regulatory Issues and Developments[2]

.13 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 record keeping. Accordingly, certain tests of controls are performed even if the auditor would not otherwise choose to do so.

.14 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. 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.

.15 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.

.16 Certain regulatory activities and developments relevant to entities operating in the securities industry are presented in the following sections.

---

[2] 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 only. Readers should refer to the full text of the regulations. The complete text of Securities and Exchange Commission (SEC) rules, including 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; New York Stock Exchange (NYSE) rules at www.nyse.com; National Association of Securities Dealers (NASD) rules at www.nasd.com; and National Futures Association (NFA) rules at www.nfa.futures.org. See the "Information Sources" table at the end of this Alert for a full list of Internet resources.

Portfolio Margining

.17 New York Stock Exchange (NYSE or the Exchange) Rule 431, *Margin Requirements*, generally prescribes minimum initial and maintenance margin requirements. On July 14, 2005 the Securities and Exchange Commission (SEC) approved, on a pilot basis expiring July 31, 2007, amendments to Rule 431 to permit the application of a prescribed risk-based margin requirement (portfolio margin) 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 margin. 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 (OCC). See SEC Releases No. 34-52032 and No. 34-52030.

.18 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.
3. Modified certain net capital requirements in connection with the maintenance of portfolio margin accounts.

.19 Collectively, these amendments are referred to as the *expanded pilot*. The expanded pilot expanded 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 pilot program 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.

.20 On December 12, 2006, the SEC approved additional amendments to NYSE Rule 431 that permit the application of portfolio margin 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 Exchange, as well as to receive from customers a signed acknowledgement, in a form to be published at a later date. The amendments are effective April 2, 2007. See SEC Releases No. 34-54918 and NYSE Information Memo No. 06-86 for more information.

.21 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.

.22 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 alternative *position-* or *strategy-based* methodologies for determining margin requirements. Lower margin requirements allow the customer more leverage in an account. Broker-dealers will benefit from portfolio margining because it recognizes a greater number of offsets than was permitted under the previously required strategy-based margin rules and is expected to result in lower margin requirements. However, under the new rules, broker-dealers would be required to actively manage the risk in portfolio margin accounts.

.23 As specified in NYSE Information Memo 06-86, member organizations, for which the Exchange is the Designated Examining Authority (DEA), seeking to participate in portfolio margin must provide written notification and receive approval from the Exchange prior to establishing a portfolio margin 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. As previously discussed in Information Memo 06-57, the procedures must be fully documented and should address, at minimum, the following:

- Opening of portfolio margin accounts
- The profile of customers who will be eligible for portfolio margining, including the initial approval process to be applied
- A description of minimum equity requirements for each customer
- The determination, review, and approval of credit limits for each customer and across all customers
- A description of any internal model used to determine risk in individual customer accounts, including the documentation for this model
- A description of correlation assumptions included in any internal models used for assessing the adequacy of margin in a customer's account
- A description of the stress testing scenarios that are performed on the accounts, and provide the frequency of such testing and the results of the most recent stress test
- Monitoring of accounts to ensure that the account contains a portfolio of hedged instruments
- Identification of security concentrations within an account
- Identification of concentrations in individual securities across customer accounts
- Intraday monitoring of exposure in customer accounts
- Detection, prevention, and circumvention of day trading requirements
- Monitoring of limitation on credit extended on portfolio margining to 1,000 percent of the member organization's net capital
- A description of the process for obtaining the TIMS theoretical valuation points and the process used to compute margin requirements in individual customer accounts
- A description of house margin requirements if they differ from the TIMS requirement
- A description of exception reports that will be utilized to monitor margin exposure
- A description of the escalation procedures to alert senior management of unusual risks
- The regular review and testing of the risk analysis procedures by an independent unit such as internal audit or other comparable group
- If an organization would like to provide portfolio margining to customers in unlisted derivatives, the application should include a description of the products as well as a detailed description of the credit analysis and collateral management process that will be utilized to monitor any exposure that may result to the broker-dealer. This information may be submitted at a later date if unlisted derivatives are not being offered to customers on the implementation date

.24 Member organizations seeking approval to participate in portfolio margining must submit all relevant supporting documentation to their finance coordinator. Such documentation must be accompanied by an organization chart identifying those persons primarily responsible for portfolio margin risk management and the person or persons to whom they report.

.25 In order for member organizations to be approved by the effective date of April 2, 2007, written notifications must be submitted no later than February 15, 2007.

Rulemaking Regarding Responsibility When Outsourcing Activities to Third-Party Service Providers

.26 The concept of outsourcing is not new to the securities industry. Introducing broker-dealers have long been permitted to contractually delegate functions and responsibilities to clearing broker-dealers. Typically, introducing firms agree to retain responsibility for the opening, approving, and monitoring of accounts and delegate to clearing firms "back office" functions, such as order execution and clearance of trades. Over the past several years, the outsourcing of services has extended beyond arrangements between registered broker-dealers. It is not uncommon to now find outsourcing arrangements between broker-dealers and other types of regulated and unregulated entities. Different outsourcing arrangements have given rise to different types of regulatory concerns.

NYSE Proposed Rule

.27 NYSE Rule 382 has allowed for the delegation of both functions *and* responsibilities to a clearing firm, and accordingly, it has required that any agreement made pursuant to its provisions be subject to the prior review and approval of the Exchange, and be limited to registered broker-dealers. On March 16, 2005 the NYSE filed with the SEC a proposed new rule, Rule 340, which would govern conditions to be satisfied in connection with outsourcing arrangements between members/member organizations and various service providers.

.28 Proposed Rule 340A prohibits members and member organizations from outsourcing certain functions. Specifically, except as otherwise permitted by the Exchange, it would prohibit members and member organizations from delegating, contracting, or outsourcing to any service provider supervisory or compliance responsibilities under Exchange Act Rule 342, as well as activities that require registration and qualification under the Exchange rules. These proposed restrictions reinforce the long-held concept that functions can be outsourced but responsibility cannot.

.29 For a full text of the proposal, please refer to www.nyse.com/pdfs/2005-22fil.pdf.

NASD Notice to Members

.30 ***Notice to Members 05-48.*** In July 2005, National Association of Securities Dealers (NASD) issued Notice to Members 05-48*, Members' Responsibilities When Outsourcing Activities to Third-Party Service Providers,* to remind members that, in general, any parties conducting activities or functions that require registration under NASD rules will be considered associated persons of the member, absent the service provider separately being registered as a broker-dealer and such arrangements being contemplated by NASD rules (such as in the case of clearing arrangements), Municipal Securities Rulemaking Board (MSRB) rules, or applicable federal securities laws or regulations. In addition, outsourcing an activity or function to a third party does not relieve members of their ultimate responsibility for compliance with all applicable federal securities laws and regulations and NASD and MSRB rules regarding the outsourced activity or function. As such, members may need to adjust their supervisory structure to ensure that an appropriately qualified person monitors the arrangement. This includes conducting a due diligence analysis of the third-party service provider.

.31 ***Interpretive Letter.*** In addition, on August 15, 2006, the NASD issued an Interpretive Letter that provides responses to questions regarding the scope of the guidance provided in Notice to Members 05-48

(NtM 05-48 or the Notice). According to the Letter, NtM 05-48 is not intended as guidance regarding the appropriateness of outsourcing a particular activity or whether an activity may or may not be outsourced to a nonbroker-dealer third-party service provider. Rather, the purpose of NtM 05-48 was to clarify a member's responsibilities if the member outsources *covered activities* which the Notice identifies as activities or functions that, if performed directly by members, would be required to be the subject of a supervisory system and written supervisory procedures pursuant to NASD Rule 3010. To help members understand the meaning of the term "covered activities," the Notice provided a short, nonexhaustive list of examples as a reference.

.32 As identified in NtM 05-48, the primary responsibility for any member outsourcing covered activities is to include procedures regarding its outsourcing practices in its supervisory system and written supervisory procedures to ensure compliance with applicable securities laws and regulations and NASD rules. In addition, because a member has a continuing responsibility to oversee, supervise, and monitor the service provider's compliance performance of covered activities, the member must have in place specific policies and procedures to monitor the service provider's compliance with the terms of any agreements and assess the service provider's continued fitness and ability to perform the covered activities being outsourced.

.33 In addition, NtM 05-48 makes clear that, under certain circumstances, a function outsourced to a third-party service provider renders the person performing that function an associated person of the member by virtue of performing that function, thereby effectively negating any outsourcing because members are responsible for the supervision of all associated persons. NtM 05-48 also points out that the ultimate responsibility for supervision lies with the member. Accordingly, the member may never contract its supervisory and compliance activities away from its direct control, although it may outsource certain activities that support the performance of its supervisory and compliance responsibilities.

.34 The full text of the NASD Interpretive Letter can be viewed at the same site as Notice to Members 05-48 at www.nasd.com/RulesRegulation/NoticestoMembers/2005NoticestoMembers/NASDW_014736.

Internal Risk Management Control Systems of Consolidated Supervised Entities

.35 In April 2004, the SEC adopted rule amendments under the Exchange Act that establish a voluntary, alternative method of computing deductions from net capital for certain broker-dealers that are part of a consolidated supervised entity (CSE). This alternative method permits a broker-dealer to use mathematical models to calculate net capital requirements for market and derivatives-related credit risk.

.36 According to the amended rules (Appendixes E and G to Rule 15c3-1, "Net Capital Requirements for Brokers or Dealers"), broker-dealers that use this alternative method of computing net capital are required to have both their internal audit function and external auditors perform specific procedures related to their internal risk management controls in accordance with Rule 15c3-4, "Internal Risk Management Control Systems for OTC Derivatives Dealers," under the Exchange Act. The amended rules specify that only a *registered public accounting firm* (as that term is defined in section 2(a)(12) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7201 *et seq*.) could act in the capacity of an external auditor for such broker-dealers. Under the rule, the external auditors would be required to review the internal risk management control system in accordance with procedures agreed upon by the broker-dealer, the external auditor conducting the review, and the SEC.

.37 The five industry participants currently registered as CSEs made a proposal to the SEC in late 2005 to replace the requirements for an annual accountants report on internal risk management control systems under Rule 15c3-1 Appendix G (b)(1)(iii)(B) with an emphasis on the role the internal audit department (IAD) would play in reviewing such controls each year. IAD would provide appropriate feedback on the regular assessment, and operating effectiveness, of the internal risk management control system within CSE registrant firms covered by Rule 15c3-4 to both senior management and the audit committee. The SEC Division of Market Regulation has agreed to the proposal which is being implemented in 2006.

Review Requirements

.38 The CSE registrants are required to demonstrate that the internal risk management control systems (as defined in Rule 15c3-4) are included within IAD's universe of coverage, that IAD reviews the key elements of those activities on a periodic basis, and that the results of those reviews are reported to senior management and the audit committee, and members of IAD are available for discussion with the SEC. In addition, IAD's periodic reviews must be conducted on a frequency and scope driven by a risk assessment program.

.39 As part of the proposal, internal risk management control system reviews should be conducted by IAD at three levels:

1. *Risk Oversight and Governance.* This is generally executed through senior risk management oversight committees that establish overall risk management policies. These committees cover, for example, credit and market risks. IAD is to conduct periodic governance reviews that include, as relevant, examination of the constitution of charters, span of authority, reporting procedures, the breadth and appropriateness of committee membership, sufficiency of committee minutes or similar documentation, and the frequency of meetings.

2. *Functional Risk Management*. This is generally executed by independent dedicated risk management functions within each CSE and includes day-to-day risk management activities, such as limit setting and monitoring, and firmwide risk aggregation. These dedicated risk management functions have responsibility for managing risks arising out of business activities, including market, credit, leverage, liquidity, legal, and operational risks. IAD is to conduct periodic reviews of these risk management functions including, as relevant, examining policies and procedures, reporting lines, limit administration, escalation procedures for limit breaches, data accuracy and completeness, data security controls, testing and authorization controls over models, processes to establish internal credit ratings, and other activities relevant to each CSE's functional risk management.

3. *Business Level Risk Management*. This is generally executed by individual business/product areas within each CSE and includes day-to-day risk management activities such as limit monitoring, the requests and approval process for limit adjustments, and the transmission of risk data to the functional risk management areas. IAD is to conduct periodic reviews of these risk management activities as a component of their business/product area audits.

Communication Requirements

.40 The scope of IAD's reviews of the internal risk management control system that should be regularly presented to the audit committee and the SEC's Division of Market Regulation should include the risk oversight and governance and functional risk management levels described above.

.41 ***Audit Committee Communications***. Periodically, but not less than annually, each CSE's IAD is to present the following materials to their audit committee at a meeting where their registered public accounting firm (RPAF) is present:

1. A schedule detailing the status of the year's audit plan over the internal risk management control system, including projected delays, if applicable

2. The rationale for any deferrals or delays in coverage

3. A review of the results of such audits

.42 The audit committee minutes need to reflect that the above topics were discussed, and should include any relevant matters raised by the RPAF. Prior to the audit committee meeting, the RPAF should have had the opportunity to review relevant reports and working papers to be in a position to discuss IAD's coverage and findings related to the internal risk management control system, and to respond to other appropriate questions.

.43 ***Periodic Meetings Between IAD and the Division of Market Regulation.*** The following specific items should be provided to the SEC's Division of Market Regulation in addition to materials already being provided during the recurring quarterly meetings relating to IAD's reviews of the internal risk management control system:

Quarterly meeting following internal audit's annual planning process:

1. IAD's universe of auditable entities comprising coverage over the internal risk management control system
2. A schedule detailing actual audit coverage, of the universe listed in item 1 above, for the past two years and projected coverage for the current and following year

Each quarterly meeting:

1. A schedule detailing the status of the year's audit coverage of the internal risk management control system, including projected delays, if applicable
2. A review of the results of completed audits relating to the internal risk management control system
3. A schedule detailing any open and past due significant issues arising from the reviews of the internal risk management control system
4. Organizational chart showing internal audit's independent reporting lines, if applicable, due to any changes since the last meeting

.44 At the request of the SEC's Division of Market Regulation, RPAFs may meet annually with the Division of Market Regulation, with the consent of the CSE's management, to discuss matters relevant to the CSE's IAD review of the internal risk management control system.

.45 The requirements discussed above are included in chapter 6 of the 2006 edition of the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*. The Broker Dealer Guide also includes two new appendixes related to CSE reporting, namely, Appendix L, "Auditor's Standard Report on Consolidated Supervised Entity," and Appendix M, "Separate Report on the Supplementary Schedule of Consolidated Supervised Entity."

Broker-Dealer Internal Audit/Compliance Priorities

.46 On October 17, 2006, Mary Ann Gadziala, Associate Director of the SEC's Office of Compliance Inspections and Examinations, spoke at the 2006 Annual Conference of the Internal Auditors Division of the Securities Industry Association (SIA). She discussed the SEC's approach to evaluating the internal audit function and areas of focus of the SEC examination program.

Evaluation of Internal Audit Work

.47 The SEC broker-dealer examination program has recently begun the implementation of a new process whereby SEC examiners may leverage off the high quality work of a firm's internal audit department (IAD) in conducting their own risk management examinations. This process is being employed only with respect to risk management examinations of broker-dealers and consolidated supervised entities at the current time because these examinations are very resource-intensive. However, she indicated that the practices and procedures that she discussed may be relevant to the development of an effective internal audit program at any firm, regardless of whether it may be subject to an SEC risk management examination. Since the scope of SEC examination, in which this new process is used, will be somewhat dependent on the SEC's evaluation of the firm's internal audit work, the SEC risk management examination process has changed to permit on-site examination to begin with a review of the work of the firm's IAD. After evaluation of the internal audit work, SEC examiners will conduct an examination of market, credit, legal and compliance, operational, and liquidity risks of the firm. They will use an examination scope that may be limited or adjusted based on the firm's internal audit work. She indicated that in order to evaluate the quality and strength of the firm's internal audit function, some areas that may be reviewed by the SEC include the qualifications and expertise of audit management and staff, the adequacy of resources and systems, the independence and authority of the IAD, and the adequacy of audit coverage throughout the organization with a focus on risk management audits.

.48 One of the first documents reviewed by the examination team is typically the internal audit charter or similar document that defines the purpose, authority, and responsibility of the internal audit function and is approved by the top levels of the firm, such as senior management and the audit committee. This document should be maintained and updated on a periodic basis and would generally include the following:

- The objectives and scope of the internal audit function;
- The IAD's role within the firm;
- The authority and access of the head of IAD to top levels of the firm, such as the audit committee and senior business executives;
- IAD's powers and responsibilities, which include full and direct access to all records and activities of the firm, as well as access to and the ability to communicate with any employee of the firm;
- The accountability of the head of IAD; and
- The terms and circumstances under which IAD may act in an advisory or consulting role.

.49 The independence of IAD is also critical to the effectiveness and quality of their evaluation of the activities and operations of an organization. Effective implementation of the internal audit function requires that IAD have adequate resources, including personnel and technology to complete the audit plan and auditing tasks effectively and in a timely manner. Auditors should have adequate experience in both auditing and an understanding of business operations of the firm where the auditor has audit responsibilities. SEC examination staff may review résumés or biographies of the internal audit staff, the firm's policies and procedures with respect to minimum qualifications, and auditors' educational level and professional experience. Training and continuing education are also assessed during the examinations.

.50 SEC examiners will evaluate the "audit universe" and audit cycles set by IAD, which are all the areas of a firm that expose it to risk. Among the SEC examiners' primary concerns regarding a firm's audit universe are its completeness, risk rankings, and cycles as related to risks and controls.

.51 An effective IAD generally has thorough and clear procedures with respect to the conduct of its audits. Effective audit procedures may (1) explain how the auditor conducts audits; (2) describe the required working papers necessary to support the audit; (3) contain guidelines for testing and sampling; (4) discuss supervision of the audit; and (5) describe reporting of audit findings and audit reports.

.52 SEC examiners will consider the guidance of recently issued SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), in their evaluation. SAS No. 103, which applies to audits of nonpublic companies, requires an auditor to prepare audit documentation that is sufficiently detailed for an experienced auditor having no previous connection to the audit to understand the audit work performed, evidence obtained, and conclusions reached. SAS No. 103 also requires auditors to assemble audit documentation that is the "final engagement file" within 60 days of the report release date. It also provides guidance on what to document; states that oral explanations by themselves are insufficient to support audit work or conclusions although they may be used to clarify audit documentation; and specifies a minimum file retention period of five years.

.53 The firm's meaningful corrective action in response to the audit is also a key element of the effectiveness of IAD's work. Therefore, appropriate dissemination of results and follow-up are essential.

.54 The SEC examination team will determine whether audit procedures include an adequate system to monitor audit findings and their resolution.

SEC Examination Focus Areas

.55 She also discussed some of the current areas of focus for the SEC examination program, including:

- *Supervision*. Written supervisory procedures should be complete and updated to keep pace with regulatory or business changes. They also need to be effectively implemented. Large, high-volume firms using manual monitoring processes may raise supervisory concerns. Branch office supervision is a growing challenge as the number of branch offices has escalated to about 170,000, and many offices are independent contractors or at remote locations, offering additional challenges. Outsourcing of more and more activities also raises supervisory issues. Supervising correspondence also remains a priority.

- *Sales Practices*. Sales and marketing to senior citizens is a top concern. SEC examiners are focusing on certain products with more frequent sales practice problems, including Section 529 plans, variable annuities, illiquid securities, and initial public offerings (IPOs). Instances of retail and corporate bond dealers charging large mark-ups or mark-downs on riskless principal and inventory transactions may raise suitability concerns. Also, SEC examiners continue to find firms that are not providing investors with appropriate breakpoint discounts on mutual fund purchases.

- *Risk Management*. Firms continue to make significant advances in risk management internal controls. However, there are still some areas to which special attention might be directed. For example, it is a good practice for firms to continually monitor and update business continuity plans as appropriate to implement technological advancements and address new challenges, such as a potential pandemic. Assuring that back office operations and compliance keep pace with sales and marketing new products is an area of focus. And SEC examiners are examining whether firms are effectively addressing problems with assignments and confirmations with respect to credit derivatives. Complex structured finance transactions should also be carefully monitored for appropriate risk management. Information security is a key risk management concern, particularly in view of increased instances of identity theft. Another critical risk management area is conflicts of interests, which should be carefully monitored especially by firms with diversified activities and customers.

- *Financial Issues*. Net capital deficiencies and inaccuracies in computing net capital remain among top findings from SEC examinations. Imposing adequate margin requirements on customers, particularly hedge funds and other significant or highly leveraged customers, is also an area of focus. Firms should be mindful of developments with respect to portfolio margining. SEC examiners have also focused a significant amount of attention on the alternative net capital computations of broker-dealers using methodologies that incorporate the concepts of the Basel capital requirements with internal mathematical models as the underlying basis.

- *Anti-Money Laundering (AML)*. Some areas of focus are: firms' relationships with foreign institutions; general risk assessment and suspicious activity reporting; independent tests—are they timely, comprehensive, and conducted by a person with sufficient knowledge of AML laws; whether firm compliance programs are adequate and effectively implemented; and whether each regulated entity has met its independent obligations under the USA PATRIOT Act.

- *Books and Records*. Having accurate books and records is a key component of ensuring compliance with the law and having financial integrity and accuracy of financial statements. They are also key to understanding firm operations and activities. It is important that all business-related correspondence and records, including e-mails, be accurately maintained and accessible as required.

- *Trading Practices*. Examinations continue to find instances of market timing in mutual funds, variable annuity products, and real estate investment trusts (REITs). Best execution of transactions is also an examination priority as well as compliance with Reg SHO. Trading practices is another area in which conflicts are a concern, particularly with respect to maintaining the confidentiality of nonpublic customer trade information and preventing insider trading, front running, and market manipulation.

.56 The full text of this speech is available at the SEC Web site at www.sec.gov/news/speech/2006/spch101706mag.htm.

Anti-Money Laundering Recent Regulatory Developments

.57 Over the past several years, regulators have issued a number of rules to implement key provisions of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the USA PATRIOT Act). It is critical for securities firms to comply with AML regulations, as noncompliance may lead to serious negative consequences, including tarnished reputations, legal and regulatory problems, and, in some cases, civil or criminal actions. Also, laundered funds and their proceeds could be subject to asset seizure and forfeiture (claims) by law enforcement agencies, which could result in material contingent liabilities during the prosecution and adjudication of cases.

.58 The following sections discuss recent AML developments as well as issues of continuing importance.

Customer Identification Programs

.59 ***SEC No-Action Letter—Financial Record Keeping and Reporting of Currency and Foreign Transactions/Broker-Dealer Customer Identification Rule***. On July 11, 2006, the staff of the Division of Market Regulation (Division), in consultation with the FinCEN, issued a letter stating that it would not recommend enforcement action to the SEC under Rule 17a-8. If a broker-dealer relies on an investment adviser, prior to such adviser becoming subject to an AML Rule, provided all the other requirements and conditions in paragraph (b)(6) of the CIP Rule are met, namely that (1) such reliance is reasonable under the circumstances; (2) the investment adviser is regulated by a federal functional regulator; and (3) the investment adviser enters into a contract requiring it to certify annually to the broker-dealer that it has implemented an AML program, and that it will perform (or its agent will perform) specified requirements of the broker-dealer's customer identification program. The relief will be withdrawn without further action on the earlier of (1) the date upon which an AML Rule for advisers becomes effective, or (2) January 12, 2008.

.60 For more information please refer to www.sec.gov/divisions/marketreg/mr-noaction/antiml071106.htm.

.61 ***Frequently Asked Questions Customer Identification Program Responsibilities Under the Agency Lending Disclosure Initiative.*** In April 2006, FinCEN together with the SEC published guidance in the form of questions and answers that address customer identification program (CIP) responsibilities where a U.S. bank or broker-dealer (agent lender) arranges a loan of securities to a broker-dealer under the Agency Lending Disclosure Initiative. The question is whether a broker-dealer borrower is required to treat the agent lender's customers as "customers" for purposes of the CIP Rule. Under the circumstances described in the document, the answer is *no.* Notwithstanding the limited information the broker-dealer borrower obtains about the underlying lender(s), the "customer" of the broker-dealer for purposes of the CIP rule is the agent lender. This guidance can be viewed on the SEC Web site at www.sec.gov/divisions/marketreg/qa-cip.htm.

.62 ***SIA AML Committee's Suggested Practices For Customer Identification Programs.*** In January of 2006, the SIA (now SIFMA) published Suggested Practices For Customer Identification Programs (CIP Suggested Practices), which is a supplement to the SIA's Preliminary Guidance For Deterring Money Laundering Activity issued in 2002. The CIP Suggested Practices discusses the minimum identification information and verification procedures required by the CIP Rule and sets forth what the AML Committee believes are certain practices firms may wish to consider in developing and implementing an effective CIP. The CIP Suggested Practices can be found at www.sia.com/publications/pdf/CIPGuidelines.pdf.

Suspicious Activity Reports

.63 ***FinCEN Guidance on Sharing of Suspicious Activity Reports by Securities Broker-Dealers, Futures Commission Merchants, and Introducing Brokers in Commodities***. In January 2006, FinCEN, after consulting with staff of the SEC and CFTC, issued Guidance on Sharing of Suspicious Activity Reports by Securities Broker-Dealers, Futures Commission Merchants, and Introducing Brokers in Commodities, in which it confirms that securities broker-dealers, FCMs, and IBs in commodities may share Suspicious Activity Reports with parent entities, both domestic and foreign. For more information, please refer to FinCEN Web site at www.fincen.gov/sarsharingguidance01202006.pdf.

Foreign Correspondence and Private Banking Accounts

.64 ***FinCEN Guidance on the Application of the Section 312 Rules to Certain Introduced Accounts and Give-up Arrangements in the Futures Industry***. In June 2006, FinCEN issued guidance in the form of a letter to clarify the obligations of FCMs subject to the final due diligence rules implementing Section 312 of the USA Patriot Act. This guidance can be found at www.sia.com/moneyLaundering/pdf/FincenResptoBarbaraWierzynski.pdf.

.65 ***FinCEN Guidance on the Application of the Section 312 Rules Requiring Special Due Diligence Programs for Certain Foreign Accounts***. In May 2006, FinCEN issued guidance in the form of a letter to clarify the due diligence obligations for broker-dealers, FCMs, and IBs in commodities under the final rules of Section 312 of the USA Patriot Act. This guidance can be found at www.sia.com/moneyLaundering/pdf/SIA-FIAfromFinCEN05-02-06.pdf.

AML Examination Findings

.66 On March 29, 2006, Lori A. Richards, Director of the Office of Compliance Inspections and Examinations of the SEC, spoke at the Sixth Annual Anti-Money Laundering Conference hosted by the SIA, where she discussed some of the important issues that have come up in recent AML examinations. The full text of this speech is available on the SEC Web site at sec.gov/news/speech/spch032906lar.htm.

Registration With PCAOB—Extension of Order Regarding Broker-Dealer Financial Statement Requirements Under Section 17 of the Exchange Act

.67 Although the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley or the Act) is directed at *issuers* (as defined by the Act) and their auditors, nonpublic broker-dealers also come under the scope of certain provisions of the Act. This is because Section 205(c)(2) of the Act amended Section 17 (15 U.S.C. 78q) of the Exchange Act to require *all* broker-dealers (both public and nonpublic) to be audited by a public accounting firm registered with the Public Company Accounting Oversight Board (PCAOB).

.68 Section 17(e)(1)(A) of the Exchange Act requires that every registered broker-dealer annually file with the SEC a certified balance sheet and income statement, and Section 17(e)(1)(B) requires that the broker-dealer annually send to its customers its certified balance sheet. The Sarbanes-Oxley Act established the PCAOB and amended Section 17(e) to replace the words *an independent public accountant* with *a registered public accounting firm.*

.69 The Act establishes a deadline for registration with the PCAOB of auditors of financial statements of "issuers." The Act does not provide a deadline for registration of auditors of nonpublic broker-dealers.

.70 On December 12, 2006, the SEC extended its Order permitting nonpublic broker-dealers (broker-dealers that are not "issuers") to file with the SEC a balance sheet and income statement and send to their customers a balance sheet certified by an independent public accountant, instead of by a PCAOB registered public accounting firm for fiscal years ending before January 1, 2009.

.71 The extension was originally issued on August 4, 2003, extended on July 14, 2004, and extended again on December 5, 2005. The 2005 Order was to expire on January 1, 2007. The SEC has determined that extending the Order for two additional years is consistent with the public interest and the protection of investors. See Release No. 34-54920 at www.sec.gov/rules/other/2006/34-54920.pdf for more information.

.72 Application of registration requirements and procedures to auditors of nonpublic broker-dealers is still being considered.

Breakpoint Refund Liability

.73 In Notice to Members 03-47, *Refunds to Customers Who Did Not Receive Appropriate Breakpoint Discounts in Connection with the Purchase of Class A Shares of Front-End Load Mutual Funds and the Capital Treatment of Refund Liability*, the NASD ordered broker-dealers to provide refunds to customers who had not been given appropriate breakpoint discounts on purchases of mutual funds with front-end loads.

.74 The NASD provided guidelines for firms to follow when calculating refunds to customers and accounting for their anticipated refund liabilities. NASD stressed that firms needed to consider the requirements of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*, when accounting for their refund liability. FASB Concept Statement No. 6 specifically recognizes that the amount of a liability does not need to be certain before it is recorded. Accordingly, approximations and estimates could be used to record the liability. Thus, firms had to determine their probable liability based upon information available at the time in accordance with FASB Concept Statement No. 6. NASD also issued further guidance to members as to the amount of refund they should be setting aside for customers, which was to be based upon a sampling. Firms were either to record this amount or justify the appropriateness of selecting an alternative amount.

.75 Based on their experiences to date, a number of broker-dealers have claimed that they were overly conservative in estimating the total amount of potential customer restitution. Presumably, many customers who likely or possibly failed to receive breakpoint discounts have not submitted claims. Accordingly, these firms believe that due to the passage of time and in light of their efforts to communicate the availability of a possible refund, it is appropriate to reverse fully or reduce their remaining liability related to such restitution.

.76 The NASD believes that while firms have generally made substantive efforts to communicate the availability of restitution where it is warranted, the current absence of customers' claims does not on its own support removal of the liability.

.77 Prior to reducing or removing its current liability, a firm should determine to the satisfaction of those responsible for the financial management of and reporting for the firm that such a reduction of the current balance of the breakpoint liability would be representatively faithful with respect to the firm's securities business and operating practices.

.78 Further, in observing in the conduct of its business high standards of commercial honor and just and equitable principles of trade, a firm should continue to provide customers through its Web site ready-access to the NASD Mutual Fund Breakpoint Search Tool and related information found on NASD's Web site.

.79 Finally, the firm should consider any customer claim regarding a possible failure to provide an available breakpoint discount, and as appropriate, compensate such customer upon determination of a bona fide claim, regardless of when the firm failed to provide an appropriate breakpoint discount.

Recent Concerns of Regulators

.80 Over the past several years during examinations of broker-dealers, regulators encountered a number of issues, some of which are discussed in this section.

SEC

.81 ***Consolidation of Subsidiaries.*** Regulators would like to remind broker-dealers and their auditors about the requirement of Rule 17a-5(d)(2), which provides that if the Statement of Financial Condition filed in accordance with instructions to Form X-17A-5, Part II or Part IIA, is not consolidated, a summary of financial data, including the assets, liabilities, and net worth or stockholders' equity for subsidiaries not consolidated in the Part II or Part IIA Statement of Financial Condition, as filed by the broker or dealer, should be included in the notes to the consolidated statement of financial condition reported on by the independent public accountant. Readers may also wish to refer to paragraphs 4.13 and 4.14 of the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* for more information.

CFTC

.82 ***Maintenance of Minimum Financial Requirements and Notification Requirements.*** 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.

.83 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 two days prior to the withdrawal. For any reduction in net capital of 20 percent or more, notice must be provided within two days after the reduction.

.84 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. Particularly, it is a violation of CFTC rules for an FCM to file notice of a withdrawal of equity capital of 30 percent or more no earlier than two days prior to 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.

.85 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).

.86 ***Segregation of Customer Funds in Multiple Currencies.*** FCMs must maintain compliance with CFTC record keeping, 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. Total amount of customer funds on deposit in segregated accounts on behalf of commodity and commodity option customers;

2. Amount of such customer funds required to be on deposit in segregated accounts; and

3. Amount of the FCM's residual interest in such customer funds.

.87 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.

.88 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 U.S. 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.

.89 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, and

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.

.90 ***Regulatory Supplemental Schedules Required by CFTC.*** Within the last year, several FCMs have notified the CFTC that, as the result of errors in calculating the amount of funds that are held or required to be held in segregated accounts for customers, there have been overstatements of the amounts of excess funds in segregation versus those reported by the FCM in their annual audited financial reports filed with the CFTC. One of the reported errors affected the segregation statement and also caused this FCM to overstate its reported amount of excess net capital. FCMs should exercise appropriate diligence when preparing their regulatory schedules and have FCM supervisory personnel review the calculations before they are filed with the CFTC; FCMs should be aware that regulators are likely to subject these schedules to a higher level of scrutiny based on the errors mentioned above. FCMs may wish to consider CFTC guidance on materiality provided to Self-Regulatory Organizations (SROs) in CFTC Financial and Segregation Interpretation No. 4-1, which addresses SROs' responsibilities with respect to in-field examinations and ongoing surveillance over members' compliance with the SRO/CFTC's financial, segregation, and related record keeping rules. FCM independent auditors may wish to read this guidance to assist them in evaluating the materiality of (1) errors affecting segregation or secured calculations, or (2) the impact these may have on an FCM's reported net capital/excess net capital. Attention is directed to paragraph 40 of this Interpretation, which defines a material error (for the purpose of an SRO in-field examination) as an error in any line item that would cause a change of 10 percent or more in excess net capital or excess segregated funds or where the adjustment, if made to the financial statements, would cause the FCM to fall below the "early warning" level. (Interpretation No. 4-1 can be accessed at the CFTC Web site at www.cftc.gov/tm/tmint4.htm).

SEC/CFTC

.91 ***Reporting Material Differences Between Unaudited and Audited Financial Statements.*** SEC Rule 17a-5 and CFTC Regulation 1.10(d)(2)(vi) require that if material differences exist between certain schedules that are filed in the registrant's audited and "most recent" unaudited FOCUS Report/Form 1-FR, a reconciliation, including appropriate explanations, must be included with the audited financial report filed with the SEC/CFTC. To avoid differences in the two reports, some registrants have filed subsequent amendments to the Form X-17-5/Form 1-FR routinely filed at the end of the year, incorporating into those filings, adjustments recommended by their independent auditors. Because of the amendments to the previous FOCUS Report/Form 1-FR, these firms claimed that there were no differences between the audited report and the firm's "most recent" FOCUS /Form 1-FR filing and would typically file no reconciliation. According to an SEC Letter to NYSE dated April 24, 1987 (the Letter), this interpretation frustrates the purpose of the Rule. The Rule requires that, in spite of the amendment, the audited version of the firm's year-end Form X-17A-5 contain a reconciliation and explanation of material differences, if any, as compared to the original filing at the end of the year. However, the Letter provides that if a broker-dealer files an amended FOCUS report that contains the reconciliation and explanation of material differences between the amended report and the original report, the audited report may be reconciled with the amended FOCUS report and would include a statement as to whether any material differences are shown in the amendment. The CFTC's requirements are substantially the same.

.92 Therefore, if the registrant's amended unaudited fiscal year-end report includes a reconciliation with appropriate explanations, no other reconciliation is required to be filed with the registrant's audited financial report, except where a separate reconciliation is necessary because there are material differences between the schedules filed in the audited report and the amended unaudited report. In such a case, the separate reconciliation filed with the audited financial report must specify that it has been made to the registrant's amended unaudited report.

NASD

.93 ***Soft Dollar and Commission Rebate and Recapture Arrangements.*** A number of broker-dealers offer some type of soft dollar or commission rebate and recapture program. Although the nature of the benefits to customers involved in such programs vary, the mechanics of the payments can substantially increase a broker-dealer's net capital requirement pursuant to the Securities Exchange Act Net Capital Rule, and may subject the broker-dealer to the requirements of the Securities Exchange Act Customer Protection Rule. NASD has encountered situations in which a broker-dealer will claim to be offering a soft dollar program—the broker-dealer presumably arranging for the provision of a service or product to a customer, independently of the customer—though, in fact, the structure of the remittance to a third party amounts to a commission rebate. Firms should be aware that the primary guidance regarding financial requirements relative to the use of commission rebate and recapture arrangements is found in a February 2002 verbal interpretation from the SEC to the New York Stock Exchange, as follows:

> Any introducing broker-dealer that rebates a portion of its commission back to its customer, either as a cash payment or to a creditor of the customer, is required by SEC Rule 15c3-1(a)(2)(i) to maintain a minimum net capital requirement of at least $250,000. It is also considered a carrying firm for purposes of SEC Rule 15c3-3 unless it elects the following method for the handling of the customers' rebates:
>
> (1) The introducing broker deposits money into a separate SEC Rule 15c3-3 bank account similar to those accounts established under an SEC Rule 15c3-3 (k)(2)(i) exemption;
>
> (2) The balance in this separate bank account at all times must equal or exceed the payables to customers; and
>
> (3) The firm issues checks from this separate bank account to pay the customer or the creditor of the customer.

.94 NASD plans to issue a Notice to Members that would provide additional guidance relative to the regulatory financial requirements that could stem from such programs and illustrate the differences between what is viewed as a soft dollar arrangement as opposed to a commission rebate and recapture program.

.95 ***Transfers or "Sweeps" of Customer Free Credit Balances to Other Locations and Into Other Investments***. In view of market conditions and the increasingly competitive industry environment, broker-dealers continuously seek to develop and offer customers new investment services and products, such as the "cash sweep" account programs. Such programs transfer customer funds over time out of the broker-dealer to an interest-bearing account for the customer at a bank often affiliated with the broker-dealer. With the increasing popularity of "sweeps" programs for customers' credit balances, the NASD is concerned with (1) the sufficiency and timeliness of the broker-dealer's communication with its customers with respect to such arrangements and (2) in some cases, the passage of "swept funds" through a number of "hands" before being invested. Under the current market conditions, NASD anticipates seeing a wider use and a greater variety of "sweep" programs, which may include participants and investees that are either contractually not accountable or lack the experience, systems, and controls to appropriately account for customer funds. NASD recommends that broker-dealers become *thoroughly* familiar with the issues addressed in the New York Stock Exchange's Information Memorandum 05-11, *Customer Account Sweeps to Banks*. Information Memo 05-11 provides that NYSE member organizations that have sweep arrangements whereby customer funds leave the broker-dealer and are held for any period of time by a party other than the bank must address critical issues relating to customer protection and net capital requirements. Customer credit balances that leave the broker-dealer and are not immediately reinvested in an account protected by the Federal Deposit Insurance Corporation (FDIC) may be deemed to be included as a credit in the reserve formula. In addition, any receivable on the broker-dealer's books resulting from a sweep may be deemed to be a nonallowable asset. Information Memo 05-11 addresses issues involving the adoption of new cash sweep programs and provides procedures designed to safeguard investor interests for programs currently in place. It was prepared to set out best practices under current Exchange rules.

.96 Currently, there is a joint industry effort to draft a circular that would request additional procedures related to bank-sweep programs. Among other things, it is expected that one of the provisions of the circular will be a requirement for broker-dealers to prepare a reconciliation between the broker-dealer's records and the amounts on deposit with each intermediary bank and destination bank. The circular is also expected to indicate that the auditors will need to include in the scope of their work procedures around this reconciliation prepared by the broker dealer, if applicable.

.97 ***Appropriateness of Amounts Added Back to Owners' Equity in Computing Net Capital Related to Deferred Tax Liabilities***. Certain firms believe that taxable temporary differences, such as deferred compensation and differences in the depreciation or amortization of non-financial assets, as well as nonsubstantive deferred tax liabilities, those that will not require a future transfer of cash or assets, such as deferred tax liabilities related to financial reporting and tax bases differences of acquired intangible assets, can be added back to owners' equity in computing net capital. These firms also assert that if the underlying asset is nonallowable, any related deferred tax liability should not result in a further reduction in deriving net capital.

.98 In accordance with paragraph (c)(2)(i)(C) of the Securities Exchange Act Rule 15c3-1 (the Net Capital Rule), only deferred tax liabilities resulting from the recognition for financial statement purposes of unrealized income or appreciation related to long inventory, investment positions, or assets that are nonallowable for net capital can be added back to owners' equity in computing net capital. However, the SEC Division of Market Regulation staff has, by specific relief, permitted the add-back of deferred tax liabilities related to the capitalization of internally developed software and deferred advertising costs. The staff will consider requests for relief relative to specific transactions that result in the recognition in deferred tax liabilities which do not entail any associated recognition of unrealized income or appreciation for financial statement purposes.

SEC Regulations

.99 The following is a summary of some rules that the SEC issued since the writing of last year's Audit Risk Alert that may be of interest to broker-dealers. In addition to reading about the regulatory matters presented below, see the AICPA general *Audit Risk Alert—2006/07*, the AICPA *Independence and Ethics Alert—2006/07* (product no. 022477kk), and the AICPA *SEC and PCAOB Alert—2006/2007* (product no. 022497kk) for a discussion of some of the most important SEC regulations that have been issued recently that affect many industries, including the securities industry. Also, auditors should visit the SEC Web site at www.sec.gov to inform themselves about recent SEC rulemaking activities.

- *Regulation NMS: Extension of Compliance Dates and Correcting Amendment*. In May 2006, the SEC extended the compliance dates for Rule 610 and Rule 611 of Regulation NMS under the Exchange Act. Rule 610 requires fair and nondiscriminatory access to quotations; establishes a limit on access fees; and requires each national securities exchange and national securities association to adopt, maintain, and enforce written rules that prohibit their members from engaging in a pattern or practice of displaying quotations that lock or cross protected quotations. Rule 611 requires trading centers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the execution of trades at prices inferior to protected quotations displayed by other trading centers, subject to an applicable exception. The SEC extended the compliance dates to give automated trading centers additional time to finalize development of their new or modified trading systems, and to give the securities industry sufficient time to establish the necessary access to such trading systems. Dates: The effective date for Rule 610 and Rule 611 remains August 29, 2005. The initial compliance date for Rule 610 and Rule 611 has been extended from June 29, 2006, to a series of five dates, beginning on October 16, 2006, for different functional stages of compliance that are set forth in section II.A of this release. The effective date for this release is May 24, 2006. See Release No. 34-53829 for more information. Also, in December 2005, the SEC published a correcting amendment to Regulation NMS. See Release No. 34-51808A for more information.

- *Securities Offering Reform: Correction (technical amendments)*. In February 2006, the SEC made technical corrections to rules adopted in Release No. 33-8591 (July 19, 2005), which were published in the Federal Register on August 3, 2005 (70 FR 44722). The adopted rules modify and advance significantly the registration, communications, and offering processes under the Securities Act of 1933. This document corrects certain errors in the regulatory text of the adopting release and otherwise clarifies certain of the rules. Effective date: February 13, 2006. See Release No. 33-8591A for more information.

.100 Some other SEC rules that might be of interest primarily to those that are public companies:

- *Executive Compensation and Related Person Disclosure.* In August 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 Exchange Act, and to registration statements under the Exchange Act and the Securities Act of 1933. The SEC also adopted a requirement that disclosure under the amended items generally be provided in plain English. Effective date: November 7, 2006. See Release No. 33-8732A for more information.

- *Amendments to Plan of Organization and Operation Effective During Emergency Conditions.* In June 2006, the SEC adopted amendments to certain of its rules that operate in the event of emergency conditions to revise the provisions on delivering submittals, the line of succession to the chairman in the event of the chairman's incapacity or unavailability, and make conforming changes. Effective date: June 9, 2006. See Release No. 34-53937 for more information.

- *Revisions to Accelerated Filer Definition and Accelerated Deadlines for Filing Periodic Reports.* In December 2005, the SEC adopted amendments to the accelerated filing deadlines that apply to periodic reports so that a "large accelerated filer" (an Exchange Act reporting company with a worldwide market value of outstanding voting and nonvoting common equity held by nonaffiliates of $700 million or more) will become subject to a 60-day Form 10-K annual report filing deadline, beginning with the annual report filed for its first fiscal year ending on or after December 15, 2006. Until then, large accelerated filers will remain subject to a 75-day annual report deadline. Accelerated filers will continue to file their Form 10-K annual reports under a 75-day deadline, with no further reduction scheduled to occur under the revised rules. Accelerated filers and large accelerated filers will continue to file their Form 10-Q quarterly reports under a 40-day deadline, rather than the 35-day deadline that was scheduled to apply in 2006 under the previously existing rules. Further, the amendments revise the definition of the term *accelerated filer* to permit an accelerated filer that has voting and nonvoting common equity held by nonaffiliates of less than $50 million to exit accelerated filer status at the end of the fiscal year in which its equity falls below $50 million and to file its annual report for that year and subsequent periodic reports on a nonaccelerated basis. Finally, the amendments permit a large accelerated filer that has voting and nonvoting common equity held by nonaffiliates of less than $500 million to exit large accelerated filer status at the end of the fiscal year in which its equity falls below $500 million and to file its annual report for that year and subsequent periodic reports as an accelerated filer, or a nonaccelerated filer, as appropriate. Effective date: December 27, 2005. See Release No. 33-8644 for more information.

- *Asset-Backed Securities; Technical Amendments*. In November 2005, the SEC issued corrections to final rules which were published in the Federal Register on Friday, January 7, 2005 (70 FR 1506). The rules relate to the registration, disclosure, and reporting requirements for asset-backed securities under the Securities Act of 1933 and the Exchange Act. Effective date: December 5, 2005. See Release No. 33-8518A for more information.

Other Recent SEC Developments

.101 The following is a brief discussion of some other SEC developments that might be of interest to broker-dealers and their auditors.

SEC Concept Releases[3]

.102 ***Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting.*** In July 2006, the SEC published this Concept Release to understand better the extent and nature of public interest in the development of additional guidance for management regarding its evaluation and assessment of internal control over financial reporting so that any guidance the SEC develops addresses the needs and concerns of public companies, consistent with the protection of investors. The comment period ended on September 18, 2006. See Release No. 34-54122 for more information.

SEC Interpretive Releases[4]

.103 ***Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934.*** On July 18, 2006, the SEC published this interpretive release with respect to the scope of "brokerage and research services" and client commission arrangements under Section 28(e) of the Exchange Act. The SEC is soliciting further comment on client commission arrangements under Section 28(e). Section 28(e) of the Exchange Act establishes a safe harbor that allows money managers to use client funds to purchase "brokerage and research services" for their managed accounts under certain circumstances without breaching their fiduciary duties to clients. In this release, the SEC issued interpretive guidance with respect to the safe harbor, with the particular goal of clarifying the scope of "brokerage and research services" in the light of evolving technologies and industry practices. Effective Date: July 24, 2006. Market participants may continue to rely on the SEC's prior interpretations of Section 28(e) until January 24, 2007. Please see Release No. 34-54165 for more information.

---

[3] The SEC occasionally publishes "concept" releases to solicit the public's views on securities issues so that it can better evaluate the need for future rulemaking. The SEC Concept Releases are available on the SEC Web site at www.sec.gov.

[4] The SEC from time to time will provide guidance relating to topics of general interest to the business and investment communities by issuing an "interpretive release," in which it publishes its views on the subject matter and interprets the federal securities laws and its own regulations. The SEC Interpretive Releases are available on the SEC Web site at www.sec.gov.

SEC Policy Statements[5]

.104 ***Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities.*** On May 19, 2004, Office of the Comptroller of the Currency, Treasury (OCC); Office of Thrift Supervision, Treasury (OTS); Board of Governors of the Federal Reserve System (the Board); FDIC; and the SEC (collectively, the Agencies) issued and requested comment on a proposed Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities (Initial Statement) of national banks, state banks, bank holding companies, federal and state savings associations, savings and loan holding companies, U.S. branches and agencies of foreign banks, and SEC-registered broker-dealers and investment advisers (collectively, termed *financial institutions* or *institutions*). The Initial Statement described some of the internal controls and risk management procedures that may help financial institutions identify, manage, and address the heightened reputational and legal risks that may arise from certain complex structured finance transactions (CSFTs). After reviewing the comments received on the Initial Statement, the Agencies are requesting comment on a revised proposed interagency statement (Revised Statement). The Revised Statement has been modified in numerous respects to address issues and concerns raised by comments; clarify the purpose, scope, and effect of the Statement; and make the statement more principles-based. These changes include reorganizing and streamlining the document to reduce redundancies and focus the statement on those CSFTs that may pose heightened levels of legal or reputational risk to the relevant institution (referred to as *elevated risk CSFTs*). In addition, the Agencies have modified the examples of transactions that may present elevated risk to make these examples more risk-focused, and have recognized more explicitly that an institution's review and approval process for elevated risk CSFTs should be commensurate with and focus on the potential risks presented by the transaction to the institution. The Revised Statement will not affect or apply to the vast majority of small financial institutions, nor does it create any private rights of action. Comment period ended on June 15, 2006. Please see Release No. 34-53773 for more information.

SEC Special Studies[6]

.105 ***Economic Analysis of the Short Sale Price Restrictions Under the Regulation SHO Pilot.*** Short selling in exchange-listed stocks in the United States has been subject to a "tick test" and a "bid test" (the latter applies to NASDAQ National Market Stocks). The tick test and bid test are generally referred to as *price restrictions*. In July 2004, the SEC adopted Regulation SHO, which contains Rule 202T, allowing the SEC to establish, by separate order, a pilot program to examine the efficacy of price restrictions. At the same time, the SEC issued an order (Pilot Order) establishing a pilot program (Pilot) exempting a third of the stocks in the Russell 3000 Index (Russell 3000) from all price restrictions. The Pilot went into effect on May 2, 2005, and was scheduled to end on April 28, 2006, but has been extended to August 6, 2007, to allow the SEC to consider potential rulemaking after evaluating the results of the Pilot. The Pilot was designed to enable the SEC and the broader community to evaluate whether the price restrictions have a substantive impact on market quality, and more generally to achieve a deeper understanding of how price restrictions affect the trading process. The goal of this study is to examine whether eliminating price restrictions has had any impact on market quality, broadly defined. In September 2006, the SEC issued a draft analysis as a result of this study.

.106 The full text of this analysis can be found at www.sec.gov/about/economic/shopilot091506/draft_reg_sho_pilot_report.pdf.

.107 ***Proposed Study to Compare Roles of Investment Advisers, Broker-Dealers***. In August 2006, the SEC issued a request for contract proposals to conduct the first stage of a major study comparing how the different regulatory systems that apply to broker-dealers and investment advisers affect investors. The study was first suggested in connection with a rule that the SEC adopted in April 2005. Broker-dealers are regulated under the Exchange Act. Investment advisers are regulated under the Investment Advisers Act of 1940. The

---

[5] From time to time, the SEC issues a policy statement to clarify its position on a particular matter.

[6] The SEC or SEC staff often undertake special projects to study and report on current trends and issues facing the securities industry.

2005 rule allowed broker-dealers to offer fee-based brokerage accounts without being required to comply with the Advisers Act. The rule was the subject of a large number of comments. Many of the concerns that commentators raised in the rulemaking, however, went well beyond the circumstances covered by the rule; the investment professional study will help the SEC determine whether the concerns are justified and, if so, decide how best to respond.

.108 The full text of the request for proposal can be accessed on the SEC's Web site at www.sec.gov/news/extra/2006/sechq1-06-r-0177.pdf. The SEC's rule providing for the study appears on the SEC's Web site at www.sec.gov/rules/final/34-51523.pdf.

.109 ***Joint Report on Efforts of the Private Sector to Implement the Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System***. Congress in the Intelligence Reform and Terrorism Prevention Act required the Federal Reserve, the Office of the Comptroller of the Currency, and the SEC (Agencies) to prepare a study on the efforts of the private sector to implement the ***Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System (Sound Practices Paper***). As directed in the legislation, this report, which was released in April of 2006, discusses the efforts of private sector financial services firms covered by the Sound Practices Paper to implement enhanced business continuity plans, and the extent to which implementation has been done in a geographically dispersed manner. This report also addresses the agencies' views whether the Sound Practices Paper should be expanded to a larger range of private sector financial services firms that play significant roles in critical financial markets and whether legislative and regulatory changes are needed to expedite implementation by affected firms and optimize business continuity planning by the financial services industry.

.110 The full text of the report can be found at www.sec.gov/news/press/studies/2006/soundpractices.pdf.

Other SEC Orders, Notices, Information

.111 ***Order Granting Approval of Plan for Allocation of Regulatory Responsibilities Between The NASDAQ Stock Market LLC and the National Association of Securities Dealers, Inc.*** On July 12, 2006, the SEC approved and declared effective a plan for allocating regulatory responsibility between the NASDAQ Stock Market LLC (NASDAQ) and NASD. Accordingly, NASD will assume, in addition to the regulatory responsibility it has under the Exchange Act, the regulatory responsibilities allocated to it under the plan. At the same time, NASDAQ is relieved of those regulatory responsibilities allocated to NASD.

.112 The plan is intended to reduce regulatory duplication for firms that are common members of NASDAQ and NASD. Included in the plan is an attachment that:

- Clearly delineates regulatory responsibilities with respect to specified NASDAQ rules and specified federal securities laws;
- Lists every NASDAQ rule that is identical or substantially similar to a NASD rule for which, under the plan, the NASD would bear responsibility for examining and enforcing compliance by common members;
- Includes the federal securities laws for which, under the plan, the NASD would bear responsibility for examining and enforcing compliance by common members;
- Provides that NASD shall not assume regulatory responsibility, and NASDAQ will retain full responsibility, for the surveillance and enforcement of trading activities or practices solely involving NASDAQ's own marketplace;
- Permits NASDAQ and NASD to terminate the plan for various reasons, including the nonpayment of fees, for cause, and for convenience.

Guide to Broker-Dealer Registration

.113 In December 2005, the SEC Department of Market Regulation issued a Guide to Broker-Dealer Registration. The Exchange Act governs how the nation's securities markets and its brokers and dealers operate. The SEC prepared the guide to summarize some of the significant provisions of the Exchange Act and its rules. Firms will find information about whether they need to register as a broker-dealer and how they can register, as well as what standards of conduct and financial responsibility rules broker-dealers must follow. The guide covers a number of topics including:

- Who is required to register
- How to register as a broker-dealer
- Security futures
- Conduct regulation of a broker-dealer and
- Financial responsibility of a broker-dealer

.114 The guide is available at the SEC Web site at www.sec.gov/divisions/marketreg/bdguide.htm#I.

CFTC Regulations

.115 The following summarizes certain amendments to regulations and interpretations of the CFTC that became effective in the latter part of 2005 and in 2006. These amendments affected the financial reporting requirements of registered FCMs, and also of IBs that are not guaranteed by FCMs. They also included changes to the filing requirements of commodity pool operators (CPOs). The amendments were published in the Federal Register, and can be accessed electronically from the CFTC Web site at www.cftc.gov.

Alternative Capital Deductions for Market Risk and Credit Risk for FCMs Within "Consolidated Supervised Entities"

.116 The CFTC issued final rules, effective February 2, 2006, that specify filing and other requirements that FCMs must comply with in order to elect to use certain alternative capital deductions for their proprietary trading assets instead of the capital deductions that CFTC Regulation 1.17(c) would otherwise require. Only those FCMs that are also registered with the SEC as securities broker-dealers, and that have obtained written SEC approval to compute alternative deductions for market risk and credit risk based on internal mathematical models, may elect to use these same alternative deductions for the capital computations required by CFTC Regulation 1.17.

.117 Simultaneously, rules were adopted affecting minimum net capital requirements of FCMs and IBs by reducing the capital deductions for their uncovered inventory or forward contracts in specified foreign currencies, consistent with prior CFTC staff guidance.

Revision of CFTC Financial and Segregation Interpretation 10

.118 Effective February 13, 2006, Financial and Segregation Interpretation No. 10-1 was amended to prohibit FCMs from depositing, holding, or maintaining margin funds for customer accounts in third-party custodial accounts, except that, under certain specified conditions, FCMs may use such accounts for the assets of a customer that is a registered investment company (RIC) under the Investment Company Act of 1940, if the FCM is not eligible under SEC rules to hold such assets because it is an affiliate of the RIC or its adviser.

Requirement for Electronic Filing of Pool Financial Statements

.119 Effective March 24, 2006, the CFTC amended its rules to require CPOs to submit commodity pool annual financial reports to the National Futures Association (NFA) via the NFA's electronic filing system.

NFA implemented EasyFile, a Web-based system, for CPOs to file their annual financial reports electronically. The system was available in January 2005 for the December 31, 2004, annual report filings on a voluntary basis and became mandatorily effective March 24, 2006, in time for the filing of annual reports as of December 31, 2005. Detailed filing instructions are available on the NFA's home page, www.nfafutures.org under Electronic Filings, Easy File for Pool Filers. CPOs should not file hard copies of annual financial reports filed through EasyFile with either NFA or the CFTC. CPOs are required, however, to provide hard copies of the annual reports to their pool participants, and maintain a manually signed copy of the audit report, readily available for inspection by regulators.

Increase in Minimum Capital Requirements

.120 The CFTC posted on its Web site in July 2006 a revised Instructions Manual for the financial Form 1-FR-FCM, which noted necessary changes to FCM financial reports in order to reflect increased capital requirements adopted by NFA rule amendments that became effective July 31, 2006. These amendments, which were approved by the CFTC, increased minimum financial requirements for FCMs, IBs, and forex dealer members (FDMs), as follows:

- For FCMs, from $250,000 to $500,000
- For IBs, from $30,000 to $45,000
- For FDMs, from $250,000 to $1,000,000

.121 The NFA amendments also imposed the following greater requirements:

- A $7,500,000 minimum capital requirement for FCMs with affiliates, if those affiliates are authorized to act as counter parties to off-exchange forex transactions with retail customers solely by virtue of their affiliation with a registered FCM; and
- A $5,000,000 minimum capital requirement for all FCMs that are counter parties to off-exchange forex options transactions with retail customers.

.122 Also, effective November 30, 2005, the NFA adopted counter party concentration charges for FDM foreign currency transactions as follows:

- For transactions with unregistered, unaffiliated counter parties, if the net open position with the counter party exceeds 10 percent of the FDM's aggregate long or short position in a particular currency, the amount in excess of 10 percent is subject to a 6 percent haircut (if the currency is euros, British pounds, Canadian dollars, Japanese yen, or Swiss francs) or a 20 percent haircut (for all other non-U.S. currencies).
- For transactions with affiliates, the required 6 or 20 percent haircut is applied to the greater of (1) the sum of the amounts by which the FDM's net open position with any single affiliate exceeds 10 percent of the FDM's total long or short position in a particular currency; or (2) the amount by which the FDM's net open position with all affiliates combined exceeds 10 percent of the FDM's aggregate long or short positions in a particular currency.

CFTC Annual "Dear CPO" Letter

.123 On February 17, 2006, 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.

.124 Major concerns addressed in the letter are:

- Due dates of commodity pool financial filings—late filings
- Amendments to Part 4
- Notification of a change in accountants
- Compliance with U.S. generally accepted accounting principles (GAAP)
- Requests for relief from U.S. GAAP compliance for certain offshore commodity pools
- Initial annual reports and final annual reports
- FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*, implementation and its impact on participants' redemptions
- Reminder regarding availability of annual report information under the Freedom of Information Act (FOIA)

.125 The letter also noted that the CFTC's Division of Clearing and Intermediary Oversight (DCIO) issued similar letters in prior years, available under the "Compliance Information" section of 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.

Self-Regulatory Organization Regulations

.126 Under the Exchange Act, all broker-dealers are required to be members of SROs such as the NYSE and NASD, or some other organization that is designated to perform routine surveillance and monitoring of its members. During the past year, a number of significant regulations were issued by SROs, some of which are described in the following sections. Please refer to the Web sites of the respective SROs for a complete listing of recently issued rules and regulations.

.127 Please note that on November 28, 2006, the NASD and the NYSE announced a plan to consolidate their member regulation operations into a SRO that will be the single regulator for all securities firms doing business with the public in the United States. Please refer to the NASD Web site at www.nasd.com/RegulatoryConsolidation/index.htm for more information.

NASD Rulemaking

.128

- *Notice to Members 06-26—Amendments to Margin Rules to Reflect Additional Complex Option Spread Strategies*. On April 3, 2006, NASD filed with the SEC for immediate effectiveness a rule change to amend NASD Rules 2520 and 2522 that revised the margin requirements to recognize specific additional complex option spread strategies for purposes of determining required margin, and has amended the provisions relating to "permitted offsets" for certain listed option transactions. Rules 2520 and 2522, as amended, are set forth in Attachment A of Notice 06-26. The effective date and the implementation date of the amendments was April 3, 2006.
- *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*. 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 06-07—SEC Approves Amendments to Anti-Money Laundering Compliance Program Rule and Adoption of Interpretive Material.* On December 28, 2005, the SEC approved amendments to NASD Rule 3011 and the adoption of IM-3011-1 and IM-3011-2. The amendments and new interpretive material require a firm to conduct an independent test of its AML compliance program on an annual basis (with the exception of certain types of firms), clarify the persons not considered to be independent for purposes of the independent testing requirement, and require a firm, on a quarterly basis, to review and, if necessary, update the information regarding the firm's AML compliance person. The new rule text and interpretive material are contained in Attachment A to Notice 06-07. The amendments became effective on March 6, 2006. Also see the "AML Testing Requirements and Auditor Independence" section of this Alert for a discussion of this rule amendment as well as the impact of AML testing engagements on the independence of auditors.

- *Notice to Members 06-04—SEC Approves Amendments to NASD Rule 3012 to Require Members Relying on Rule 3012's "Limited Size and Resources" Exception to Notify NASD of their Reliance.* On November 18, 2005, the SEC approved amendments to NASD Rule 3012 to require members relying on the "limited size and resources" exception to Rule 3012's general supervisory requirement for conducting producing managers' supervisory reviews to report electronically to NASD their reliance on the exception. NASD issued this *Notice to Members* to advise members of the rule change and to introduce the electronic reporting system that members will need to use to notify NASD of their reliance on Rule 3012's "limited size and resources" exception. Questions and answers relating to the rule change and the reporting system are included. The new rule text appears in Attachment A to Notice 06-04. It became effective on February 14, 2006. A sample screen shot of the electronic notification system Web page is in Attachment B to Notice 06-04.

.129 The rules are available at the NASD Web site at www.nasd.com.

.130 Please be aware that securities industry professionals and others can subscribe to NASD's free e-mail service. Among other things, subscribers can obtain weekly notifications of regulatory information and updates, including new speeches, news releases, announcements, and publications. This service would be an excellent source of current information for anyone involved with broker-dealers and who is seeking to learn what regulatory issues may be affecting the industry. You can subscribe to NASD e-mail service at apps.nasd.com/contact_us/SubscriptionForm.aspx?lists=prof.

.131 Also, broker-dealers and other interested parties should avail themselves of other resources available on the NASD Web site, including:

- *NASD Manual Online*. Recently redesigned, the manual contains core regulatory content, including rules and bylaws.
- *NASD Rule Filing Status Report*. This provides a comprehensive list of pending rule filings.
- *NASD Frequently Asked Questions*. These clarify rules to better understand compliance requirements.
- *OFAC Search Tool.* This automated tool searches the "Specially Designated Nationals and Blocked Persons" list.

.132 This information is available at www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&nodeId=606&ssSourceNodeId=612.

NYSE Rulemaking

.133

- *Information Memo 06-86, Amendments to NYSE Rules 431 and 726 That Expand Customer Portfolio Margining.* See the "Portfolio Margining" section of this Alert.

- *Information Memo 06-57, Amendments to Rules 431 and 726 That Expand the Scope of Eligible Products for the Customer Portfolio Margining Pilot.* See the "Portfolio Margining" section of this Alert.

- *Information Memo 06-56, Amendments to Rules 104 123E to Change the Capital Requirements for Specialist Organizations.* On July 25, 2006, the SEC issued an order approving amendments to NYSE Rules 104, *Dealings by Specialists*, and 123E, *Specialist Combination Review Policy*, which change the capital requirements of specialist organizations. The amendments to Rules 104 and 123E restructure the capital requirements of specialist organizations from an approach based on the valuation of classes of allocated securities, which included capital penalties for mergers among specialists, to an approach based on specialist market share measured by total dollar volume traded combined with market stress and volatility risk analysis.

- *Information Memo 06-51, Independent Contractor Arrangements.* The SEC approved amendments to the Interpretation of NYSE Rule 345, *Employees—Registration, Approval, Records*, that eliminate the requirement that proposed independent contractor arrangements be submitted to the NYSE for approval. Further, the amendments eliminate the general prohibition against the assertion of independent contractor status by persons who have been delegated supervisory responsibility pursuant to Rule 342, *Supervision—Approval, Supervision and Control*. The revised Interpretation appears in Exhibit A to Information Memo 06-51. It became effective immediately.

- *Information Memo 06-30, Guidance Pertaining to Business Continuity and Contingency Plans Relating to a Potential Pandemic.* The spread of avian flu that was experienced in 2006 raised concerns among governmental and public health officials of a near-term pandemic flu. A pandemic flu would involve the person-to-person transmission of a "virulent human flu that causes a global outbreak, or pandemic, of serious illness." Although there is no pandemic flu at this time, were one to occur, it could cause a significant and extended business interruption differing materially from the emergencies recently confronted by member organizations of the NYSE. For example, a pandemic flu is expected to occur in multiple "waves," each potentially spanning weeks or longer, and thus might have a substantially greater duration than the blackout of August 14 and 15, 2003, or the terrorist attacks of September 11, 2001. In addition, a pandemic flu is expected to involve outbreaks in numerous domestic and international locations. Therefore, unlike the regional emergencies created by Hurricanes Katrina and Rita, a pandemic flu might affect a member organization's main office, branch offices, backup locations, suppliers, and customers, regardless of their geographic diversity. As a result of the concern over a potential pandemic flu, NYSE Regulation, Inc., issued this Information Memo to provide guidance to member organizations as to how to assess whether their Business Continuity and Contingency Plans (BCPs) would be suitable for a prolonged, widespread public health emergency. This memorandum reflects the current state of publicly available information concerning a potential pandemic and commonly accepted strategies for pandemic preparedness. Ultimately, the key to any BCP is flexibility: member organizations should tailor their planning efforts to their particular business models and customer needs, and should become and remain informed about developing pandemic flu projections.

- *Information Memo 06-22, Executive Responsibilities.* This Information Memo reminds member organizations that the front page of the FOCUS report specifically requires a distinct affirmation by the member organization, through its signatories, that the content of the FOCUS is "true, correct and complete." Consequently, in order to achieve the level of diligence necessary for this assertion, the chief financial officer (and other persons signing the Form) must be in a position to vouch for its content, based upon his or her knowledge of the information contained therein and the information supporting the filing. Persons signing the FOCUS report must be knowledgeable and have an independent basis for believing that the report is accurate and complete. The fact that certain clerical or computational activity has been outsourced will not serve to avert responsibility for the integrity of the final product. A close review of the report, questioning of those who may have prepared elements of it and inquiry into specific items on a random basis may be insufficient if the report is later determined to be inaccurate or incomplete; ultimate responsibility cannot be delegated. Member organizations should have systems in place to ensure that processes for the reconciliation, posting, and preparation of books and records are performed accurately and on a timely basis. The levels of care and application called for in the preparation of the FOCUS report are also applicable to forms and filings that are submitted by the member organization to all regulatory authorities, and conscientious diligence must be a uniform standard. Member organizations and their principal executives are urged to review their practices and procedures to ensure that the content of each FOCUS report and other financial submissions to the Exchange satisfy the level of accuracy required.

- *Information Memo 06-21,* Revised: *Agency Lending Disclosure Initiative*—Revised Timeline. Information Memo 06-21 is an update to Information Memo 05-39, *Agency Lending Disclosure Initiative*, which was issued in June 2005. SEC staff raised concerns regarding the level of transparency and information disclosure in agency securities lending transactions and the impact on credit and regulatory capital monitoring. The long-standing practice in the broker-dealer industry was to record agency securities lending transactions at the agent level, with few or no details disclosed regarding the transactions with or exposure to the underlying principal lenders. SEC staff concluded that to comply with existing financial responsibility rules, particularly the net capital rule, broker-dealers engaged in the business of agency securities lending must: (1) maintain books and records of loan activity with each underlying principal lender, (2) monitor credit exposure to each underlying principal lender, and (3) calculate regulatory capital exposure to each underlying principal lender. Subsequent discussions on this issue between regulators and the industry led to the formation, in January 2004, of the Agency Lending Disclosure Taskforce (the Industry Taskforce). The Industry Taskforce has drafted documents summarizing the industry deliverables in order to ensure agreement with the regulators. Among the documents is a specific timeline for the Agency Lending Disclosure Initiative. Members and member organizations that engage in the business of agency securities lending should be aware of the Agency Lending Disclosure Initiative. The purpose of the Agency Lending Disclosure Initiative is to establish uniform processes to assist members and member organizations in their compliance with existing rule requirements related to books and records, net capital, and internal controls when engaged in agency securities lending activities. Information on the efforts and all material produced by the Industry Taskforce regarding the Agency Lending Disclosure Initiative (ALDI) can be found on its Web site at www.agencylending.capco.com. As an update to Information Memo 05-39, the ALDI Industry Taskforce revised the milestones on the specific timeline for the ALDI and those revisions are reflected in Information Memo 06-21. October 1, 2006 was the deadline for completion of ALDI.

- *Information Memo 06-04, Amendments to Rule 445, Anti-Money Laundering Compliance Program.* On January 25, 2006, the SEC issued an order approving amendments to NYSE Rule 445, *Anti-Money Laundering Compliance Program*. Rule 445 requires NYSE members and member organizations to develop an AML compliance program designed to comply with the requirements of the Bank Secrecy Act and the implementing regulations promulgated thereunder. Rule 445 further requires the designation of a person or persons, commonly known as *AML Officers*, responsible for implementing and monitoring the AML program's day-to-day operations and internal controls. In addition, Rule 445 requires the "independent testing" of the AML program. The amendments to Rule 445 (which appear in Exhibit A to Information Memo 06-04) establish a time frame for the "independent testing" requirement, a standard to determine who is adequately qualified and sufficiently independent to conduct such testing, and affiliation guidelines for AML Officers (which appear in Exhibits B and C to Information Memo 06-04). The amendments became effective immediately. Also see the "AML Testing Requirements and Auditor Independence" section of this Alert for a discussion of these amendments as well as the impact of AML testing engagements on the independence of auditors.

- *Information Memo 05-108, Elimination of Paper Copy FOCUS Report Submission to NYSE*. Effective with the January 2006 filing of Form X-17A-5 FOCUS Report, the electronic submission of the FOCUS Report has been the only filing required to meet the reporting requirement of SEA Rule 17a-5, *Reports to Be Made by Certain Brokers and Dealers*. Consequently, members and member organizations are no longer required to submit a paper copy of the FOCUS Report to the NYSE. Members and member organizations are reminded that the signatures of at least two principal executive officers or partners are required on the cover page of the FOCUS Report at the time it is electronically filed with the Exchange. Specialist organizations that deduct specialist haircut charges pursuant to SEA Rule 15c3-1(c)(2)(vi) but also add back haircut charges to their capital on their specialist positions pursuant to SEA Rule 15c3-1(c)(2)(vi)(N), and where this add-back to capital is only disclosed on their paper copy FOCUS Reports, should continue to retain these FOCUS Reports as part of their books and records pursuant to SEA Rule 17a-4, *Records to be Preserved by Certain Exchange Members*, Brokers and Dealers, and NYSE Rule 440, *Books and Records*. NYSE staff may request to review these FOCUS reports during their examinations.
- *Information Memo 05-101—Amendments to NYSE Rule 342.30—Annual Report; Chief Compliance Officer Designation; Chief Executive Officer Certification.* On November 16, 2005, the SEC approved amendments to NYSE Rule 342, *Offices—Approval, Supervision and Control*, and its Interpretation that require each member not associated with a member organization (non-associated member) and each member organization to file with the Exchange, by April 1 of each year, a report (the Annual Report) that addresses the member's or member organization's supervision and compliance efforts during the preceding calendar year, as well as ongoing compliance processes and procedures. The Amendments also require that each member organization's Annual Report include the designation of a principal executive officer or general partner as chief compliance officer. The Amendments further require that the Annual Report include a certification, signed by the non-associated member or the Chief Executive Officer of the member organization submitting it, that processes are in place to establish, maintain, and review policies and procedures reasonably designed to achieve compliance with applicable Exchange rules and federal securities laws and regulations (a sample Certification Form is included as Exhibit C). The amendments became effective immediately; the annual report for calendar year 2005 was due April 1, 2006.

.134 The rules are available at the NYSE Web site at www.nyse.com.

Audit and Accounting Issues and Developments

Trends in SEC Comment Letters

Income Statement

.135 SEC Regulation S-X, Article 5-03 provides guidance on income statement presentation, which is geared towards commercial and industrial companies. The AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* and the AICPA Practice Aid, *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools*,[7] provide a different format for income statement presentation. Recently, the SEC has requested several financial service filers to change their income statement format to comply with that of Article 5-03. In some of those cases, the SEC has accepted expanded disclosure in lieu of changing the presentation of the income statement.

---

[7] The Commodity Practice Aid Task Force of the AICPA is in the process of revamping the *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools* Practice Aid to reflect changes in accounting and auditing guidance and regulatory rules that 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. Readers should be alert to further developments.

Statement of Cash Flows

.136 In the past year, there have been a number of restatements in the area of cash flow statements. In the financial services industry, most of the restatements were due to incorrect application of guidance in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale*. Paragraph 9 of FASB Statement No. 102 states:

> Some loans are similar to securities in a trading account in that they are originated or purchased specifically for resale and are held for short periods of time. Cash receipts and cash payments resulting from acquisitions and sales of loans also shall be classified as operating cash flows if those loans are acquired specifically for resale and are carried at market value or at the lower of cost or market value. Cash receipts resulting from sales of loans that were not specifically acquired for resale shall be classified as investing cash inflows. That is, if loans were acquired as investments, cash receipts from sales of those loans shall be classified as investing cash inflows regardless of a change in the purpose for holding those loans.

.137 A number of finance companies had restatements resulting from the misclassification of cash flows related to certain loans that were originated or purchased with the intent to sell as cash flows from investing activities, instead of operating activities, which is the presentation required by FASB Statement No. 102.

Issues Associated With FASB Statement No. 133 Accounting for Derivative Instruments and Hedging Activities

.138 Numerous companies have been required to restate their financial statements due to technical noncompliance with the provisions of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, although their derivatives performed as expected as effective economic hedges. Broker-dealers applying hedge accounting pursuant to FASB Statement No. 133 should ensure that their application of hedge accounting is contemporaneously documented and meets all requirements of FASB Statement No. 133 and related implementation guidance. In particular, firms applying the "shortcut" method of hedge accounting should ensure that their application is appropriate and consistent with paragraph 68 in its entirety and that any unique features of instruments are evaluated closely in consideration of paragraph 68e. FASB Statement No. 133 limits the use of the "shortcut" method to hedges of interest rate risk that involve interest-rate swaps and recognized interest-bearing assets or liabilities. It also requires that general hedge requirements such as contemporaneous formal documentation be met. It then adds nine additional criteria, specific to shortcut method hedges, which must also be met. Furthermore, Derivative Implementation Group (DIG) Issue E4, *Hedging-General: Application of the Shortcut Method*, indicates that each and every one of the shortcut criteria must be met and that "a hedging relationship cannot qualify for application of the shortcut method based on an assumption of no ineffectiveness justified by applying other criteria."

AML Testing Requirements and Auditor Independence

.139 NASD Rule 3011 and NYSE Rule 445, both entitled *Anti-Money Laundering Compliance Program*, require, among other things, that member firms and member organizations independently test their AML programs. In Notice to Member 02–21 NASD stated that such testing can be done by either personnel of the broker-dealer or a qualified outside party. In one of the speeches by SEC staff, the following was said in connection with this requirement: "Many of you have voiced concerns regarding this requirement. As regulators, we understand that maintaining the independence of auditors can be a challenging task for small firms." As a result, many practitioners have questioned whether the auditor's independence is compromised if the auditor performs the independent AML testing for a firm that is an audit client.

.140 The 2006 conforming changes to the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* include revisions to the "Anti-Money Laundering Regulations" section to address this concern. Specifically, based on discussions with SEC staff, paragraph 3.103 was revised to indicate that,

> It would be proper for the auditor of the broker-dealer to perform testing of anti money laundering program if it is done in accordance with attestation standards. It can be performed as agreed upon procedures, or an attestation of management assertions. However, if performed as a consulting service, such as generating work papers, reports for the NASD or NYSE to review, the SEC staff believes this would be considered a management function, and therefore, would impair the auditor's independence.

.141 It should be noted that both NASD and NYSE recently amended their AML testing requirements. On December 28, 2005, the SEC approved amendments to NASD Rule 3011 and the adoption of new interpretive material IM-3011-1 and IM-3011-2. The amendments and new interpretive material clarify that, in most instances, firms are required to test their AML programs at least annually (on a calendar-year basis). However, the rule change allows firms that do not execute transactions for customers or otherwise hold customer accounts and do not act as an introducing broker with respect to customer accounts, to test once every two years (on a calendar-year basis) rather than on an annual basis. The amendments and new interpretive material also clarify the persons not considered to be independent for purposes of the independent testing requirement and require a firm, on a quarterly basis, to review and, if necessary, update the information regarding the firm's AML compliance person. For more information please refer to NASD Notice to Members 06-07, which is discussed in the "NASD Rulemaking" section of this Alert.

.142 On January 25, 2006, the SEC approved amendments to NYSE Rule 445. The amendments to Rule 445(3) establish that members and member organizations that conduct a public business must independently test their AML program, at a minimum, on an annual calendar year basis. Members and member organizations that do not conduct a public business must independently test their AML Program, at a minimum, every two calendar years. Members and member organizations that conduct no public business include those that engage solely in proprietary trading or that conduct business only with other broker-dealers. Section .10 of the Rule's Supplemental Material obliges members and member organizations to undertake more frequent testing if circumstances warrant (for example, a material change to the business mix of the member or member organization; in the event of a merger or acquisition; if testing of the AML program reveals systematic weaknesses; or in response to any other regulatory red flags). The amendments to rule 445 also establish a standard to determine who is adequately qualified and sufficiently independent to conduct such test, and establish affiliation guidelines for AML officers. For more information, please refer to NYSE Information Memo 06-04, which is discussed in the "NYSE Rulemaking" section of this Alert.

Annual Certification of Compliance and Supervisory Processes

.143 NASD Rule 3013, *Annual Certification of Compliance and Supervisory Processes*, requires members to (1) designate a chief compliance officer (CCO) and (2) have the chief executive officer (CEO) or equivalent officer certify annually that the member has in place processes to establish, maintain, review, test, and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance with applicable NASD rules, Municipal Securities Rulemaking Board (MSRB) rules, and federal securities laws and regulations. Recently amended NYSE Rule 342.30, *Annual Report and Certification*, contains similar requirements. (For more information on the NYSE rule, please refer to NYSE Information Memo 05-101, which is discussed in the "NYSE Rulemaking" section of this Alert.) First annual certification pursuant to these rules had to be executed by April 1, 2006.

.144 Given that 2006 is the first year in which these certifications are to be executed, auditors should consider obtaining and reading this letter to ensure there are no compliance issues affecting the internal control and/or financial reporting of their broker-dealer clients.

Report on Internal Control

.145 SEC Rule 17a-5, *Reports to Be Made by Certain Brokers and Dealers,* requires independent auditors to issue a report on broker-dealers' internal control. To meet this requirement, a report should (*a*) express an opinion on the adequacy of the practices and procedures listed in SEC Rule 17a-5(g)(1) (in relation to the definition of a material inadequacy as stated in SEC Rule 17a-5(g)(3)) and (*b*) disclose material weaknesses in internal control (including procedures for safeguarding securities) that are revealed through auditing procedures designed and conducted for the purpose of expressing an opinion on the financial statements. CFTC Regulation 1.16, *Qualifications and Reports of Accountants*, requires independent auditors of entities it regulates to issue a similar report on internal control.

.146 A material inadequacy that is expected to be reported includes any condition that has either contributed substantially to or, if appropriate corrective action is not taken, could reasonably be expected to cause any of the following:

a. Inhibit a broker-dealer from completing securities transactions or promptly discharging its responsibilities to customers or to other brokers, dealers, or creditors

b. Result in material financial loss

c. Result in material misstatements of the broker's or dealer's financial statements

d. Result in violations of the SEC's recordkeeping or financial responsibility rules to an extent that could reasonably be expected to result in the conditions described in the preceding three items *a, b, or c.*

.147 CFTC Regulation 1.16d(2) provides a similar definition.

.148 In addition to material inadequacies, reports on internal control submitted to the SEC and CFTC should also address the existence of material weaknesses as defined in SAS 112, *Communication of Internal Control Related Matters Noted in an Audit*

.149 For audits of financial statements for periods ending before December 15, 2006, auditors may follow guidance in SAS No. 60 to satisfy the internal control reporting requirements described above. SAS No. 60 defines a material weakness in internal control as a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

.150 In May 2006, the ASB issued SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit,* which supersedes SAS No. 60. SAS No. 112 is effective for audits of financial statements for periods ending on or after December 15, 2006. Earlier implementation is permitted. Auditors who audit financial statements for periods ending on or after December 15, 2006, or choose to implement SAS No. 112 early, should follow guidance in SAS No. 112 when reporting on internal control of their broker-dealer clients.

.151 SAS No. 112 provides the following definitions:

- 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 GAAP such that there is more than a remote likelihood [*footnote omitted*] 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.

.152 Among other matters, SAS No. 112 also:

- Provides guidance to the auditor in evaluating the severity of control deficiencies based on the likelihood and magnitude of misstatements, including whether misstatements or potential misstatements are "more than inconsequential," and the possible mitigating effects of effective compensating controls that have been tested and evaluated as part of the financial statement audit.
- Identifies certain areas deficiencies in which ordinarily would be considered at least significant deficiencies in internal control
- Provides 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
- Includes an appendix containing examples of circumstances that may be control deficiencies, significant deficiencies, or material weaknesses.

.153 Paragraph 3.85 of the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* indicates that the term *material inadequacy* encompasses either a material weakness in internal control or a material inadequacy in the practices and procedures in SEC Rule 17a-5(g)(1) or Regulation 1.16d(1) of the CFTC, as appropriate. Please refer to the SEC and CFTC rules as well as paragraphs 3.77–3.91 and 5.100–5.103 of the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* for additional guidance on broker-dealer internal control reporting. The guide also provides examples of reports on internal control in Appendixes C, "Report on Internal Control Required by SEC Rule 17a-5;" D, "Report on Internal Control Required by SEC Rule 17a-5 for a Broker-Dealer Claiming an Exemption From SEC Rule 15c3-3;" and F, "Report on Internal Control Required by CFTC Regulation 1.16 and SEC Rule 17a-5(g)(1)." Please note that the 2006 edition of the guide contains two versions of each appendix, one based on guidance in SAS No. 60 (Appendixes C, D, and F) and the second version is based on guidance in SAS No. 112 (Appendixes C-1, D-1, and F-1). Similarly, Chapters 3 and 5 of the guide contain guidance based on both SAS No. 60 (paragraphs 3.81 and 5.100) and SAS No. 112 (paragraphs 3.82–3.84 and 5.101–5.103).

.154 Following the issuance of 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)[8] in June of 2004, the number of material weaknesses and material inadequacies reported to the regulators has increased. This can partially be attributed to increased awareness about internal control in light of the issuance of PCAOB Auditing Standard No. 2. Also, for broker-dealers that are subsidiaries of public companies, auditors may have performed additional procedures to be able to report on the consolidated entity's financial statements and internal control in accordance with PCAOB standards. As auditors performed more internal control work for such broker-dealer clients, they became aware of additional issues and areas in which problems may arise, which could also explain the increase in the number of reported material weaknesses and material inadequacies.

.155 The number of material weaknesses and material inadequacies reported to the regulators is expected to increase even further as auditors start adopting SAS No. 112.

[8] On December 19, 2006, the PCAOB issued a proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements,* which would supersede PCAOB Auditing Standard No. 2. For more information, please refer to the discussion in the "Auditing Pipeline—Public Companies" section of this Alert.

.156 Auditor-initiated adjusting journal entries are common for broker-dealer clients and in the past had not often been reported to regulators as material weaknesses or material inadequacies unless those entries resulted from a systemic problem, affected net capital, or had an impact on customers. Under both PCAOB Auditing Standard No. 2 and SAS No. 112, identification by the auditor of a material misstatement in financial statements for the period under audit that was not initially identified by the entity's internal control is at least a significant deficiency and a strong indicator that a material weakness in internal control over financial reporting exists. Both standards also indicate that this is a strong indicator of a material weakness even if management subsequently corrects the misstatement. In light of that guidance, adjustments that previously were not considered material weaknesses would potentially be treated as such if they are material to the broker-dealer's audited financial statements. Also, every time a reconciliation for the computation of net capital or for determination of the reserve requirements is provided along with the audited financial statements, the auditor should consider whether there is a material weakness or material inadequacy.

.157 Also, auditors who assist their broker-dealer clients with drafting financial statements have questioned whether this constitutes a significant deficiency or a material weakness. The answer is that it depends and there is nothing that the auditor does or does not do that creates an automatic deficiency. The client's internal control system, which should encompass the preparation of the financial statements, is independent of the auditor's work and vice versa. The auditor cannot be part of the client's internal control system, because to become part of the client's system would impair independence. If the auditor is involved in assisting the client with drafting financial statements (or anything else that is directly or indirectly related to the financial statements) the auditor needs to assess whether the client's controls are designed and placed in operation to prevent and detect a material misstatement to the financial statements.

.158 Auditors may find it helpful to refer to the new Audit Risk Alert entitled *Understanding SAS No. 112 and Evaluating Control Deficiencies—A Companion to SAS No. 112, Communicating Internal Control Related Matters Identified In An Audit* (product no. 022536kk). This Audit Risk Alert provides an overview of the requirements of SAS No. 112 and how this SAS differs from SAS No. 60. Plus, this Risk Alert offers several case studies that 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 to help readers better understand and evaluate control deficiencies.

Brady Bond Warrants

.159 For many years, warrants tied to the price of oil and issued with dollar denominated foreign bonds (Brady Bonds) were considered worthless and written off, given the low value of the price of oil. As a result, securities firms were not diligent in their clearance and settlement of the warrants as they were with the bond with which it traded.

.160 However, with the escalation of the price of a barrel of oil, these instruments have significant value. Now, firms are undertaking substantial efforts to review their books and records, identify those counter parties that failed to deliver the warrants as well as those counter parties that failed to receive warrants, and enter into arrangements to settle outstanding obligations.

.161 As an auditor of a broker-dealer, you need to be satisfied concerning the propriety of any financial statement asset or liability related to the failure to receive or deliver a Brady Bond Warrant and the appropriateness of its consideration for Net Capital and Customer Reserve Formula computation purposes.

Demutualization of Exchanges

Background

.162 Demutualization is the process through which a member-owned organization becomes shareholder-owned. This frequently occurs as part of taking an organization public. Over the past several years, a number of stock and commodity exchanges underwent demutualization, and some are considering it.

.163 In 2000, the Chicago Mercantile Exchange (CME) became the first U.S. financial exchange to demutualize into a shareholder-owned corporation. It went public in December of 2002, becoming yet again the first exchange to do so. The Chicago Board of Trade (CBOT) became public in October 2005. (The CBOT has agreed to merge with the CME.) In March 2006, the NYSE became a for-profit, publicly traded company following the completion of its merger with an electronic stock-exchange operator, Archipelago Holdings Inc. In November 2006, the parent of the New York Mercantile Exchange (NYMEX), NYMEX Holdings, Inc. went public with an IPO.

.164 As part of these transactions, seat owners typically receive shares in the successor company, a cash payment, or a mixture of both. The received shares often have transfer restrictions. For example, shares of NYSE Group, Inc. (NYX), the combined firm formed as a result of the merger between the NYSE and Archipelago Holdings Inc., are subject to transfer restrictions for three years with one-third of the restriction lifted every year. After restrictions on the NYX stock expire, there is no requirement for broker-dealers to own any stock in the Exchange in order to trade directly on the Exchange; however, broker-dealers will have to buy annual trading licenses. Other exchanges have different terms and require broker-dealers to own a certain number of shares in the exchange in order to conduct business there.

.165 There are a number of accounting issues associated with demutualization of financial exchanges, some of which are discussed below.

Shares With Transfer Restrictions

.166 An ownership interest in an exchange that is not required to be held for operating purposes and is a financial instrument should be accounted for at fair value. On September 15, 2006, the FASB issued FASB Statement No. 157, *Fair Value Measurements*, which provides enhanced guidance for using fair value to measure assets and liabilities. 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. 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.

.167 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). 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.

.168 However, even prior to the issuance of FASB Statement No. 157, the predominant practice was to factor in the restriction period in the fair value of the restricted stock through some discount of the market price for those securities that are freely traded. Most firms would mark these positions to market through the income statement, but would reduce the value by some percentage based on the restriction period. Each firm is expected to use judgment to estimate the discount percentage due to the restriction. Typically, sale restrictions would be evaluated by period. For example, securities saleable in one year might be discounted by 10 percent, those saleable in two years, by 15 percent, and those saleable in three years, by 20 percent. These percentages are for illustrative purposes only and will vary depending on the facts and circumstances. In practice, the percentages typically range between 5 percent and 30 percent.

.169 NYSE Interpretation Memo 06-03 discusses the net capital treatment of NYX shares of common stock and provides that the NYX shares subject to transfer restrictions should be treated as a nonallowable asset for net capital purposes in accordance with SEC Rule 15c3-1(c)(2)(vii) for the duration of the applicable restriction period. The net capital treatment of nonrestricted NYX shares will be the same as that of any other nonrestricted security, as outlined in SEC Rule 15c3-1(c)(2)(vi). The Memo also reminds noncarrying member organizations that a PAIB agreement is required for any nonrestricted NYX shares held by their carrying organizations in order for the shares to be deemed an allowable asset for net capital purposes.

Shares Required to Be Owned in Order to Conduct Business on an Exchange

.170 Some exchanges, including the CME and CBOT, require broker-dealers to own a certain number of shares in order to trade on the exchange, or to obtain the lower "member" rates. These shares may represent either (*a*) both an ownership interest and the right to conduct business on the exchange, or (*b*) an ownership interest, which must be held by a broker-dealer to conduct business on the exchange. These shares should be accounted for at cost or at a lesser amount if there is an other-than-temporary impairment in value as provided in paragraph 7.34 (a) of the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*.

Annual Trading License

.171 In order to be able to trade directly on the NYSE, broker-dealers have to buy one-year trading licenses. The cost of the license should be set up as a prepaid asset (non–allowable for net capital purposes) and amortized to expense monthly.

AICPA 2006 Audit and Accounting Guide *Brokers and Dealers in Securities*

.172 AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*, with conforming changes as of May 1, 2006 (product no. 012706kk), has been updated to reflect the issuance of recently issued authoritative pronouncements. The Guide is available through the AICPA's reSOURCE Online and reSOURCE CD-ROM products, as well as through a loose-leaf subscription service. Paperback editions of Audit and Accounting Guides can be purchased as well.

> **Help Desk—**Subscriptions to AICPA reSOURCE, subscriptions to the loose-leaf service, and paperback copies of the Broker Dealer Guide may be obtained by calling the AICPA Order Department (Member Satisfaction) at (888) 777-7077, by faxing a request to (800) 362-5066, or by going online at www.cpa2biz.com.

Recent Auditing and Attestation Pronouncements, and Related Guidance

.173 Presented below is a list of auditing and attestation pronouncements, and other guidance issued since the publication of last year's Alert. For information on auditing and attestation standards, quality control standards, and other guidance that may have been issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org and the PCAOB Web site at www.pcaobus.org (public company audits only). You may also look for announcements of newly issued standards in the *CPA Letter*, *Journal of Accountancy* (available at www.aicpa.org/Magazines+and+Newsletters/), and the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA's Auditing Standards Team (available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Opinion/).

.174 The summaries provided below are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standards and other guidance. You should visit the applicable Web site for complete information.

.175 The standards and Interpretations promulgated by the AICPA Auditing Standards Board (ASB) are available free of charge by visiting the AICPA's Audit & Attest Standards Team's page at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/. Members and non-members 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 Member Satisfaction Center at (888) 777-7077 or online at www.cpa2biz.com.

SAS No. 102, *Defining Professional Requirements in Statements on Auditing Standards* SSAE No. 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (December 2005) (Not applicable to audits conducted in accordance with PCAOB standards)	These standards established two categories of professional requirements that are identified by specific terms. The words *must* or *is required* are used to indicate an unconditional requirement. The word *should* is used to indicate a presumptively mandatory requirement. (The words *may, might, could,* and *should consider* represent actions that auditors have a professional obligation to consider.) The provisions of SAS No. 102 and SSAE No. 13 were effective upon issuance. It is the ASB's intention to make conforming changes to AICPA literature over the next several years to remove any language that would imply a professional requirement where none exists.
SAS No. 103, *Audit Documentation* (December 2005) (Not applicable to audits conducted in accordance with PCAOB standards)	See the "Statement on Auditing Standards No. 103" section below.
SASS No. 104-111, *"Risk Assessment Standards"*	See the "AICPA Risk Assessment Standards" section below.
SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (May 2006) (Not applicable to audits conducted in accordance with PCAOB standards)	This new standard supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* as amended. 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. Effective for periods ending on or after December 15, 2006. See the "Report on Internal Control" section above which also discussed major provisions of SAS No. 112.
SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (December 2006) (Not applicable to audits conducted in accordance with PCAOB standards)	See the "Statement on Auditing Standards No. 114" section below.

(continued)

Non-Authoritative Practice Aid, *Alternative Investments—Audit Considerations*	See the "AICPA Practice Aid *Alternative Investments—Audit Considerations*" section below.
PCAOB Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist* (February 2006) (Applicable to audits conducted in accordance with PCAOB standards only)	This standard applies if auditors report on the elimination of a material weakness in a company's internal control over financial reporting. The standard establishes a voluntary engagement that would be performed at the election of the company.
PCAOB Conforming Amendment to AT 101.04, *Attest Engagements* (February 2006) (Applicable to audits conducted in accordance with PCAOB standards only)	*Conforming Amendment to PCAOB Related Auditing and Professional Practice Standards Resulting from the Adoption of the Auditing Standard No. 4* This states that Auditing Standard No. 4 must be used for reporting on whether a material weakness continues to exist for any purpose other than a company's internal use.

AICPA Risk Assessment Standards

.176 In March 2006, the AICPA ASB issued eight SASs that provide extensive guidance concerning the auditor's assessment of the risks of material misstatement in a financial statement audit, and the design and performance of audit procedures whose nature, timing, and extent are responsive to the assessed risks. Additionally, the SASs establish standards and provide guidance on planning and supervision, the nature of audit evidence, and evaluating whether the audit evidence obtained affords a reasonable basis for an opinion regarding the financial statements under audit. The following table lists the eight SASs and their effect on existing standards:

Statement on Auditing Standard	**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")*	Amends SAS No. 1, *Due Professional Care in the Performance of Work* (AU section 230)
SAS No. 105, *Amendment to Statement on Auditing Standards No. 95*, Generally Accepted Auditing Standards	Amends SAS No. 95, *Generally Accepted Auditing Standards* (AU section 150)
SAS No. 106, *Audit Evidence*	Supersedes SAS No. 31, *Evidential Matter* (AU section 326A)
SAS No. 107, *Audit Risk and Materiality in Conducting an Audit*	Supersedes SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AU section 312)
SAS No. 108, *Planning and Supervision*	Supersedes SAS No. 1, *Appointment of the Independent Auditor* (AU section 310); and supersedes SAS No. 22, *Planning and Supervision* (AU section 311A)

SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*	Supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AU section 319)
SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*	Supersedes SAS No. 45, *Substantive Tests Prior to the Balance-Sheet Date* (AU section 313); and together with SAS No. 109, supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AU section 319)
SAS No. 111, *Amendment to Statement on Auditing Standards No. 39*, Audit Sampling	Amends SAS No. 39, *Audit Sampling* (AU section 350)

Key Provisions of the New Standards

.177 The SASs emphasize the link between understanding the entity, assessing risks, and the design of further audit procedures. The SASs introduce the concept of risk assessment procedures, which are deemed necessary to provide a basis for assessing the risk of material misstatement. Risk assessment procedures, along with further audit procedures, which consist of tests of controls and substantive tests, provide the audit evidence to support the auditor's opinion on the financial statements. According to the SASs, the auditor should perform risk assessment procedures to gather information and gain an understanding of the entity and its environment, including its internal controls. These procedures include inquiries, analytical procedures, and inspection and observation. Assessed risks and the basis for those assessments should be documented; therefore, auditors may no longer default to maximum control risk for an entity's risk assessment without documenting the basis for that assessment. The SASs also require auditors to consider and document how the risk assessment at the financial statement level affects individual financial statement assertions, so that auditors may tailor the nature, timing, and extent of their audit procedures to be responsive to their risk assessment. It is anticipated that generic audit programs will not be appropriate for all audit engagements, as risks vary between entities.

Effective Date and Implementation

.178 The SASs are effective for audits of financial statements for periods beginning on or after December 15, 2006; earlier application is permitted. In most cases, implementation of the SASs will result in an overall increased work effort by the audit team, particularly in the year of implementation. 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. Readers can obtain the SASs, the related AICPA Audit Risk Alert entitled *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk) and the AICPA Audit Guide entitled *Assessing and Responding to Audit Risk In a Financial Statement Audit* (product no. 012456kk) at www.cpa2biz.com.

Statement on Auditing Standards No. 103

.179 The ASB has issued SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards,* vol. 1, AU sec. 339), which supersedes SAS No. 96 of the same name and amends SAS No. 1, section 530 *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 530). Effective for audits of financial statements for periods ending on or after December 15, 2006, with earlier application permitted. One key provision of this standard is the amendment of paragraphs .01 and .05 of AU sec. 530, which 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." The footnote to this section 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 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.

Statement on Auditing Standards No. 114

.180 The ASB has issued SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), which replaces SAS No. 61, *Communication with Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380A). The new SAS 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
- The form and timing of the communication

.181 SAS No. 114 is applicable to audits of the financial statements of all nonissuers and is effective for audits of financial statements for periods beginning on or after December 15, 2006.

AICPA Practice Aid Alternative Investments—Audit Considerations

.182 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 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.

.183 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:

1. General considerations pertaining to auditing alternative investments
2. Addressing management's financial statement existence assertion
3. Addressing management's financial statement valuation assertion
4. Management representations
5. Disclosure of certain significant risks and uncertainties
6. Reporting

.184 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"

.185 You can download the Practice Aid at www.aicpa.org/download/members/div/auditstd/Alternative_Investments_Practice_Aid.pdf.

Recent AICPA Independence and Ethics Pronouncements

.186 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 that Alert to be aware of independence and ethics matters that will affect their practices.

Recent Accounting Pronouncements and Related Guidance

.187 Presented below is a list of recently issued accounting pronouncements and other guidance issued since the publication of last year's Alert. For information on accounting standards issued subsequent to the publication of this Alert, please refer to the AICPA Web site at www.aicpa.org and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and the *Journal of Accountancy*.

.188 You can obtain copies of AICPA standards and other guidance by contacting the Member Satisfaction Center at (888) 777-7077 or online at www.cpa2biz.com. FASB Statements and staff positions can be downloaded free of charge from the FASB Web site at www.fasb.org.

.189 The AICPA general *Audit Risk Alert—2006/07* and other AICPA industry-specific Alerts contain summaries of these recent pronouncements. Some of the recently issued pronouncements that have particular significance to the securities industry are discussed below.

FASB Statement No. 155	*Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*
FASB Statement No. 156	*Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140*
FASB Statement No. 157	*Fair Value Measurements*
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)*
FASB Interpretation No. 48	*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).

(continued)

AICPA Technical Practice Aids 2130.09–2130.35 (December 2005) (Nonauthoritative)	Various topics on the application of SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*
AICPA Technical Practice Aids 5600.07–5600.17 (November 2005) (Nonauthoritative)	Various lease topics
AICPA Technical Practice Aid 6910.16–6910.20 (January 2006) (Nonauthoritative)	*Nonregistered Investment Partnerships*
AICPA Technical Practice Aid Working Draft as of December 1, 2006 (December 2006) (Nonauthoritative)	*Convertible Debt, Convertible Preferred Shares, Warrants, and Other Equity-Related Financial Instruments*

.190 The summaries provided below are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standards and other guidance. You should visit the applicable Web site for complete information.

FASB Statement No. 157

.191 On September 15, 2006, the FASB issued FASB Statement No. 157, *Fair Value Measurements*, 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. Below 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.

Exit Price Concept

.192 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).

Fair Value Hierarchy

.193 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.

Measurement of Blocks

.194 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.

.195 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."

Nullification of Guidance in Footnote 3 of EITF Issue No. 02-3

.196 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) and/or the risk inherent in the inputs to the valuation technique (a risk premium notion). 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.

.197 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.*

.198 At the 2006 AICPA National Conference on Current SEC and PCAOB Developments, SEC staff provided their views on the impact of FASB Statement No. 157 on the recognition of day one or inception gains. For more information, please refer to Joseph D. McGrath's speech which can be found at www.sec.gov/news/speech/2006/spch121106jdm.htm.

Inputs Based on Bid and Ask Prices

.199 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.

Restricted Assets

.200 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.

Entity's Credit Standing

.201 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.

Disclosures

.202 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.

Effective Date

.203 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. 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.

.204 You can access FASB Statement No. 157 at www.fasb.org/pdf/fas157.pdf.

FASB Statement No. 156

.205 In March of 2006, the FASB issued FASB Statement No. 156, *Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140*, which simplifies the accounting for servicing assets and liabilities, such as those common with mortgage securitization activities. Specifically, FASB Statement No. 156 addresses the recognition and measurement of separately recognized servicing assets and liabilities and permits an entity to elect to carry servicing assets and liabilities at fair value through earnings, which may simplify efforts to obtain hedge-like accounting.

.206 This Statement:

1. 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 in any of the following situations:

   a. A transfer of the servicer's financial assets that meets the requirements for sale accounting

   b. A transfer of the servicer's financial assets to a qualifying special-purpose entity (QSPE) in a guaranteed mortgage securitization in which the transferrer retains all of the resulting securities and classifies them as either available-for-sale securities or trading securities in accordance with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*

   c. An acquisition or assumption of an obligation to service a financial asset that does not relate to financial assets of the servicer or its consolidated affiliates

2. Requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable.

3. Permits an entity to choose either of the following subsequent measurement methods for each class of separately recognized servicing assets and servicing liabilities:

   a. *Amortization method*—Amortize servicing assets or servicing liabilities in proportion to and over the period of estimated net servicing income or net servicing loss and assess servicing assets or servicing liabilities for impairment or increased obligation based on fair value at each reporting date.

   b. *Fair value measurement method*—Measure servicing assets or servicing liabilities at fair value at each reporting date and report changes in fair value in earnings in the period in which the changes occur.

4. At its initial adoption, permits a one-time reclassification of available-for-sale securities to trading securities by entities with recognized servicing rights, 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.

5. 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.

.207 Entities should adopt FASB Statement No. 156 as of the beginning of its first fiscal year that begins after September 15, 2006. Earlier adoption is permitted as of the beginning of an entity's fiscal year, provided the entity has not yet issued financial statements, including interim financial statements, for any period of that fiscal year.

.208 You can access FASB Statement No. 156 at www.fasb.org/pdf/fas156.pdf.

FASB Statement No. 155

General Provisions of FASB Statement No. 155

.209 In February of 2006, the FASB issued FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*, which allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. FASB Statement No. 155 also:

a. Clarifies which interest-only strips and principal-only strips are not subject to the requirements of FASB Statement No. 133

b. Eliminates the exemption from FASB Statement No. 133 for interests in securitized financial assets provided temporarily by Implementation Issue D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets," and establishes a requirement to evaluate those interests to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation

c. Clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives

d. Amends paragraphs 35(c)(2) and 40 of 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.

.210 FASB Statement No. 155 is effective for all financial instruments acquired, issued, or subject to a remeasurement (new basis) event occurring after the beginning of an entity's first fiscal year that begins after September 15, 2006. The fair value election provided for in paragraph 4(c) of FASB Statement No. 155 may also be applied upon its adoption for hybrid financial instruments that had been bifurcated under paragraph 12 of FASB Statement No. 133 prior to the adoption of FASB Statement No. 155. Earlier adoption is permitted as of the beginning of an entity's fiscal year, provided the entity has not yet issued financial statements, including financial statements for any interim period, for that fiscal year.

.211 You can access FASB Statement No. 155 at www.fasb.org/pdf/fas155.pdf.

.212 On November 8, 2006, the FASB issued proposed FASB Statement No. 133 Implementation Issue No. B40, *Application of Paragraph 13(b) to Securitized Interest in Prepayable Financial Assets*, to provide guidance on implementation issues related to FASB Statement No. 155. Please refer to the "On the Horizon" section of this Alert for a discussion of this proposed Implementation Issue.

FASB Interpretation No. 48

.213 In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement No. 109.* FASB Interpretation No. 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.

.214 FASB Interpretation No. 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, Internal Revenue Service (IRS) developments, state taxing authorities, and/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.

.215 The scope of FASB Interpretation No. 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.

.216 Prior to the issuance of FASB Interpretation No. 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 FASB Interpretation No. 48 now provides guidance, FASB Statement No. 5 no longer applies to uncertain tax positions. However, for clarification, FASB Interpretation No. 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.

.217 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 FASB Interpretation No. 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. Earlier application of its provisions is encouraged if the enterprise has not yet issued financial statements, including interim financial statements, in the period adopted.

.218 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 FASB Interpretation No. 48. Note that companies that do not file quarterly reports may be able to put compliance off for a year.

.219 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 and/or expected to be taken in tax returns yet to be filed. 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 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.

.220 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 intended to assist practitioners in quickly understanding the requirements of FASB Interpretation No. 48. The Practice Guide can be accessed at tax.aicpa.org/Resources/Professional+Standards+and+Ethics/Practice+Guide+on+Accounting+for+Uncertain+Tax+Positions+Under+FIN+48.htm.

FASB Staff Position FIN 46(R)-6

Background

.221 There is diversity in practice in determining the variability that should be considered in applying FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities* (FASB Interpretation No. 46(R)). For example, some believe that only the variability that results from changes in cash flows (referred to as the *cash flow method*) should be considered, while others believe that only the variability that results from changes in fair value (referred to as the *fair value method*) should be considered. In applying FASB Interpretation No. 46(R), a reporting enterprise may have—but not always—reached the same conclusion as to whether the entity is a variable interest entity (VIE) and which interests should be considered variable interests regardless of the method used.

.222 An entity may enter into an arrangement, such as a derivative contract, to either reduce or eliminate (1) the variability created by certain assets or operations of the entity or (2) mismatches between the overall asset and liability profiles of the entity, thereby protecting certain liability and equity holders from exposure to such variability. During the life of the entity, those arrangements can be in either an asset position or a liability position (recorded or unrecorded) from the perspective of the entity. Currently, there is diversity in practice as to whether these arrangements should be treated as variable interests or considered as creators of variability. In certain cases, application of either the cash flow method or the fair value method will not result in a clear determination as to whether those arrangements are variable interests or creators of variability.

FASB Staff Position

.223 FASB Staff Position (FSP) FIN 46(R)-6, *Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R)*, issued on April 13, 2006, addresses how a reporting enterprise should determine the variability to be considered in applying Interpretation 46(R). The variability that is considered in applying Interpretation 46(R) affects the determination of (1) whether the entity is a VIE, (2) which interests are variable interests in the entity, and (3) which party, if any, is the primary beneficiary of the VIE. That variability will affect any calculation of expected losses and expected residual returns, if such a calculation is necessary.

.224 FSP FIN 46(R)-6 provides that the variability to be considered in applying FASB Interpretation No. 46(R) should be based on an analysis of the design of the entity as outlined in the following steps:

- *Step 1.* Analyze the nature of the risks in the entity (paragraphs 6 and 7 of this FSP).
- *Step 2.* Determine the purpose(s) for which the entity was created and determine the variability (created by the risks identified in Step 1) the entity is designed to create and pass along to its interest holders (paragraphs 8–14 of this FSP).

.225 For the purposes of this FSP, interest holders include all potential variable interest holders (including contractual, ownership, or other pecuniary interests in the entity). After determining the variability to consider, the reporting enterprise can determine which interests are designed to absorb that variability. The cash flow and fair value methods described in this FSP are examples of methods that can be used to measure the amount of variability (that is, expected losses and expected residual returns) of an entity. However, a method that is used to measure the amount of variability does not provide an appropriate basis for determining which variability should be considered in applying FASB Interpretation No. 46(R).

.226 An enterprise should apply the guidance in FSP FIN 46(R)-6 prospectively to all entities (including newly created entities) with which that enterprise first becomes involved and to all entities previously required to be analyzed under FASB Interpretation No. 46(R) when a reconsideration event has occurred pursuant to paragraph 7 of FASB Interpretation No. 46(R) beginning the first day of the first reporting period beginning after June 15, 2006. Early application is permitted for periods for which financial statements have not yet been issued. Retrospective application to the date of the initial application of FASB Interpretation No. 46(R) is permitted but not required. Retrospective application, if elected, must be completed no later than the end of the first annual reporting period ending after July 15, 2006.

.227 Please refer to www.fasb.org/fasb_staff_positions/fsp_fin46r-6.pdf for a complete text of this FSP.

AICPA Technical Practice Aid *Convertible Debt, Convertible Preferred Shares, Warrants, and Other Equity-Related Financial Instruments—Working Draft as of December 1, 2006*

.228 This Technical Practice Aid 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. This Technical Practice Aid is a working draft and the 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 and they must be alert to any changes. This Technical Practice Aid has not been approved, disapproved, or otherwise acted on by any senior technical committee of the AICPA or the FASB or the staff of the SEC and has no official or authoritative status.

.229 Financial instruments that are indexed to and potentially settled in a company's own stock have become increasingly popular in the current financial markets. These financial instruments may be either freestanding or embedded in the structure of other financial instruments. Examples of freestanding instruments include written and purchased stock options, forward stock purchase/sale contracts, and various combinations of these instruments. Examples of embedded features that may require bifurcation include conversion options in convertible debt. Preparers and auditors of financial statements often need to decide whether these financial instruments, or some component of those financial instruments, qualify for classification in stockholders' equity (or nonbifurcation if the instrument is an embedded derivative) or should be accounted for as a financial asset or liability.

.230 The FASB currently has a long-term project on its agenda to develop a comprehensive standard of accounting and reporting for financial instruments with characteristics of liabilities and equity, in addition to several short-term projects under consideration. In the absence of a single comprehensive accounting standard for such instruments, the existing accounting literature was developed in a largely piecemeal fashion, by various standard-setting bodies, often in response to specific instruments that have been observed in the marketplace.

.231 Practitioners often find it difficult to navigate standards relevant to these financial instruments, particularly because two or three of these standards must often be considered in contemplation of one another before reaching a final conclusion on the appropriate accounting for a financial instrument. The interaction between these standards, coupled with the complex nature of financial instruments, requires that practitioners be familiar with complex accounting rules and possess knowledge of the various common types of financial instruments. In addition, analyzing these financial instruments requires that practitioners exercise significant judgment on complex accounting issues.

.232 This Technical Practice Aid 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.

.233 This Practice Aid 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.

SEC Staff Accounting Bulletins

.234 Auditors of public companies and of those companies that file with the SEC need to consider the accounting and financial reporting requirements contained in the SEC regulations as well as requirements imposed upon auditors. Currently, public companies must adhere to the requirements set forth in SEC Staff Accounting Bulletins (SABs), but private companies are not bound by them. However, with respect to SAB No. 108, Topic 1N, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements,* which is discussed below, on December 19, 2006, the FASB said it would issue guidance specifying that private companies should use the same methods as public companies to evaluate the materiality effects of prior-year adjustments on current year financial statements. FASB said it would incorporate the concepts from SAB No. 108 as part of a narrow scope look at the issue in either a FASB staff position or an interpretation. The FASB said it also would issue guidance modifying current standards to allow for a one-time cumulative-effect adjustment for private companies to correct misstatements resulting from the carryover or reversal of prior year misstatements.

.235 The summary below is for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable rules. See the SEC Web site at www.sec.gov for complete information.

Staff Accounting Bulletin No. 108

.236 On September 13, 2006, the SEC released SAB No. 108. 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.

.237 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.

.238 The 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.

.239 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 the SAB. 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, please refer to the full text of SAB No. 108 at www.sec.gov/interps/account/sab108.pdf.

On the Horizon

.240 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 certain projects that are expected to result in final standards in the near future. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or generally accepted auditing standards (GAAS).

.241 The following table lists the Web sites of various standard-setting bodies, at which 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 Public Company Accounting Oversight Board sets auditing standards.)	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/
Public Company Accounting Oversight Board (PCAOB)	www.pcaobus.org
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/Professional+Resources/Accounting+ and+Auditing/Accounting+Standards/
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 memsat@aicpa.org. Indicate "exposure draft e-mail list" in the subject header field to help process your submission more efficiently. Include your full name, mailing address and, if known, your membership and subscriber number in the message.

.242 Below are discussions of some of the projects that have particular significance to the securities industry. These summaries are for informational purposes only.

Proposed FASB Statement, *Accounting for Transfers of Financial Assets*

.243 On August 11, 2005, the FASB issued an exposure draft of a proposed Statement, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140*. This exposure draft is a revision of the June 2003 exposure draft, *Qualifying Special-Purpose Entities and Isolation of Transferred Assets.* The revised exposure draft reflects what the FASB learned from constituents' comments in the earlier effort and deals with some new issues.

.244 Specifically, the revised proposed Statement seeks to (1) clearly specify the circumstances that require the use of a QSPE in order to de-recognize all or a portion of financial assets, (2) provide additional guidance on permitted activities of QSPEs, (3) eliminate the prohibition on a QSPE's ability to hold passive derivative financial instruments that pertain to beneficial interests held by a transferrer, and (4) revise the initial measurement of interests related to transferred financial assets held by a transferrer.

.245 During re-deliberations of this proposed Statement the FASB decided to amend the isolation criteria in paragraph 9(a) of FASB Statement No. 140 for consolidated financial statements that include a transferrer by requiring that the legal analysis treat all of the involvements in the transferred financial assets by any entity that is included in the consolidated financial statements being presented as if those involvements were made by the transferrer. In order for a parent entity of a transferrer to meet the isolation requirement, an isolation analysis must conclude that the transferred financial assets would be beyond the reach of all of the entities (and their creditors) included in the financial statements being presented, using the assumption that all of the involvements of the entities were made by the transferrer.

.246 You can access this exposure draft at www.fasb.org/draft/rev_ed_qspe_amend_st140.pdf and get updated information on the status of its deliberations at www.fasb.org/project/transfers_of_financial_assets.shtml.

Proposed FASB Statement, *The Fair Value Option for Financial Assets and Financial Liabilities*

.247 In January 2006, the FASB issued an exposure draft of a proposed Statement, *The Fair Value Option for Financial Assets and Financial Liabilities*. The fair value option project has two phases: This proposed Statement represents Phase 1, which addresses the fair value option for certain financial assets and financial liabilities. Phase 2 will consider permitting the fair value option for certain nonfinancial assets and nonfinancial liabilities and some of the financial assets and financial liabilities excluded from the scope of Phase 1.

.248 This proposed Statement would create a fair value option under which an entity may irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and financial liabilities, with changes in fair value recognized in earnings as those changes occur. An entity would be permitted to elect the fair value option at initial recognition of a financial asset or financial liability or upon an event that gives rise to new-basis accounting for that item. The election of the fair value option would be made on a contract-by-contract basis and would need to be supported by concurrent documentation or a preexisting documented policy.

.249 This proposed Statement would require an entity to report its financial assets and financial liabilities that, pursuant to electing the fair value option, would be subsequently measured at fair value in a manner that separates those reported fair values from the carrying amounts of assets and liabilities subsequently measured using another measurement attribute on the face of the statement of financial position. To accomplish that separate reporting, an entity would either (1) display separate line items for the fair value and nonfair-value carrying amounts or (2) present the aggregate of those fair value and nonfair-value amounts and disclose parenthetically the amount of fair value included in the aggregate amount. This proposed Statement would amend FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* to require that securities reported at fair value in accordance with FASB Statement No. 115 satisfy this financial statement presentation requirement.

.250 This proposed Statement would also require an entity to provide information that would allow users to understand the effect on earnings of changes in the fair values of assets and liabilities subsequently measured at fair value as a result of a fair value election.

.251 It is expected that *The Fair Value Option* Statement will have the same effective date as the effective date of FASB Statement No. 157; that is, effective for financial statements issued for fiscal years beginning after November 15, 2007. Entities will be permitted to early adopt *The Fair Value Option* Statement provided that the entity also adopts all of the requirements (measurement and disclosure) of FASB Statement No. 157 concurrent with or prior to the early adoption of *The Fair Value Option* Statement.

.252 You can access this exposure draft at www.fasb.org/draft/ed_fair_value_option.pdf and get updated information on the status of this project at www.fasb.org/project/fv_option.shtml.

Proposed FASB Statement, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*

.253 On December 8, 2006, FASB issued an exposure draft of a proposed Statement, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*, which would amend and expand the disclosure requirements in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and other related literature. This proposed Statement would enhance the current disclosure framework by requiring that objectives and strategies for using derivative instruments be discussed in terms of underlying risk and accounting designation. The exposure draft would require tabular disclosure of notional and fair value amounts of derivatives instruments and the gains and losses on derivatives instruments and related hedged items. Additionally, the proposed Statement would require disclosure of information about counter party credit risk and the existence and nature of contingent features in derivative instruments.

.254 The requirements of the proposed Statement would be effective for financial statements issued for fiscal years and interim periods ending after December 15, 2007, with early application encouraged. The proposed Statement would encourage but would not require disclosures for earlier periods at initial adoption. In years after initial adoption, the proposed Statement would require disclosures for earlier periods.

.255 You can access this exposure draft at www.fasb.org/draft/ed_derivatives_disclosure.pdf and get updated information on the status of this project at www.fasb.org/project/derivative_disclosures.shtml. Comment deadline is March 2, 2007.

EITF Issue No. 06-12, *Application of AICPA Audit and Accounting Guide, Brokers and Dealers in Securities to Entities That Engage in Commodity Trading Activities and Related Issues*

.256 At its November 16, 2006, meeting, the EITF discussed Issue No. 06-12, "Application of AICPA Audit and Accounting Guide, *Brokers and Dealers in Securities*, to Entities That Engage in Commodity Trading Activities and Related Issues."

.257 The landscape for the commodities trading market continues to expand both in volume and in diversity of market participants. Although some global investment banks and energy companies have been trading a wide range of energy-related products (and other physical commodities) for many years, other financial intermediaries have become increasingly active over the last several years in the energy trading markets. Traditionally, the product offerings were primarily focused on financial products including those based on crude oil, natural gas, power, coal, and base metals; in addition to market making, speculation, and risk management trading activities. Recently, these other financial intermediaries have expanded their portfolios to incorporate the purchase and sale of commodities by taking physical delivery of the underlying commodity. These entities may or may not be regulated as broker-dealers.

.258 Although GAAP applies to broker-dealers in the same manner as it applies to other industries, certain activities of a broker-dealer's operations are unique. For this reason, the Broker Dealer Guide provides certain interpretations and other guidance specific to broker-dealers. Determining whether an entity is within the scope of the Broker Dealer Guide is significant because it provides a specialized accounting model. One important difference in financial reporting for entities within the scope of the Broker Dealer Guide is the requirement to carry inventory at fair value.

.259 The specific accounting requirements for a broker-dealer make it important to consistently determine whether an entity is within the scope of the Broker Dealer Guide, which states:

> This Guide applies to preparation and audit of financial statements of entities that are broker-dealers in securities. The activities of broker-dealers in securities are described in Chapter 1. Operations of such entities are subject to the rules and regulations of the Securities and Exchange Commission and other regulatory bodies.
>
> Broker-dealers in securities are subject to regulation under the Securities Exchange Act of 1934. Some broker-dealers are also futures commission merchants for commodity futures and commodity option contracts subject to regulation under the Commodity Exchange Act.

.260 In practice, diversity exists regarding the interpretation of the type of entity that can apply the Broker Dealer Guide. Some believe the Broker Dealer Guide is only applicable to entities that are regulated as broker-dealers under the Exchange Act, while others believe the Broker Dealer Guide is applicable based on the activity of the entity, if the activities of the entity are similar to those of a regulated broker-dealer. Entities that qualify as a consolidated supervised entity have applied the Broker Dealer Guide under an activities-based approach to nonregulated subsidiaries (or subsidiaries regulated in other jurisdictions) that conduct activities similar or identical to regulated broker-dealers. The SEC has prohibited certain other entities that are not subject to regulation as a broker-dealer under the 1934 Act from applying the Broker Dealer Guide under an activities-based approach on the basis that their organizations are predominantly financial institutions (conducting banking activities) that are subject to the banking regulations.

.261 In addition to the identification of the type of entity that can apply the Broker Dealer Guide, diversity exists on whether entities that are within the scope of the Broker Dealer Guide should be accounting for physical commodity inventory at fair value. Many entities (both those that are and those that are not regulated) that are applying the Broker Dealer Guide believe that physical commodity positions (such as natural gas, crude oil, and so forth) should be recorded at fair value based on an interpretation of the Broker Dealer Guide that allows all trading inventory to be measured at fair value.

.262 Although inventory is not specifically defined in the Broker Dealer Guide, industry practice has been to use references linked to the Broker Dealer Guide to interpret the definition of inventory as all trading positions, including financial instruments and physical commodities, that are held for sale to customers in connection with market making activities, as proprietary positions, or to economically hedge risks inherent in both.

.263 However, paragraph 17 of EITF Issue No. 02-3 prohibits fair value accounting for nonderivative contracts. The consensus in EITF Issue No. 02-3 observes that prior to EITF Issue No. 02-3, broker-dealers carried physical commodity inventory at fair value. However, EITF Issue No. 02-3 eliminated "any basis for recognizing physical inventories at fair value, except as provided by other guidance under higher categories of the GAAP hierarchy." Furthermore, Chapter 4, *Inventory Pricing*, of Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins* (ARB 43), has historically been the accounting guidance applied to measure commodity inventory for most nonregulated broker-dealers. ARB 43 describes inventory held for sale in the ordinary course of business and requires that inventory be recognized at cost less impairment; however, ARB 43 allows an exception in Chapter 4, Statement 9, which states, in part:

> Only in exceptional cases may inventories properly be stated above cost. For example, precious metals having a fixed monetary value with no substantial cost of marketing may be stated at such monetary value; any other exceptions must be justifiable by inability to determine appropriate approximate costs, immediate marketability at quoted market price, and the characteristic of unit interchangeability.

.264 The SEC has further interpreted ARB 43 to imply that recognition of inventory above cost should be rare. Many times, energy-based financial products are marked-to-market because they meet the definition of a derivative (including physically settled contracts that meet the requirements of FASB Statement No. 133).

However, since the Broker Dealer Guide provides specialized accounting guidance that may not be specifically addressed by ARB 43, entities that qualified for the Broker Dealer Guide have applied the provisions of the Broker Dealer Guide as it relates to inventory.

.265 Energy companies that conduct similar commodities trading activities do not fair value their physical commodity inventory since they have historically been considered outside the scope of the Broker Dealer Guide and do not meet the guidance in Chapter 4, Statement 9, of ARB 43. These entities contend that they are at a competitive disadvantage since their energy trading subsidiaries are conducting activities similar to those of a regulated broker-dealer, but have no basis to support fair value accounting recognition.

.266 EITF Issue No. 06-12 will address the following two accounting issues:

- *Issue 1.* How to determine whether an entity is included within the scope of the Broker-Dealer Guide
- *Issue 2.* Whether entities within the scope of the Broker Dealer Guide should record physical commodity inventory at fair value

.267 At the November 16, 2006, meeting the EITF deferred making a decision on this Issue and recommended that the FASB address the accounting for traded physical commodity inventory through the issuance of an FSP. The EITF also recommended that the FASB consider amending ARB 43, Chapter 4, "Inventory Pricing," to remove any perceived conflict with the Broker-Dealer Guide in the accounting for physical commodity inventory as part of the proposed FSP. At a future meeting, the EITF will evaluate whether it is necessary to continue discussing this Issue after considering the FASB's decision on whether to add the recommended project to the FASB's agenda. In the event that the EITF decides to continue discussing this Issue, the EITF requested that the staff further explore the criteria used to determine the application of an activities-based approach to interpreting whether an entity should be included within the scope of the Broker-Dealer Guide.

.268 For more information on this Issue, please refer to the "Issue Summary" that was presented to the EITF in November and which can be accessed at www.fasb.org/eitf/IS0612WW.pdf.

Proposed FASB Staff Position FIN 39-a, *Amendment of FASB Interpretation No. 39*

.269 On December 13, 2006, the FASB issued a proposed FSP FIN 39-a that addresses:

a. Certain modifications to FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*

b. Whether a reporting entity that is party to a master netting arrangement 1 can offset the receivable or payable recognized upon payment or receipt of cash collateral 2 against fair value amounts recognized for derivative instruments that have been offset under the same master netting arrangement in accordance with paragraph 10 of Interpretation 39.

.270 Specifically, this FSP amends paragraph 3 to replace the terms *conditional contracts* and *exchange contracts* with the term *derivative instruments* as defined in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* and paragraph 10 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 recognized for derivative instruments executed with the same counter party under the same master netting arrangement that have been offset in accordance with paragraph 10 of Interpretation 39.

.271 The guidance in this proposed FSP would be effective for fiscal years beginning after December 15, 2006. A reporting entity would recognize the effects of applying this FSP as a change in accounting principle through retrospective application for all financial statements presented unless it is impracticable to do so. If a reporting entity determines it is impracticable to retrospectively apply the guidance in this FSP for all financial statements presented, the reporting entity would disclose why it is impracticable and apply the guidance in this FSP retrospectively for as many consecutive prior financial statements as practicable. Upon adoption of this FSP, a reporting entity would be permitted to change its accounting policy to offset or not offset fair value amounts recognized for derivative instruments under master netting arrangements.

.272 For the full text of this FSP, please refer to the FASB Web site at www.fasb.org/fasb_staff_positions/prop_fsp_fin39a.pdf.

Proposed FASB Statement No. 133 Implementation Issue No. B40, *Embedded Derivatives: Application of Paragraph 13(b) to Securitized Interests in Prepayable Financial Assets*

.273 On November 8, 2006, the FASB issued proposed FASB Statement No. 133 Implementation Issue No. B40, *Application of Paragraph 13(b) to Securitized Interest in Prepayable Financial Assets*, with an accelerated 30-day public comment period that ended on December 6, 2006.

.274 The objective of this project is to provide guidance on implementation issues related to FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments,* which have been raised by constituents. Specifically, the proposed Implementation Issue clarifies 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 specified criteria.

.275 The provisions in the proposed Implementation Issue would be effective upon initial adoption of FASB Statement No. 155. An entity that adopted FASB Statement No. 155 prior to December 31, 2006, would apply the guidance in the first reporting period beginning before December 31, 2006 for which financial statements have not yet been issued.

.276 You can access this proposed Implementation Issue at www.fasb.org/derivatives/11-08-06.pdf and get updated information on the status of this project at www.fasb.org/project/st155_implementation_issues.shtml.

Proposed SOP, *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*

.277 At its September 13, 2006, meeting, the FASB met with representatives of the AICPA's Accounting Standards Executive Committee (AcSEC) and discussed final clearance of the AICPA Statement of Position (SOP), *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*. The FASB did not object to issuance of that final SOP. AcSEC expects to issue the final SOP by March 2007.

.278 This SOP provides guidance for determining whether an entity is within the scope of the AICPA Audit and Accounting Guide *Investment Companies*. For those entities that are investment companies under this SOP, this 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*). In addition, this SOP includes certain 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.

.279 Some practitioners are concerned that the conditions specified in the proposed SOP for determining whether investment company accounting should be retained in the consolidated financial statements of the entity's parent company or an equity method investor are too restrictive. For example, paragraph 30(b) of the proposed SOP provides that to retain investment company accounting in the financial statements of the parent company, the consolidated group (the parent company and its consolidated subsidiaries) should follow established policies that effectively distinguish the nature and type of investments made by the investment company from the nature and type of investments made by other entities within the consolidated group that are not investment companies. Those policies should address, at a minimum (1) the degree of influence held by the investment company and its related parties over the investees of the investment company, (2) the extent to which investees of the investment company or their affiliates are in the same line of business as the parent company or its related parties, and (3) the level of ownership interest held in the investment company by the consolidated group. The guidance in this condition is intended to prohibit the consolidated group from selectively making investments within an investment company subsidiary that are similar to investments held by noninvestment company members of the consolidated group when those investments would be accounted for by the equity method, by consolidation, or at cost if the investment were made by a noninvestment company member of the consolidated group.

.280 Practitioners in the industry are concerned that those provisions are overly strict and would prohibit a company from using investment company accounting if it has an investment through an investment company and simultaneously has a direct investment in that same or similar investment. According to the notes of the September 13, 2006, FASB meeting, the FASB staff discussed that concern with some of those constituents. The staff believes that the proposed SOP is operational as written.

.281 Some broker-dealers have real estate and other investment type vehicles that might be affected by the applicability of the new scope of the Investment Companies guide. The proposed SOP includes Appendix C, Applying the Provisions of this Statement of Position to Entities That Hold Investments in Real Estate," which discusses the application of the provisions of this SOP to entities that hold investments in real estate. Certain entities that hold investments in real estate may meet the definition of an *investment company*. Paragraph 5 of the proposed SOP defines an *investment company*, in part, as a "separate legal entity whose business purpose and activity are investing in multiple substantive investments for current income, capital appreciation, or both, with investment plans that include exit strategies." The proposed SOP includes no specific conclusions applicable to entities that own direct interests in real estate. Entities with direct interests in real estate should consider whether the entity's activities pertaining to those investments would result in the entity not meeting the definition of an *investment company*. Appendix C should help practitioners in determining whether the entity is a real estate investment company (an investment company that holds direct ownership of real estate) or an operating company (not an investment company).

.282 The proposed SOP is expected to become effective for fiscal years beginning on or after December 15, 2007, with earlier application encouraged. You can access the most recent draft of the SOP updated as of August 15, 2006, at www.aicpa.org/download/acctstd/investment_cos_scope_SOP71.pdf.

Revision of AICPA Practice Aid *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools*

.283 This Practice Aid provides practitioners with nonauthoritative practical guidance on auditing financial statements of FCMs, IBs, and commodity pools. Organized to complement the Audit and Accounting Guide *Brokers and Dealers in Securities*, this Practice Aid includes an overview of the commodity industry; discussions of regulatory considerations, auditing considerations, and accounting standards; and illustrative financial statements of FCMs, IBs, and commodity pools.

.284 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. Readers should be alert to further developments.

Auditing Pipeline—Nonpublic Companies

Proposed Statement on Standards for Attestation Engagements, Reporting on an Entity's Internal Control Over Financial Reporting

.285 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). In May 2006, the PCAOB announced plans to amend certain aspects of PCAOB Auditing Standard No. 2 to improve its implementation. Because the forthcoming changes to the PCAOB Standard will be relevant to the revision of AT Section 501, the ASB has decided to defer the issuance of a final revised AT Section 501 until the PCAOB issues their amendments and the ASB has time to consider them. For additional information, see the section, "FDICIA Update—What's New (or Not) for 2006?"

Proposed Amendment to SAS No. 69, The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles, for Nongovernmental Entities*

.286 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 moves responsibility for the GAAP hierarchy for nongovernmental entities from the auditing literature (SAS No. 69) 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 FASB proposed Statement, which can be obtained at www.fasb.org.

Auditing Pipeline—Public Companies

.287 In addition to reading about the matters presented below, see the AICPA *SEC and PCAOB Alert—2006/2007* (product no. 022497kk) for a detailed overview of recent developments at the SEC and PCAOB with respect to financial reporting and auditing matters.

Proposed PCAOB Auditing Standard, An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements

.288 This proposed standard would supersede 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), and is designed to focus the auditor on the matters most important to internal control; eliminate unnecessary procedures; simplify and shorten the standard by reducing detail and specificity; and make the audit more scalable for smaller and less complex companies. Among other things, the proposed standard would:

- Direct the auditor to the most important controls and emphasize the importance of risk assessment;
- Revise the definitions of significant deficiency and material weakness, as well as the "strong indicators" of a material weakness;
- Clarify the role of materiality, including interim materiality, in the audit;
- Remove the requirement to evaluate management's process;

- Permit consideration of knowledge obtained during previous audits;
- Direct the auditor to tailor the audit to reflect the attributes of smaller and less complex companies;
- Refocus the multi location testing requirements on risk rather than coverage; and
- Recalibrate the walkthrough requirement.

.289 The PCAOB is also seeking comment on certain related proposals that would facilitate the PCAOB's efforts to make audits of internal control more effective and efficient. These related proposals are described below.

Proposed PCAOB Auditing Standard, Considering and Using the Work of Others

.290 This proposed standard would supersede AU section 322 (AICPA, *PCAOB Standards and Related Rules*) and the direction currently contained in PCAOB Auditing Standard No. 2 regarding using the work of others. Among other things, the proposed standard would:

- Allow the auditor to appropriately use the work of others, and not just internal auditors, for both the internal control audit and the financial statement audit, eliminating a barrier to integration of the two audits;
- Encourage greater use of the work of these others by requiring auditors to evaluate whether and how to use their work to reduce auditor testing;
- Require the auditor to understand the relevant activities of these others and determine how the results of that work may affect the audit;
- Provide a single framework for using the work of others based on the auditor's evaluation of the combined competence and objectivity of others and the subject matter being tested; and
- Eliminate the explicit principal evidence provision previously included in PCAOB Auditing Standard No. 2.

Proposed Rule 3525, Audit Committee Pre-Approval of Services Related to Internal Control

.291 The proposed new independence rule would replace direction currently contained in PCAOB Auditing Standard No. 2 regarding independence and internal control-related services. The proposed 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. The new rule would also recognize that audit committees may pre-approve the provision by their independent auditor of internal control-related services on an ad hoc (i.e., specific to each request) basis, or pursuant to committee-approved policies and procedures.

Proposed Amendments to PCAOB Interim Standards

.292 The PCAOB proposed amendments that, among other things, would:

- Simplify the internal control standard by moving certain information currently contained in PCAOB Auditing Standard No. 2 to other existing interim standards. For example, the proposed amendments would move the auditor's responsibilities for management's internal control certifications under Section 302 of the Act into AU section 722, *Interim Financial Information* (AICPA, *PCAOB Standards and Related Rules*); and
- Change the existing requirement that "generally, the date of completion of the field work should be used as the date of the independent auditor's report" to "the auditor should date the audit report no

earlier than the date on which the auditor has obtained sufficient competent evidence to support the auditor's opinion."

.293 Comments on these proposals should be received no later than February 26, 2007. The proposed standards and related documents are available on the PCAOB's Web site under Rulemaking Docket 21.

SEC Proposed Guidance on *Management's Report on Internal Control Over Financial Reporting*

.294 In addition to reading about the proposal discussed below, see the AICPA *SEC and PCAOB Alert—2006/2007* (product no. 022497kk) for a detailed overview of recent developments at the SEC and PCAOB with respect to financial reporting and auditing matters.

.295 On December 20, 2006, the SEC proposed interpretive guidance for management regarding its evaluation of internal control over financial reporting. The interpretive guidance sets forth an approach by which management can conduct a top-down, risk-based evaluation of internal control over financial reporting. The proposed guidance is intended to assist companies of all sizes to complete their annual evaluation in an effective and efficient manner and it provides guidance on a number of areas commonly cited as concerns over the past two years. In addition, the SEC proposed an amendment to its rules requiring management's annual evaluation of internal control over financial reporting to make it clear that an evaluation that complies with the interpretive guidance is one way to satisfy those rules. Further, the SEC proposed an amendment to its rules to revise the requirements regarding the auditor's attestation report on the assessment of internal control over financial reporting. Under the proposed rule amendments, the auditor would express only a single opinion on the effectiveness of the company's internal controls in its attestation report rather than expressing separate opinions directly on the effectiveness of the company's internal control over financial reporting and on management's assessment. In addition, the proposed rule amendments would clarify the circumstances in which the SEC would expect that the accountant cannot express an opinion.

.296 Comments on this proposal should be received on or before February 26, 2007. Please see Release No. 33-8762 for more information.

Resource Central

On the Bookshelf

.297 The following AICPA publications deliver valuable guidance and practical assistance as potent tools to be used in your engagements:

- Audit and Accounting Guide *Brokers and Dealers in Securities* (product no. 012706kk)
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (product no. 012526kk)
- Audit Guide *Auditing Revenue in Certain Industries* (product no. 012516kk)
- Audit Guide *Audit and Accounting Sampling* (product no. 012530kk)
- Audit Guide *Analytical Procedures* (product no. 012556kk)
- Audit Guide *Service Organizations: Applying SAS No. 70, As Amended* (product no. 012776kk)
- *Accounting Trends & Techniques—2006* (product no. 009898kk)

- Practice Aid *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* (product no. 006701kk)
- Practice Aid *Fraud Detection in a GAAS Audit* (product no. 006615kk)

Audit and Accounting Manual

.298 The *Audit and Accounting Manual* (product no. 005136kk) is developed exclusively for small- and medium-size CPA practices. This unique one-volume manual explains and demonstrates useful techniques and procedures for conducting compilation, review and audit engagements—from planning to internal control to accountants' reports.

AICPA reSOURCE Online: Accounting and Auditing Literature

.299 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 online service, go to cpa2biz.com.

Educational Courses

.300 The AICPA has developed a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry. Those courses include:

- *AICPA's Annual Accounting and Auditing Update Workshop* (2006 edition) (product no. 736182kk, text; also available in video and DVD formats with a manual). 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.
- *Fraud and the Financial Statement Audit: Auditor Responsibilities Under SAS 99* (product no. 731813kk, text; for product numbers for other formats please refer to the cpa2biz.com Web site). The new fraud standard may not change your responsibilities for detecting fraud in a financial statement audit, but it will change how you meet that responsibility. Practitioners will benefit from a risk assessment approach to detecting fraud in a financial statement audit. You will learn the conceptual framework necessary to understand the characteristics of fraud.
- *Auditing for Internal Fraud* (product no. 730277kk). This course provides the auditor with the tools to identify fraud schemes. It trains CPAs to focus their analytical and substantive tests on the fraud triangle when evaluating internal controls. It also illustrates the latest in fraud prevention and detection programs implemented by industry leaders.
- *Identifying Fraudulent Financial Transactions* (product no. 730546kk). Learn to identify the red flags of fraud in financial information and to analyze a variety of fraud schemes. You will develop a framework for detecting financial statement fraud and learn about fraud schemes in revenue, inventory, liabilities, and assets.
- *Independence* (product no. 739175kk). This interactive CD-ROM course reviews the AICPA authoritative literature covering independence standards (including the AICPA SEC practice section independence requirements), SEC regulations on independence, and Independence Standards Board (ISB) standards.
- *SEC Reporting* (product no. 736773kk, text; for product numbers for other formats, please refer to the www.cpa2biz.com Web site). This course helps the practicing CPA and corporate financial officer learn to apply SEC reporting requirements. It clarifies the more important and difficult disclosure requirements.
- *Internal Control and IT: Reliable Reporting and Fraud Prevention* (product no. 732551kk). This course 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.

.301 For listing of additional courses available, please download the *Fall/Winter 2006 AICPA CPE Catalog* and *Accounting and Auditing CPE Catalog*, which are available at https://www.cpa2biz.com/CPE/CPEFilter.htm.

Online CPE

.302 AICPA CPExpress, offered exclusively through cpa2biz.com, is AICPA's flagship online learning product. 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/infobytes.

Webcasts

.303 Stay plugged in to what's 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 on the discussion. If you can't make the live event, each Webcast is archived and available on CD-ROM.

CFO Quarterly Roundtable Series

.304 The CFO Roundtable Webcast Series—brought to you each calendar quarter—is designed to cover a broad array of "hot topics" that successful organizations employ and subjects that are important to a 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

.305 The SEC Quarterly Update Webcast Series—brought to you each calendar quarter—showcases the profession's leading experts on what's "hot" at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and CorpFin activities, these hard-hitting sessions will keep you "plugged-in" to what's important. A must for both 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.

National Securities Industry Conference

.306 Each year, the AICPA cosponsors with the Financial Management Division of the SIA (now SIFMA) the National Conference on the Securities Industry, which is specifically designed to update auditors and securities industry financial executives on significant accounting, legal, financial, and tax developments affecting the securities industry. Information on the conference may be obtained by calling the AICPA CPE Conference Hotline at (888) 777-7077 or visiting the AICPA Web site at www.aicpa.org.

Member Satisfaction Center

.307 To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Member Satisfaction Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.308 The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

.309 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

.310 AICPA Online, at www.aicpa.org, offers CPAs the unique opportunity to stay abreast of matters relevant to the CPA profession. AICPA Online informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, www.cpa2biz.com offers all the latest AICPA products, including the Audit Risk Alerts, Audit and Accounting Guides, the professional standards, and CPE courses.

Other Helpful Web Sites

.311 Further information on matters addressed in this Audit Risk Alert is available through various publications and services offered by a number of organizations. Some of those organizations are listed in the "Information Sources" table at the end of this Alert.

.312 This Audit Risk Alert replaces *Securities Industry Developments—2005/06*. The *Securities Industry Developments* Audit Risk Alert is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Alert would also be appreciated. You may e-mail these comments to ymishkevich@aicpa.org, or write to:

Yelena Mishkevich, CPA
AICPA
Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881

.313

Information Sources

Organization	*Web Site, Address, Telephone*
American Institute of Certified Public Accountants	www.aicpa.org Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 Telephone: (888) 777-7077
Financial Accounting Standards Board	www.fasb.org Order Department: 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116 Telephone: (203) 847-0700
Financial Crimes Enforcement Network (FinCEN)	www.fincen.gov/
U.S. Securities and Exchange Commission	www.sec.gov 100 F Street, NE Washington, DC 20549 *Publications Unit* (202) 551-4040 *SEC Public Reference Room* (202) 551-8090
Securities Industry and Financial Markets Association	www.sifma.org 120 Broadway, 35th Floor New York, NY 10271-0080 Telephone: (212) 608-1500 360 Madison Ave. New York, NY 10017-7111 Telephone: (646) 637-9200
New York Stock Exchange, Inc.	www.nyse.com 11 Wall Street New York, NY 10005 Telephone: (212) 656-3000
National Association of Securities Dealers, Inc.	www.nasd.com 1735 K Street, NW Washington, DC 20006-1500 Telephone: (202) 728-8000
Commodity Futures Trading Commission	www.cftc.gov Three Lafayette Centre 1155 21st Street, NW Washington, DC 20581 Telephone: (202) 418-5000

Organization	*Web Site, Address, Telephone*
Futures Industry Association	www.futuresindustry.org 2001 Pennsylvania Avenue NW Suite 600 Washington, DC 20006 Telephone: (202) 466-5460
National Futures Association	www.nfa.futures.org 200 West Madison Street Chicago, IL 60606 Telephone: (800) 621-3570

[*The next page is 8375*.]

AAM Section 8120

Not-for-Profit Organizations Industry Developments—2006/07

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

NOTICE TO READERS
NOT-FOR-PROFIT ORGANIZATIONS INDUSTRY DEVELOPMENTS—2006/07

This Audit Risk Alert, prepared by the AICPA staff, is intended to help you identify the significant business risks that may result in the material misstatement of your client's financial statements. This Alert provides CPAs with an overview of recent economic, business, 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 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.

Lori West, CPA
Technical Manager
Accounting and Auditing Publications

Acknowledgments

The AICPA staff wishes to thank Joel Tanenbaum, Technical Manager, AICPA Accounting Standards; Christopher Cole, CPA, CFE, Technical Manager, AICPA, Accounting and Auditing Publications Team; and various members of the not-for-profit profession, including Gregory Capin, CPA; Carrie R. Charles, CPA; Julie Floch, CPA; Betsy Krisher, CPA, CGFM; Richard Larkin, CPA; Amanda E. Nelson, CPA; Nancy E. Shelmon, CPA; and Scott D. Steffens, CPA, for their assistance and contributions to this Audit Risk Alert.

How This Alert Helps You

.01 This Audit Risk Alert (Alert) helps you plan and perform your not-for-profit organization (NPO) audits. The information delivered by this Alert assists you in achieving a more robust understanding of the business and economic environment in which your clients operate—an understanding that is more clearly linked to the assessment of the risk of material misstatement in the financial statements. Also, this Alert delivers information about emerging practice issues and current accounting, auditing, and regulatory developments.

.02 If you understand what is happening in the NPO 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

.03 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

.04 The NPO 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).

.05 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. 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; however, not all business risks give rise to risks of material misstatement.

.06 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.

.07 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, will help you better assess risks of material misstatement of the financial statements, and could strengthen the integrity of your audits.

Economic and Industry Developments

The State of the Economy

.08 One aspect of obtaining an understanding of the client and the environment in which they operate is to develop a sense of the economic situation during the period under audit. There are many competing and conflicting factors affecting the United States economy. At the present time, the consensus is that the economy is growing, but not quickly.

.09 An indicator of economic conditions is the U.S. gross domestic product (GDP) which measures output by labor and property within the U.S. and increases as the economy grows. The GDP was up by 3.3 percent in 2006. The overall pace of growth is essentially the same as that of 2005 when GDP increased by 3.2 percent; however, the third and fourth quarters of 2006 produced annualized growth rates of only 2.0 percent and 2.2 percent, respectively, demonstrating a slowdown from the 5.6 percent expansion in the first quarter of 2006.

.10 The overall unemployment rate, which is a lagging indicator of economic conditions, has ranged from 4.4 percent to 4.8 percent during 2006 with an annual average of 4.6 percent representing just over 7 million people. The 2006 figures represent the lowest annual rate and total number of jobless since 2000, according to statistics from the U.S. Department of Labor, Bureau of Labor Statistics (BLS). During that period, from 2000 to 2006, 8 million new jobs were added. These data further demonstrates the economic growth the U.S. has experienced since the beginning of 2006.

.11 The Consumer Price Index (CPI) is a measure of the average change in prices over time of goods and services purchased by households. The CPI for All Urban Consumers (CPI-U) and the Chained CPI for All Urban Consumers (C-CPI-U), which cover approximately 87 percent of the total population and include, in addition to wage earners and clerical worker households, groups such as professional, managerial, and technical workers; the self-employed; short-term workers; the unemployed; retirees and others not in the labor force. The CPIs are based on prices of food, clothing, shelter, fuels, transportation fares, charges for doctors' and dentists' services, drugs, and other goods and services that people buy for day-to-day living. The CPI-U in January 2007 was 2.1 percent higher than in January 2006. This is a relatively low rate and indicates moderate price inflation levels.

.12 According to the BLS, average gross weekly earnings increased 4 percent in 2006, which is the largest increase since 1997 and resulted in a per capita increase in disposable income of 1.8 percent for the year. The increase in disposable income along with moderate inflation numbers may be a contributing factor to a fourth quarter increase in the retail consumer spending rate of 4.1 percent over the same period in 2005. The excess of spending over the growth in disposable income has further exacerbated the negative savings trend over the past few years. Americans are spending 1 percent more than they earn according to the U.S. Department of Commerce, Bureau of Economic Analysis (BEA) and Bureau of the Census (BC).

.13 The Federal Reserve has kept the federal funds rate, the rate for overnight inter-bank loans, at five and a quarter percent since June 2006. According to Federal Reserve Chairman Ben Bernanke, consumer spending strength has buoyed the economy and should continue to do so in the near future. The stability in the federal funds rate generally indicates a low to moderate growth rate in both economic expansion and inflationary bellwethers.

.14 Energy prices, including natural gas and gasoline, were explosive in 2006. Prices shot up 25 percent to 30 percent during the first quarter and then dropped back down to beginning-of-the-year levels early in the fourth quarter. The higher mid-year prices impact almost every aspect of the economy from the cost of office supplies to the cost of air and ground transportation.

.15 The housing market appears to be stopping to catch its breath. The Case-Shiller price index showed a 0.4 percent increase in prices during 2006. On an inflation-adjusted basis, that translates to a 1.6 percent decrease. A variety of opinions exist on the direction the market will take in the next year. One effect of the current slowdown is an increase in foreclosure rates. As low, introductory mortgage rates expire and ratchet up payments, many homeowners find themselves unable to make even the minimum payment on their loans. Refinancing existing loans may not be an option due to lack of equity in the property or failure to qualify as lenders tighten standards. Mortgage delinquency and foreclosure rates are up to levels last seen after the economic recession in 2001. The majority of delinquencies and foreclosures are occurring in the subprime mortgage market, although, there has been an increase in the midlevel credit or "Alt-A" market as well. As a result, several lenders who cater to the subprime segment have ceased operations.

The State of Not-for-Profits

.16 The NPO 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 1994 to 2004, the total number of NPOs recognized by the Internal Revenue Service (IRS) increased by 27 percent and assets increased by 90.7 percent. Contributions to these groups in 2005 topped $260 billion and 65 million people in the United States did volunteer work for them. As of September 30, 2006, there were 1.6 million NPOs registered with the IRS.

.17 NPOs 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 NPOs and further discussion of future expansion of those or similar regulations to NPOs.

.18 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 NPO 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

.19 Since 2002 when the Sarbanes-Oxley law was enacted, there have been a number of accounting fraud cases that 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 there are provisions that currently apply to both publicly held companies and NPOs, there has been discussion of the applicability and practicality of expanding more of the provisions to include NPOs. Some very large NPOs have voluntarily adopted some of the provisions of Sarbanes-Oxley, either as a result of expectations from their corporate board members or in an effort to improve governance and accountability practices.

.20 According to a recent survey conducted in 2006, 54 percent of NPOs 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, 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 have included a certified public accountant on their governing board or audit committee. Additionally, reporting policies have been strengthened at some organizations through implementation of some form of certification of the financial statements by the executive director and board president or treasurer.

.21 The IRS has issued a discussion draft titled *Good Governance Practices for 501(c)(3) Organizations*, which is available on the IRS Web site at: www.irs.gov/charities/charitable/article/0,,id=167626,00.html. In this document, the IRS suggests a variety of areas that NPOs can consider in an effort to promote good governance practices. In addition to the items mentioned earlier in this section, the IRS recommends a review of the organization's mission statement and governance practices including organizational transparency, compensation practices, and board member responsibilities in the areas of due diligence and duty of loyalty.

Corporate Sponsors

.22 Corporate giving continues to rise even though it represents only 5.3 percent of the total giving in 2005. Corporate contributions increased 22 percent from 2004 to $13.77 billion in 2005, much of which can be tied to disaster relief efforts; more than one-third of corporate giving is "in-kind." In some circumstances, resources received from corporations are advertising or sponsorship arrangements, rather than contributions and often then strings are attached to the funds. The corporation may have specific requirements in return for those funds, such as naming opportunities, discounted access to services, and advertisement of the company, among others. NPOs must be sure that the goals of their sponsors do not conflict with the goals and mission of their organization.

Funding Administrative Costs

.23 Foundations, corporations, and individuals may have different priorities when it comes to selecting an NPO to support. Some may consider the organization's mission, its reputation, the number of people served, or even who else supports them, but the one factor that most often receives 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 only supporting programmatic activities. Operating expenses such as the accounting department, maintenance and utilities, and the executive management staff must therefore be supported by unrestricted dollars. As a result, organizations and their auditors should be careful to understand the administrative allocation process, as overhead costs cannot be charged against gifts that prohibit that funding.

Volunteers

.24 The Independent Sector announced that the 2006 estimate for the value of a volunteer hour is $18.77. A recent study conveys the fact that there are approximately 6 million active volunteers at the core of many NPOs. These volunteers are contributing 15 million hours, which equates to a value of close to $284 million in volunteer labor. As indicated by these statistics, retaining volunteers is an integral part of many NPOs.

.25 The USA Freedom Corps was established by the President of the United States in early 2007 as a response to a 7 percent decrease in volunteerism from 2005 to 2006. In part, the decrease may be a result of the 31 percent of baby boomers that do not return to volunteer their time after the first year of service. Retention of volunteers can be seen as a significant problem for organizations. Frequently, the NPO has invested resources such as staff time in the recruiting and training process for volunteers just as they would for paid staff. A similar rate of turnover among employees would be considered a significant problem in most organizations.

Changing Face of Donors

.26 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.

Retiring Work Force

.27 The demographic shift in the workplace, as baby boomers near retirement, is impacting the NPO 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.

.28 Because 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.

Cyber Donations

.29 As the internet becomes the quick and easy means of providing access to information, it has also become a tool to expand the audience of NPOs. As you surf the net you will find Web sites for thousands of NPOs 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 NPO. This may be an area that auditors find worthy of attention in that the nonprofit's internal controls over these accounts may not be as thorough as those for deposit accounts at brick and mortar banks.

Ethics Rules Overhaul

.30 Lawmakers cannot accept gifts from groups that employ lobbyists. Currently, it is still unclear whether charities are included in these new rules; thus, this has led to confusion around charitable events because lawmakers and charities are unclear whether meals, gift bags, or spousal attendance of events violates these rules.

Mission Related Investments

.31 There has been an increased focus on socially responsible investing. "Mission investing" has been defined as making loans to NPO groups, engaging in shareholder activism to influence corporations' policies, investing in companies that seek to make money and solve a social or environmental problem, and screening stocks to align a fund's investments with its philanthropic mission by the FSG Social Impact Advisors, formerly known as Foundation Strategy Group. For instance, some foundations may not opt to invest in tobacco companies or may make a concerted effort to purchase stock in businesses that are environmentally friendly.

Regulatory and Legislative Developments

NPO Audits Performed Under Government Auditing Standards and Circular A-133

.32 NPOs may receive federal or state assistance that results in additional audit requirements. For example, they will be required to comply with *Government Auditing Standards* (GAS, also referred to as the Yellow Book). In addition, auditors may be required to perform a single audit and comply with applicable rules. A *single audit* is an audit of an entity's federal financial assistance, as required by the Single Audit Act Amendments of 1996 (the Act), and Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (Circular A-133).[1]

.33 When performing audits under *Government Auditing Standards* or single audits, auditors should refer to the guidance in AICPA Audit Guide Government Auditing Standards *and Circular A-133 Audits* (GAS/A133 Guide). That Guide is updated each year for conforming changes. The 2007 update to the GAS/A133 Guide is expected to be issued in June 2007 (product number 012747kk). Auditors should also refer to the AICPA Audit Risk Alert, Government Auditing Standards *and Circular A-133 Audits—2007* (product number 022457kk) for further developments.

IRS Activities

New Law Revised Exempt Organization Tax Rules, Pension Protection Act of 2006

.34 On August 17, 2006, the President signed the Pension Protection Act of 2006. The new law contains numerous changes to the tax law provisions affecting tax-exempt organizations.

.35 The following are key provisions of the legislation:

---

[1] Instead of a single audit, under certain circumstances, program-specific audits may be conducted.

- ***Controlling organizations*** must report income from and loans to controlled organizations as well as transfers between controlled and controlling organizations. This provision is effective for returns due (without regard to extensions) after the date of enactment.
- ***Section 501(c)(3) organizations*** that file unrelated business income tax returns (Forms 990-T) must now make them available for public inspection. This provision is effective for returns filed after the date of enactment.
- ***Private foundation and excess benefit penalty excise taxes*** are doubled.
- ***Donor advised funds, supporting organizations, and credit counseling organizations*** are subject to new requirements. Donor advised funds and supporting organizations will be subject to continued federal study.
  - — Supporting organizations that want to change their public charity classification should follow the procedures outlined in **Announcement 2006-93** at www.irs.gov/pub/irs-drop/a-06-93.pdf.
  - — **Notice 2006-109** provides interim guidance on issues affecting supporting organizations and sponsoring organizations of donor advised funds. Go to link www.irs.gov/pub/irs-drop/n-06-109.pdf.
- Applicable exempt organizations are subject to new reporting requirements when they acquire life insurance contracts that are structured to give both the exempt organization and private investors an interest in the contract. For purposes of this reporting requirement, applicable exempt organizations include governmental organizations (including Indian Tribal Governments) and employee stock ownership plans.
  - — **Notice 2007-24** at www.irs.gov/pub/irs-drop/n-07-24.pdf requests public comments on Forms 8921 and 8922 which will be used to satisfy this requirement as well as to gather data for the study mandated by Congress.
- Individual Retirement Account (IRA) owners age 70½ or older are permitted to directly transfer, tax-free, up to $100,000 per year to an eligible charity.
  - — **Notice 2007-7** at www.irs.gov/pub/irs-drop/n-07-07.pdf clarifies several issues related to this provision.
- Charitable contribution deductions for food, books, and certain conservation property are increased.
- Starting in 2007, donors must maintain written documentation (cancelled check or communication from the donee) for **all** contributions—even cash put in a church collection plate, not just contributions over $250, if they want to take an income tax deduction for the gift. Organizations should try to ensure that donors are aware of this new requirement.
- Charitable contribution deductions for monetary donations, certain easements, taxidermy property, clothing and household goods, and certain other items are limited.
  - — **Notice 2006-96** at www.irs.gov/pub/irs-drop/n-06-96.pdf provides guidance regarding appraisal requirements for noncash charitable contributions, including transitional guidance relating to the definitions of *qualified appraisals* and *qualified appraiser*.
  - — **Notice 2006-110** at www.irs.gov/pub/irs-drop/n-06-110.pdf provides guidance on new recordkeeping requirements for charitable contributions made through payroll deductions.
  - — The IRS highlighted changes that may affect charitable giving in **News Release IR-2006-192** at www.irs.gov/newsroom/article/0,,id=164997,00.html.
- Beginning in 2008, exempt organizations with gross receipts under $25,000 must file an annual notice. The IRS Web site indicates that the IRS is currently proposing an annual electronic notice—e-postcard Form 990-N (see www.irs.gov/charities main page).

Changes to the 2006 Form 990

.36 Certain provisions of the Pension Protection Act of 2006 result in new reporting requirements for Forms 990, 990-EZ, 990-PF, 990-T, and 4720. As a result the instructions to the 2006 Forms 990, 990-EZ, and Schedule A have been revised to incorporate those significant changes in an effort to address the legislation enacted in 2006.

.37 The following are highlights of the significant changes.

.38 ***Family and Business Relationships of Officers, Directors, Trustees, and Key Employees***

- The definitions of family and business relationships used for purposes of completing Form 990, line 51 must now also be used for purposes of completing Form 990, line 75b. See pages 32 and 35 of the Form 990 Instructions.

.39 ***Compensation of Officers, Directors, Trustees, and Key Employees From Related Organizations***

- The definition of *related organization* (used for purposes of completing Form 990, line 75c) is clarified by listing 8 specific relationships. See page 35 of the Form 990 Instructions.
- The definition of *related organization* excludes certain bank or financial institution trustees and certain common independent contractors.
- Organizations no longer have to report the ***amount*** of compensation where (1) the organization conducts joint programs or shares facilities or employees, (2) one or more persons exercise substantial influence over two organizations, and (3) volunteers control two organizations.
- The definition of *substantial influence* is clarified by referencing Internal Revenue Code section 4958(f)(1) and Regulations section 53.4958-3.

.40 ***Supporting Organizations***

- A supporting organization must now generally file Form 990 (or Form 990-EZ, if applicable) even if its gross receipts are normally less than $25,000. See page 2 of the Form 990 Instructions.
- A supporting organization must provide additional information on Schedule A, page 3. See page 7 of Schedule A instructions.

.41 ***Organizations Maintaining Donor Advised Funds***

- Organizations maintaining donor advised funds must complete new lines 1a and 22a on Form 990. See pages 23 and 28 of Form 990 Instructions.
- Organizations maintaining donor advised funds must complete new lines 4a–4g on the Schedule A. See pages 3 and 4 of the Schedule A Instructions.

.42 ***Organizations with Controlled Entities***

- Organizations with controlled entities must file Form 990 even if their gross receipts are normally less than $25,000. See page 2 of the Form 990 Instructions.
- Organizations with controlled entities must file Form 990 even if their gross receipts are normally less than $25,000. See pages 2 and 41 to 42 of the Form 990 Instructions and Code section 512(b)(13).

.43 ***Organizations Paying Travel and Entertainment Expenses for Government Officials***

- Organizations paying travel and entertainment expenses for federal, state and local government officials and their family members must separately report certain payments on Form 990, line 43 as described on page 30 of Form 990 Instructions.

.44 ***Organizations With Conservation Easements***

- An organization receiving or holding conservation easements must complete Schedule A, line 3c and attach a schedule with the information described on page 3 of the Schedule A Instructions.

IRS, Treasury Issue Priority Guidance Plan for 2007

.45 Fiscal year (FY) 2007 priorities will include a number of ongoing projects as well as the beginning of some new projects. In addition, the enactment of the Tax Increase Protection and Reconciliation Act of 2005 and the Pension Protection Act of 2006, which contains significant changes to the laws that govern tax-exempt organizations, will require substantial time and resource commitments to implement the changes as well as provide guidance, education, and outreach.

.46 New projects for FY 2007 include:

- Implementing new legislation
- Gaming
- Employment taxes
- Telephone excise tax refund
- Community foundations
- College and university unrelated business income tax

.47 Among the ongoing projects, the Form 990 redesign continues with a goal of having a draft form and instructions available for comment in 2007.

.48 The joint endeavor among the Chief Counsel and Treasury will continue in an effort to provide new guidance on topics that further the strategic goals of the IRS as well as topics that are of concern to the NPO community. In particular, the FY 2007 Priority Guidance Plan includes:

- Guidance on political activities by section 501(c)(3) organizations
- A revenue procedure on processing exemption applications that will replace Revenue Procedure 90-27
- Final regulations under sections 501(c)(3) and 4958 on revocation standards (proposed regulations were published on September 9, 2005)
- Guidance on advance and definitive rulings for publicly supported organizations
- Guidance under section 509(a)(3) regarding supporting organizations
- Guidance under section 527(l) with respect to the reasonable cause standard for penalties imposed on political organizations for failing to comply with notice and reporting requirements
- Regulations under section 529 regarding qualified tuition programs
- Guidance on section 516 of the Tax Increase Prevention and Reconciliation Act of 2005 regarding the involvement of accommodation parties in tax shelter transactions

.49 Quality education and outreach programs will continue to be provided including:

- A new interactive Web-based training program modeled on our Small and Mid-Size Exempt Organizations workshop
- Information on the new legislative changes

- Phone forums on the hottest topics
- Updates to the Charities and Non-Profits page on www.irs.gov

.50 Readers may go to www.irs.gov/pub/irs-tege/fy07_implementing_guidelines.pdf to view the FY 2007 Exempt Organizations Implementing Guidelines document in its entirety.

Exemption Application Form for Charities Revised

.51 The exemption application form 1023 used to apply for section 501(c)(3) exemption has been updated to incorporate new user fee information.

.52 A document containing the changes can be found at www.irs.gov/pub/irs.pdf/f1023.pdf.

Frequently Asked Questions About Exempt Organizations Revised

.53 Additional frequently asked questions (FAQs) about issues of interest to the general public regarding exempt organizations have been posted to www.irs.gov/charities/article/0,,id=96583,00.html.

Information for Tax Professionals and E-Filing

.54 Tax professionals who plan to file Forms 990, 990-EZ, 990-PF, or 1120-POL electronically must submit a new or revised electronic IRS *e-file* application using the electronic e-services application. This is a one-time registration process and you must apply at least 45 days before you plan to file electronically. Go to www.irs.gov/taxpros/article/0,,id=109646,00.html for additional information.

Report on Exempt Organizations Executive Compensation Compliance Project—Parts I and II issued in March 2007

.55 In 2004, the IRS, through the Exempt Organizations Office of the Tax Exempt and Government Entities Division, implemented the Executive Compensation Compliance Initiative (the Project). The Project encompassed Forms 990 and related returns for tax years beginning in 2002, and was divided into three parts. The report discusses Part I, involving compliance check letters sent to 1,223 organizations, and Part II, a separate project involving examinations of 782 organizations. Approximately 10 percent of the examinations remain open. Part III was initiated based on information gathered in Part II, and is ongoing as work is continued in the executive compensation compliance area.

.56 The Project revealed mixed results regarding reporting and compliance by the contacted organizations. The compliance checks uncovered significant reporting errors and omissions in specific areas, particularly excess benefit transactions and transactions with disqualified persons, as well as potential compliance issues related to loans made to officers.

.57 On the other hand, the examinations closed thus far have indicated that those selected for examination generally were compliant with section 4958 and private foundation self-dealing rules. However, breaches of the rules were uncovered, such as excessive compensation to executives and officers which resulted in tens of millions of dollars in penalties. More than 30 percent of the 1,223 organizations that received letters by the Exempt Organizations Office of the IRS amended their Form 990 as a result. The IRS then selected 782 organizations to be examined. Forty people in 25 organizations were assessed penalties totaling more than $21 million. Besides lavish salaries and bonuses, the examinations uncovered payments for meals, gifts, automobiles, and even vacation homes not reported as compensation.

.58 Internal Revenue Code Section 4958 imposes an excise tax of 25 percent of an "excess benefit" provided by an exempt organization to a person who exercises or is in a position to exercise substantial influence over the organization's affairs. If the excess benefit is not corrected within the tax period in which it is initially assessed, the penalty increases to 200 percent. An excess benefit is one that exceeds the value of a person's service to the organization. Section 4958 also imposes a 10 percent penalty on excess benefits to officers, directors, or trustees of organizations.

.59 The Report includes a summary of findings, background information, methodology, detailed findings for Part I, compliance check results and Part II, examination results, as well as lessons learned and recommendations. Readers should go to www.irs.gov/pub/irs-tege/exec._comp._final.pdf to view the complete report.

New Electronic Filing Requirement for Small Tax-Exempt Organizations—Annual Electronic Notice—e-Postcard (Form 990-N)

.60 Beginning in 2008, small tax-exempt organizations that previously were not required to file returns may be required to file an annual electronic notice, Form 990-N, Electronic Notice (e-Postcard) for Tax-Exempt Organizations not required to file Form 990 or 990-EZ. This filing requirement applies to tax periods beginning after December 31, 2006.

.61 Small tax-exempt organizations, whose gross receipts are normally $25,000 or less, are not required to file Form 990, Return of Organization Exempt From Income Tax, or Form 990-EZ, Short Form Return of Organization Exempt from Income Tax. With the enactment of the Pension Protection Act of 2006, these small tax-exempt organizations will now be required to file electronically Form 990-N, also known as the e-Postcard, with the IRS annually. Exceptions to this requirement include organizations that are included in a group return, private foundations required to file Form 990-PF, and section 509(a)(3) supporting organizations required to file Form 990 or Form 990-EZ.

.62 For additional information go to www.irs.gov/charities/article/0,,id=169250,00.html.

Other Technical Guidance for Tax Exempt Entities

Definition of "Party" and Allocation of Net Income or Proceeds for Purposes of Section 4965

.63 Notice 2007-18 provides guidance under section 4965 of the Internal Revenue Code to tax-exempt entities described in section 4965(c) regarding whether they are parties to a prohibited tax shelter transaction. This notice also provides guidance to tax-exempt entities described in sections 4965(c)(1), (2), and (3) that are subject to tax under section 4965(a) regarding the allocation to various periods of net income or proceeds attributable to a prohibited tax shelter transaction. To view the notice in its entirety, readers should go to www.irs.gov/pub/irs-drop/n-07-18.pdf. Furthermore, it will be included in the IRB 2007-9 dated February 26, 2007.

Refund for Federal Telephone Excise Tax Paid

.64 The Telephone Excise Tax Refund is a one-time payment available on the 2006 federal income tax return. It is designed to refund previously collected long distance telephone taxes. Individuals, businesses and tax-exempt organizations are eligible to request it by attaching Form 8913 (Credit for Federal Telephone Excise Tax Paid) to a tax form. The Form 990-T instructions illustrate how to complete the form when it is filed only to request this credit. Forms and instructions are available on-line at www.irs.gov/charities/article/0,,id=164585,00.html.

New Internet-Based Workshop for Exempt Organizations

.65 The IRS has launched a *new* Web-based version of its popular Exempt Organizations Workshop covering tax compliance issues confronted by small and mid-sized tax exempt organizations.

.66 The free online workshop—*Stay Exempt—Tax Basics for 501(c)(3)s*—consists of 5 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?

.67 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.

Executive Compensation Project Report

.68 A report of findings of the Exempt Organizations Executive Compensation Compliance Project has been issued. Go to the following link to view the March 2007 findings of the compliance project www.irs.gov/pub/irs-tege/exec._comp._final.pdf.

Listing of Published Guidance—2007

.69 Readers should be aware the IRS Web site contains a digest of exempt organizations' published guidance issued in 2007 at www.irs.gov/charities/content/0,,id=165801,00.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.

.70 Additionally, the IRS Web site also contains an archive which 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.

Group Exemptions Publication Available

.71 The IRS Tax Exempt and Government Entities Division issued publication 4573, *Group Exemptions*, which answers questions about the rules and procedures for group exemptions. The publication is available at www.irs.gov/pub/irs-tege/p4573.pdf.

.72 Group exemptions are sometimes issued by the IRS to recognize a group of organizations as tax-exempt if they are affiliated with a central organization. This avoids the need for each of the organizations to apply for exemption individually. A group exemption letter has the same effect as an individual exemption letter except that it applies to more than one organization.

A Charity Scam is Included in the IRS's Dirty Dozen

.73 The IRS's "dirty dozen" for 2007 continues to include the following scam that is designed to exploit the laws governing charitable organizations. Readers should be aware of arrangements involving charities and NPOs that continue to remain high on the 2007 IRS dirty dozen tax scam list.

.74 ***Abuse of Charitable Organizations and Deductions:*** (number 10 on the tax scam list) The IRS continues to observe the use of tax-exempt organizations to improperly shield income or assets from taxation. This can occur when a taxpayer moves assets or income to a tax-exempt supporting organization or donor-advised fund but maintains control over the assets or income. Contributions of noncash assets continue to be an area of abuse, especially with regard to overvaluation of contributed property. In addition, the IRS is noticing the return of private tuition payments being disguised as charitable contributions to religious organizations.

Independent Sector

.75 The Panel on the Nonprofit Sector, convened by the Independent Sector, submitted a final report to Congress and the Nonprofit Sector in June 2005 in response to a request from the Senate Finance Committee. As discussed in last year's Alert, the final report included and expanded the ideas contained in the Panel's March 1, 2005, Interim Report, and included an overview of the charitable community, including its achievements, scope, and existing programs to improve ethics and accountability. The focal point of the report was the 120 or so recommendations for action by Congress, the IRS, and charitable organizations for improving transparency and governance, while stressing the need to maintain a balance between legitimate oversight and protecting the independence that charitable organizations need to remain innovative and effective.

.76 Readers can view the final report in its entirety at www.nonprofitpanel.org/final/Panel_Final_Report.pdf.

.77 In April 2006, the Panel on the Nonprofit Sector released additional recommendations to Congress as part of its continuing effort to strengthen the accountability of the nation's 1.3 million charitable organizations. The Supplemental Report focused on 9 areas, including international grantmaking and charitable solicitation.

.78 Readers can view the supplement to the final report in its entirety at www.nonprofitpanel.org/supplement/Panel_Supplement_Final.pdf.

.79 The recommendations in these reports helped to shape the NPO reforms legislated as part of the Pension Protection Act of 2006. (See "IRS Activities" section of the Alert.)

.80 In March 2007, the Panel released Draft Principles for Effective Practice, which were developed by its Advisory Committee on Self-Regulation of the Charitable Sector. After reviewing various marketplace standards and principles, the committee developed principles of effective practice that all charitable organizations should consider adopting. These draft principles can be accessed at www.nonprofitpanel.org/selfreg/All_Principles_Revised.pdf.

.81 Comments were initially requested to be received by March 30, 2007 but the advisory committee indicates that it continues to welcome feedback. A final report will be issued late spring 2007 based on comments received.

.82 The Panel is also continuing to study recommendations for improvements to Form 990, 990-PF, and uniform financial standards and reports.

Uniform Prudent Management of Institutional Funds Act Update

.83 As discussed in last year's Alert, the profession continues to monitor the development and the enactment of the Uniform Prudent Management of Institutional Funds Act (UPMIFA). On February 12, 2007 the UPMIFA, which provides a major overhaul of proposed legislation pertaining to charitable institutions, was approved by the American Bar Association's House of Delegates. The Act was drafted and approved by the National Conference of Commissioners on Uniform State Laws in 2006.

.84 At the time the Alert was written, the following two states had adopted the Act:

- Utah
- South Dakota

.85 Furthermore, the Act had been introduced into the following jurisdictions:

- Connecticut
- Idaho
- Indiana
- Kentucky
- Minnesota
- Montana
- Nebraska
- Nevada
- Oklahoma
- Oregon
- Tennessee
- Texas
- U.S. Virgin Islands

.86 Readers can access the most recent UPMIFA update at www.nccusl.org./Update/CommitteeSearchResults.aspx?committee=288. The July 2006 final Act document can be viewed at www.law.upenn.edu/bll/ulc/umoifa/2006final_act.htm.

Other Regulatory Activities

.87 Listed below are links to documents of interest for NPOs not discussed elsewhere in the Alert. Readers should continue to monitor all activity revolving around the NPO sector.

1. Principles of International Charity (March 2005) www.independentsector.org/programs/gr/CharityPrinciples.pdf
2. Voluntary Treasury Anti-Terrorist Financing Guidelines (October 2006) www.ustreas.gov/press/releases/reports/0929%20finalrevised.pdf
3. Council on Foundations requests withdrawal of Anti-Terrorist Financing Guidelines and the substitution of the Principles of International Charity (letter dated December 18, 2006) www.cof.org/Action/content.cfm?ItemNumber=8998&navItemNumber=2466#Sixth
4. Political Activity and Disclosure Requirements (March 2006) Congressional Research Library Report RL-33377 www.ncseonline.org/NLE/CRSreports/06May/RL33377.pdf
5. Tax Relief and Health Care Act of 2006 (December 20, 2006) www.pgdc.com/usa/print_item/?itemID=390921
6. IRS Charitable Rollover Clarification by the IRS (January 2007) Notice 2007-05 www.irs.gov/irb/2007-05_IRB/ar11.html

Audit and Attestation Issues and Developments

Alternative Investments

.88 Over the past several years, allocation of NPO assets to alternative investments has grown significantly. Although not a defined term in generally accepted accounting principles (GAAP), the term alternative investments generally refers to investments for which a readily determinable fair value does not exist. Such investments include hedge funds, private equity funds, venture capital funds, real estate funds, as well as bank common and collective trust funds. Some of the NPOs invest in a single alternative investment while others have portfolios of hundreds of alternative investments.

.89 Alternative investments can present challenges with respect to obtaining sufficient appropriate audit evidence in support of the existence and valuation assertions, because of the lack of readily determinable fair value for these investments and the limited information generally provided by fund managers. In July 2005, the Auditing Standards Board (ASB) Audit Issues Task Force issued Interpretation No. 1 to AU Section 332, "Auditing Investments in Securities Where a Readily Determinable Fair Value Does Not Exist" (AICPA, *Professional Standards*, vol. 1, AU sec. 9332.01–.04) (the Interpretation), which interprets SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1, AU sec. 332). The Interpretation provides auditing guidance related to the existence and valuation assertions for investments in securities where readily determinable fair values do not exist.

.90 In July 2006, the AICPA issued a nonauthoritative Practice Aid, "Alternative Investments—Audit Considerations" (the Practice Aid) to provide additional guidance on the existence and valuation assertions associated with alternative investments. The guidance may be useful to both financial statement preparers and the auditor. The Practice Aid describes management's responsibility for establishing a valuation process and the related internal control. Appendix 2 to the Practice Aid contains illustrative examples of due diligence, ongoing monitoring, and financial reporting controls.

.91 The Practice Aid reminds auditors that their audit approach is based on an assessment of the risk of material misstatement of the financial statements. It states that the risk assessment with respect to alternative investments depends on the particular facts and circumstances, including (1) the significance of alternative investments to the financial statements as a whole; (2) the nature, complexity, and volatility of the underlying investments; (3) the nature and extent of management's process and related internal controls associated with the valuation of alternative investments; and (4) the nature and extent of information available to management to support its valuation process and conclusions. It also describes the relationship between the auditor's risk assessment and the sufficiency and appropriateness of audit evidence. The Practice Aid indicates that the auditor's understanding of management's process for determining estimated fair value affects the nature, timing and extent of audit procedures, and it provides example approaches. Appendix 1 to the Practice Aid also contains an example confirmation for alternative investments. The Practice Aid also reminds auditors that if the auditor is unable to obtain sufficient appropriate evidence to support the financial statement assertions, it will be necessary to qualify or disclaim an opinion due to a scope limitation.

.92 The Practice Alert is available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Practice+Aids+and+Tools/alternative_investments.htm.

The Auditor's Communication With Those Charged With Governance

.93 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. 380), as amended. The new SAS establishes standards for the matters *required* to be communicated by the auditor with those charged with governance in relation to an audit of financial statements, the form and timing of that communication, and to whom the matters should be communicated. The new SAS applies to all entities regardless of size, ownership, or organizational structure.

.94 Paragraph 3 of SAS No. 114 has particular relevance to NPOs as it defines *those charged with governance.* Those charged with governance are defined as 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 term *board of directors* or *audit committee* used elsewhere in generally accepted auditing standards (GAAS).

.95 SAS No. 114 recognized 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 some specific matters to be communicated with them. Additional matters to be communicated are identified in other SASs, which are reflected in Appendix A of SAS No. 114.

.96 Paragraph 5 of SAS No. 114 states that 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.

Identifying Those Charged With Governance

.97 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.

.98 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 NPOs, 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.

.99 Paragraphs 29–33 of SAS No. 114 add requirements to communicate an overview of the planned scope and timing of the audit. Paragraph 64 of SAS No. 114 also requires significant matters communicated with those charged with governance to be documented.

.100 SAS No. 114 is effective for audits of financial statements for periods beginning on or after December 15, 2006.

Practice Implications Related to the Revisions Made by SAS No. 112

.101 In May 2006, the 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* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), 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

.102 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:

1. Identify as significant deficiencies and material weaknesses
2. Communicate to management and those charged with governance

.103 You may emphasize and therefore spend more time evaluating identified control deficiencies than you did in the past.

Discussions With Management and Others

.104 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.

.105 You may 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.

.106 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

.107 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.

.108 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, because 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 client's control weakness by assisting in drafting the financial statements does not change that control weakness.

.109 ***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.

.110 The AICPA has published the Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk) to assist you in the implementation of this Standard.

The Risk Assessment Standards

.111 In March 2006, the AICPA's ASB issued 8 SASs. SASs No. 104–No. 111 were issued together and are known as the *risk assessment standards*, applying to audits conducted in accordance with GAAS. While the new risk assessment standards 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 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. They are effective for audits of financial statements for periods beginning on or after December 15, 2006, with earlier application permitted. Below is a table listing the 8 SASs and their effect on existing standards.

Statement on Auditing Standard	***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")	Amends SAS No. 1, *Due Professional Care in the Performance of Work* (AU section 230)
SAS No. 105, *Amendment to Statement on Auditing Standards No. 95*, Generally Accepted Auditing Standards	Amends SAS No. 95, *Generally Accepted Auditing Standards* (AU section 150)
SAS No. 106, *Audit Evidence*	Supersedes SAS No. 31, *Evidential Matter* (AU section 326)
SAS No. 107, *Audit Risk and Materiality in Conducting an Audit*	Supersedes SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AU section 312)

[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).

SAS No. 108, *Planning and Supervision*	Supersedes SAS No. 1, *Appointment of the Independent Auditor* (AU section 310); and supersedes SAS No. 22, *Planning and Supervision* (AU section 311)
SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*	Supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AU section 319)
SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*	Supersedes SAS No. 45, *Substantive Tests Prior to the Balance-Sheet Date* (AU section 313); and together with SAS No. 109, supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AU section 319)
SAS No. 111, *Amendment to Statement on Auditing Standards No. 39*, Audit Sampling	Amends SAS No. 39, *Audit Sampling* (AU section 350)

Some Key Highlights of the New Risk Assessment Standards

.112 Whether due to error or fraud, the new risk assessment standards require the auditor to understand and respond to the risk of material misstatement. That understanding should identify risks to your 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. While 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 relates 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 you have previously done. Implementation of the SASs will most likely result in significant changes to your firm's audit methodologies and the training of your personnel. Therefore, it is recommended that you 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 Assessments* (product number 022526kk) at www.cpa2biz.com.

New Companion Audit Guide

.113 In December 2006, the AICPA issued an Audit Guide titled, *Assessing and Responding to Audit Risk in a Financial Statement Audit* (product no. 012456kk). This Guide helps practitioners 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.

Practice Alert 07-1, *Dating of the Auditor's Report and Related Practical Guidance*

.114 In December 2005, the ASB issued SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339). One 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. Footnote 1 to AU section 530.01 of the Standard 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 the 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 the 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.

.115 The purpose of the Practice Alert is 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

.116 Readers may download the AICPA Practice Alert at www.aicpa.org/download/auditstd/pract_alert/pa_2007_1.pdf.

Accounting Issues and Developments

Reporting No Fundraising Expense

.117 Some NPO's with contributions report no fundraising expense. Paragraph 13.34 of the NPO Guide provides that the financial statements should disclose total fundraising expenses. It would be unusual for an NPO to have contributions but have minimal or no fundraising expense.

.118 Examples of circumstances in which an NPO with contributions may have no fundraising expense, or minimal fundraising expense in relation to contributions, include the following:

- A religious organization obtains most or all of its contributions from member tithing.
- Most or all contributions arise from volunteers making phone calls or writing letters on the organization's behalf (and this volunteer activity does not meet the recognition criteria for contributed services in paragraph 9 of Financial Accounting Standards Board (FASB) Statement No. 116, *Accounting for Contributions Received and Contributions Made*).
- An organization has no paid staff and most or all contributions arise from uncompensated board members soliciting contributions (and this board member activity does not meet the recognition criteria for contributed services in Paragraph 9 of FASB Statement No. 116).

.119 The reporting organization is a private foundation or is supported by a private foundation and the reporting organization expends no or minimal resources in soliciting those contributions.

Application of FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*, and FASB Statement No. 159, *The Fair Value Option for Financial Assets or Financial Liabilities—Including an amendment of FASB Statement No. 115*

.120 In February 2007, the FASB issued FASB Statement No. 159 to permit entities to choose to measure many financial instruments and certain other items at fair value at specified election dates. The Statement applies to all entities, including NPOs.

.121 FASB Statement No. 159 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. FASB Statement No. 155 similarly permits an elective fair value remeasurement for any hybrid financial instrument that contains an embedded derivative, if that embedded derivative would otherwise have to be separated from its debt host in conformity with FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities.* An election is made on an instrument-by-instrument basis (with certain exceptions), generally when an instrument is initially recognized in the financial statements.

.122 Most financial assets and financial liabilities are eligible to be recognized using the fair value option, as are firm commitments for financial instruments and certain other items, including certain items arising from arrangements that are not financial instruments. Specifically excluded from eligibility are investments in other entities that are required to be consolidated, employer's and plan's obligations under post-employment, postretirement plans, and deferred compensation arrangements (or assets representing overfunded positions in those plans), financial assets and liabilities recognized under leases, deposit liabilities of depository institutions, and financial instruments that are, in whole or in part, classified by the issuer as a component of shareholder's equity. Additionally, the election cannot be made for most nonfinancial assets and liabilities or for current or deferred income taxes.

.123 FASB Statement No. 159 also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. Organizations should report assets and liabilities that are measured using the fair value option in a manner that separates those reported fair values from the carrying amounts of similar assets and liabilities measured using another measurement attribute. To accomplish that, an organization should either (*a*) report the aggregate carrying amount for both fair value and non-fair-value items on a single line, with the fair value amount parenthetically disclosed or (*b*) present separate lines for the fair value carrying amounts and the non-fair-value carrying amounts.

.124 FASB Statement No. 159 will be effective as of the beginning of each reporting entity's first FY that begins after November 15, 2007 and should not be applied retrospectively to FYs beginning prior to the effective date, except as permitted in paragraph 30 of the Statement for early adoption.

.125 At the effective date, an entity may elect the fair value option for eligible items that exist at that date. An NPO should report such cumulative-effect adjustment as a separate line item within the changes in the appropriate net asset class or classes in its statement of activities, outside of any performance indicator or other intermediate measure of operations.

.126 For the complete Statement, readers should go to www.fasb.org/pdf/fas159.pdf.

.127 FASB Statement No. 158 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 as changes in unrestricted net assets of an NPO. It 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.

.128 All NPOs with single employer defined benefit pension, health, and other postretirement plans are within the scope of FASB Statement No. 158. The Statement includes extensive guidance tailored for NPOs and their reporting requirements. Paragraph 8 of the Statement provides guidance for an NPO that sponsors one or more single-employer defined benefit plans (an NPO employer). Paragraph 9 provides guidance for the measurement date of plan assets and benefit obligations for an NPO employer. The Statement also provides guidance in paragraph 10 on disclosure requirements. Furthermore, Example 3 of Appendix A, "Implementation Guidance," provides guidance for an NPO that sponsors a defined benefit postretirement plan. In addition, paragraph 8 of the Statement provides that NPOs recognize as a separate line item or items within changes in unrestricted net assets, apart from expenses, the gains or losses and the 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*, and No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*. Consistent with the provisions of FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, FASB Statement No. 158 does not prescribe whether the separate line item or items should be included within or outside an intermediate measure of operations or performance indicator, if one is presented.

.129 An organization without publicly traded equity securities must initially apply the requirement to recognize the funded status of a benefit plan (FASB Statement No. 158, paragraphs 4 and 8) and the disclosure requirements (FASB Statement No. 158, paragraphs 7 and 10) as of the end of the FY ending after June 15, 2007, but the measurement date provision need not be applied until FYs ending after December 15, 2008.

.130 For the complete Statement, readers should go to www.fasb.org/pdf/fas158.pdf.

Application of FASB Statement No. 157, *Fair Value Measurements*

.131 FASB Statement No. 157 defines fair value, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. The Statement applies under other accounting pronouncements that require or permit fair value measurements. FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made;* FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations;*and FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others* are such accounting pronouncements specific to NPOs where fair value is the relevant measurement attribute. Accordingly, FASB Statement No. 157 does not require any new fair value measurements; however, for some entities, the application of FASB Statement No. 157 will change current practice.

.132 FASB Statement No. 157 does not tell entities how to specifically value assets and liabilities, nor does it tell entities what judgments to make when developing estimates of the inputs that go into valuation techniques.

.133 NPOs should be aware that FASB Statement No. 157 provides guidance pertaining to the effect of donor restrictions on the fair value of assets. Appendix A, "Implementation Guidance," paragraph A30 of FASB Statement No. 157 includes a comprehensive NPO example illustrating this principle (Example 9, *Restrictions on Use of Asset*).

.134 Readers should also be aware that some of the accounting pronouncements within the scope of FASB Statement No. 157 permit practicability exceptions to the requirement to use fair value measurements in specified circumstances. FASB Statement No. 157 does not amend those other pronouncements to eliminate those practicality exceptions. Practicability exceptions that may be of particular interest to NPOs include the following:

- An exemption to the requirement to measure fair value if fair value cannot be measured with sufficient reliability (contributions under FASB Statement No. 116, and AICPA Audit and Accounting Guide *Not-for-Profit Organizations*).
- Paragraph 21 of FASB Statement No. 116 provides that unconditional promises to give that are expected to be collected or paid in less than one year may be measured at net realizable value because that amount results in a reasonable estimate of fair value.

.135 In addition, it should be noted that the FASB has published an index of Statement No. 133 Implementation Issues revised to conform to FASB Statement No. 157. One that specifically relates to NPOs is Statement

No. 133 Implementation Issue B35, "Application of Statement No. 133 to a Not-for-Profit Organization's Obligation Arising from an Irrevocable Split-Interest Agreement."

.136 FASB Statement No. 157 is effective for financial statements issued for FY beginning after November 15, 2007, and interim periods within those FY. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that FY, including any financial statements for an interim period within that FY.

.137 For the complete Statement, readers should go to www.fasb.org/pdf/fas157.pdf.

FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No . 109*

.138 This Interpretation clarifies and expands the accounting and financial reporting for uncertainties related to income taxes. This Interpretation is applicable to all entities, including NPOs. Tax positions taken by any entity that may result in potential future obligations to a taxing authority (for example, IRS or state revenue department) may have to be recorded under this interpretation. Specific types of taxes which may need to be considered include the tax on unrelated business income and the excise tax on private foundation net investment income. FASB Interpretation No. 48 also applies to tax-exempt organizations with net operating loss (NOL) or an NOL carryover for unrelated business income tax purposes, and tax positions taken in allocating expenses through joint venture and other business relationships with taxable entities. NPOs should also note that the term *tax position* as defined in paragraph 4 of FASB Interpretation No. 48 encompasses "a decision to classify a transaction, entity, or other position in a tax return as tax exempt," thereby requiring all tax exempt NPOs to think about events or circumstances that could endanger their tax exempt status and how that would affect the financial statements.

.139 The Interpretation is effective for FY beginning after December 15, 2006. Earlier application is encouraged if the organization has not yet issued financial statements, including interim financial statements, in the period FASB Interpretation No. 48 is adopted.

.140 For additional guidance, the AICPA has issued a Practice Guide about FASB Interpretation No. 48. It is available at www.aicpa.org/fin48guide.

Staff Accounting Bulletin No. 108

.141 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.

.142 There have been two common methods 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 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.

.143 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.

.144 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, nonissuers (private companies) may also consider this guidance when quantifying financial statement misstatements. In general, SAB No. 108 is effective for financial statements for FY ending after November 15, 2006, with earlier application encouraged in any report for an interim period of the first FY 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.

.145 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.

.146 As a result, on March 31, 2007 the FASB staff issued Proposed FASB Staff Position (FSP) Financial Accounting Standards (FAS) No. 154-a, *Considering the Effects of Prior-Year Misstatements When Quantifying Misstatements in Current-Year Financial Statements,* which provides 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. The FASB has stated that private companies should be given the same favorable opportunity as public companies to correct the misstatements without having to restate prior year financial statements. The comment deadline was April 30, 2007. Readers should monitor the progress of the potential FSP by going to www.fasb.org/project/sab_108.shtml.

.147 Furthermore, the AICPA Center for Audit Quality has developed FAQs on Quantifying Financial Statement Misstatements based on discussions with the SEC staff. The FAQs provide much needed clarification for implementing certain aspects of SAB No. 108. To access the complete Center for Audit Quality SAB No. 108 FAQs, go to www.aicpa.org/caq/download/AICPA_SAB_108_FAQ.pdf.

Emerging Issues Task Force Issues and FSPs

.148 The FASB is very active in issuing Emerging Issues Task Force (EITF) Issues and 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 client's financial statements. In the AICPA general *Audit Risk Alert—2006/07* (product no. 022337kk), you will find a list of selected EITF Issues and FSPs that have been issued recently and have broad interest. Recently issued EITF Issues and FSPs that may be of particular interest to auditors of NPOs are discussed in this section of the Alert.

.149 Some practitioners may inadvertently fail to consider FASB EITF consensus opinions when working on NPO engagements; however, EITF consensus opinions that do not conflict with guidance at levels (a) and

(b) of GAAP are applicable to NPOs. Therefore, we present these EITF Issues for consideration on your engagements. Readers should be aware of the guidance in the following EITF Issues and FSPs.

FSP FAS No. 126-1, "Applicability of Certain Disclosure and Interim Reporting Requirements for Obligors for Conduit Debt Securities"

.150 FSP No. 126-1 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. A number of NPOs, largely in the health care and higher education sector that are obligors on municipal publicly traded bonds issued by a state or local government, will be affected by the issuance of this FSP. In all instances where NPOs enter into conduit debt arrangements, it will be necessary to determine whether the bonds are publicly traded or privately placed for purposes of applying this FSP.

.151 This FSP amends Accounting Principles Board (APB) Opinion No. 28, *Interim Financial Reporting*; FASB Statements No. 69, *Disclosures about Oil and Gas Producing Activities—an amendment of FASB Statements 19, 25, 33, and 39*, No. 109, *Accounting for Income Taxes*, No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities—an amendment of FASB Statement No. 107*, No. 131, *Disclosures about Segments of an Enterprise and Related Information*, No. 132(R) (revised 2003), *Employers' Disclosures about Pensions and Other Postretirement Benefits—an amendment of FASB Statements No. 87, 88, and 106*, and No. 141, *Business Combinations*; and AICPA Audit and Accounting Guides *Health Care Organizations* and *Not-for-Profit Organizations* to include conduit bond obligors in the definition of a public entity or enterprise. The biggest effect for NPOs is likely to relate to FASB Statement No. 132(R).

.152 The guidance in this FSP shall be applied prospectively in fiscal periods beginning after December 15, 2006. An entity may elect to retrospectively apply the guidance to all prior periods. If an entity issues interim financial statements, this FSP shall be applied to the first interim period after the date of adoption.

.153 The FSP can be viewed in its entirety at www.fasb.org/fasb_staff_positions/fsp_fas126-1.pdf.

FSP Authoritative Guidance Audits of Airlines-1, "Accounting for Planned Major Maintenance Activities"

.154 FSP Authoritative Guidance (AUG) Audits of Airlines (AIR)-1 addresses the accounting for planned major maintenance activities. This FSP amends certain provisions in the AICPA Industry Audit Guide, *Audits of Airlines* (Airline Guide), and APB Opinion No. 28. Although the principal source of guidance on the accounting for planned major maintenance activities is the Airline Guide, the methods discussed are widely used by other industries. Accordingly, the guidance in FSP AUG AIR-1 is applicable to entities in all industries. The FSP prohibits the use of the accrue-in-advance method of accounting for planned major maintenance activities in annual and interim financial reporting periods.

.155 For example, FSP AUG AIR-1 discusses accounting for planned activities that improve the operating efficiency of an asset, comply with regulatory operating guidelines, or extend the useful life of the asset. In compliance with that FSP, NPOs should not use an accrue-in-advance method of accounting for those planned major maintenance activities because they do not embody a present duty or responsibility of the entity until the obligating transaction or event occurs.

.156 FSP AUG AIR-1 is effective for the first FY beginning after December 15, 2006. Earlier adoption is permitted as of the beginning of an entity's FY.

.157 The FSP can be viewed in its entirety at www.fasb.org/fasb_staff_positions/fsp_augair-1.pdf.

FSP EITF Issue No. 00-19-2, "Accounting for Registration Payment Arrangements"

.158 FSP EITF Issue No. 00-19-2 addresses an issuer's accounting for registration payment arrangements. The FSP may be applicable to colleges and universities or other NPOs with conduit debt or bond issuances.

.159 This FSP specifies that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement, whether issued as a separate agreement or included as a provision of a financial instrument or other agreement, should be separately recognized and measured in accordance with FASB Statement No. 5, *Accounting for Contingencies*. The guidance in this FSP amends FASB Statements No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, and FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, to include scope exceptions for registration payment arrangements. This FSP further clarifies that a financial instrument subject to a registration payment arrangement should be accounted for in accordance with other applicable GAAP without regard to the contingent obligation to transfer consideration pursuant to the registration payment arrangement.

.160 Readers should refer to the FSP for the effective date and transition guidance. The FSP can be viewed in its entirety at www.fasb.org/fasb_staff_positions/fsp_eitf00-19-2.pdf.

EITF Issue No. 06-2, "Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43"

.161 EITF Issue No. 06-2 may be of particular interest to colleges and universities. The EITF states that an employee's right to a compensated absence under a sabbatical or other similar benefit arrangement (1) that requires the completion of a minimum service period and (2) in which the benefit does not increase with additional years of service accumulates pursuant to paragraph 6(b) of FASB Statement No. 43 for arrangements in which the individual continues to be a compensated employee and is not required to perform duties for the entity during the absence. Therefore, assuming all of the other conditions of paragraph 6 of FASB Statement No. 43 are met, the compensation cost associated with a sabbatical or other similar benefit arrangement should be accrued over the requisite service period.

.162 EITF Issue No. 06-2 is effective for fiscal periods beginning after December 15, 2006. The EITF can be viewed in its entirety at www.fasb.org/pdf/abs06-2.pdf.

EITF Issue No. 06-3, "How Taxes Collected From Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation)"

.163 EITF Issue No. 06-3 is of particular interest for those NPOs that collect and remit significant amounts of sales, use, value added, or excise taxes in associated with their revenue producing activities.

.164 The EITF states that the presentation of taxes within the scope of Issue 1 of the EITF on either a gross basis (included in revenues and costs) or a net basis (excluded from revenues) is an accounting policy decision that should be disclosed pursuant to APB Opinion No. 22. An entity is not required to reevaluate its existing policies related to taxes assessed by a governmental authority as a result of the consensus. In addition, for any such taxes that are reported on a gross basis, an entity should disclose the amounts of those taxes in interim and annual financial statements for each period for which an income statement is presented if those amounts are significant. The disclosure of those taxes can be done on an aggregate basis.

.165 EITF Issue No. 06-3 is effective for fiscal periods beginning after December 15, 2006. The EITF can be viewed at www.fasb.org/pdf/abs06-3.pdf.

Recent Auditing, Attestation, and Quality Control Pronouncements and Related Guidance

.166 Presented here is a list of auditing, attestation, and related guidance issued since the publication of last year's Alert. 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/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/ASB+Technical+Activities+and+Publications.htm. As a reminder, AICPA auditing and attest standards are applicable only to audits and attestation engagements of nonissuers.

.167 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/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Opinion/.

Statement on Auditing Standards (SAS) No. 114 (December 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 Statement on Auditing Standards—2006*
Interpretation No. 1 to AU section 330, *The Confirmation Process*	"Use of Electronic Confirmations"
SSAE No. 14 Issue Date: November 2006	*SSAE Hierarchy*
AICPA Technical Practice Aids 8100.01 and 8100.02 (nonauthoritative)	"Determining the Effective Date of a New Statement on Auditing Standards for Audits of a Single Financial Statement" "Determining the Effective Date of a New Statement of Auditing Standards for Audits of Interim Periods"

.168 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

.169 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/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Authoritative+Standards+and+Related+Guidance+

for+Non-Issuers/default.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

.170 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 that Alert to be aware of independence and ethics matters that will affect their practice.

Recent Accounting Pronouncements and Related Guidance

.171 Presented here 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. 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 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. 143 and No. 150, among others; and FASB Interpretation 46(R).
AICPA Statement of Position 06-1 (April 2006)	*Reporting Pursuant to the Global Investment Performance Standards*
AICPA TPA 9510.03 (Nonauthoritative)	"Reporting on New York State Medicaid Cost Reports"

Practice Alert 07-1	"Dating of the Auditor's Report and Related Practical Guidance"
Interpretation No. 29 of AR section 100	"Reporting on an Uncertainty Including an Uncertainty About an Entity's Ability to Continue as a Going Concern"

On the Horizon

.172 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 here) for a complete picture of all accounting and auditing projects in progress. Presented is brief information about some ongoing projects that are especially relevant to the NPO industry. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS.

.173 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)	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/edo/index.htm
Financial Accounting Standards Board (FASB)	www.fasb.org/draft/index.shtml
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.

Overhaul Project—AICPA Audit and Accounting Guide *Not-for-Profit Organizations*

.174 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 the NPO Guide was originally issued in 1996. During this project, the AICPA will continue to issue annual editions of the NPO Guide, updated to reflect recent pronouncements.

Auditing Pipeline—Nonpublic Companies

.175 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 Amendment to SAS No. 69, The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles, for Nongovernmental Entities*

.176 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* (AICPA, *Professional Standards*, vol. 1, AU sec. 411), as amended, for Nongovernmental Entities. This proposed SAS, which applies only to nongovernmental entities, has been issued in response to the FASB's proposed Statement 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) 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 FASB proposed statement, which can be obtained at www.fasb.org.

Accounting Pipeline

.177 Presented below are accounting pronouncements currently in the exposure process. Some of the proposed pronouncements discussed in the prior year Alert have not been finalized as of the date of this writing, and are thus included again.

Mergers and Acquisitions by a Not-for-Profit Organization

.178 On October 9, 2006 the FASB issued two exposure drafts intended to improve the accounting and disclosures related to mergers and acquisitions (M&A) by NPOs. The first exposure draft is *Not-for-Profit Organizations: Mergers and Acquisitions*, and the second exposure draft is *Not-for-Profit Organizations: Goodwill and Other Intangible Assets Acquired in a Merger or Acquisition—an amendment of FASB Statement No. 142*. The proposals reflect the Board's commitment to meet the reporting needs of the NPO community and to ensure that financial statement users have access to decision-useful information.

.179 The two exposure drafts propose accounting standards that would produce financial information that is more consistent, comparable, and representationally faithful of the underlying economics of M&A events.

.180 Specifically, the first exposure draft, *Not-for-Profit Organizations: Mergers and Acquisitions,* would eliminate the use of the pooling-of-interests method of accounting by NPOs, in which assets acquired and liabilities assumed are recorded as "carryover" amounts on the books of acquired organizations. This proposal would instead require the application of the acquisition method to all mergers and acquisitions by an NPO. In applying that method, the proposal generally would require that NPOs:

1. Identify one of the parties to the merger as the acquiring party

2. Recognize the identifiable assets acquired and liabilities assumed that compose the business or NPO activity acquired in a merger or acquisition

3. Measure those assets and liabilities at their fair values as of the acquisition date

4. Recognize either goodwill of the acquired business or NPO activity or the contribution inherent in the merger or acquisition as a residual based on the value of the identifiable assets acquired, liabilities assumed, and the consideration transferred (if any)

5. Disclose information to enable users of the financial statements to evaluate the nature and financial effects of the merger or acquisition

.181 The second exposure draft, *Not-for-Profit Organizations: Goodwill and Other Intangible Assets Acquired in a Merger or Acquisition—an amendment of FASB Statement No. 142*, proposes accounting guidance for intangible assets acquired in a merger or acquisition after the merger or acquisition. The proposed guidance is consistent with the accounting for all other acquired intangible assets—whether purchased or donated, or whether acquired individually or as part of a group.

.182 One practical problem readers should be aware of is how to identify the acquirer when the merger appears to be a merger of equals. The *acquirer* is defined in paragraph 4b of the mergers of NPO entities exposure draft as "the organization that obtains control of the acquiree and recognizes the acquiree in its financial statements." Determining whether an organization obtains control of an acquiree would be based on existing guidance, including Statement of Position (SOP) 94-3, *Reporting of Related Entities by Not-for-Profit Organizations* and the Health Care Guide. If an acquirer cannot be determined based solely on that guidance, this proposed Statement would require that the factors provided in paragraph 11 of the exposure draft be considered.

.183 Under this proposal, NPOs would be required to provide:

1. Consistent and comparable information about identifiable intangible assets acquired by NPOs in a merger or acquisition.

2. More representationally faithful and relevant information about events resulting in impairments of goodwill that an NPO has acquired. Goodwill will not be amortized. Goodwill would, however, be subject to an impairment test.

.184 An NPO would be required to apply the provisions in this proposed Statement prospectively in its FY that begins approximately six months after the issuance of a final Statement. For example, if a final Statement is issued on June 30, 2007, its application would be required in FY beginning after December 15, 2007. Earlier application would be encouraged for organizations with annual periods that begin on or after the date a final Statement is issued. The two proposed Statements would be effective at the same time.

.185 For a tentative summary of the decisions reached by the FASB and to access both exposure drafts and comment letters go to www.fasb.org/project/nfp.shtml. The FASB Staff is currently analyzing the comments received from constituents and will begin its redeliberations in the second quarter of 2007. Readers should monitor the progress of these exposure drafts.

Proposed FASB Statements, Business Combinations—a replacement of FASB Statement No. 141, *and* Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries—a replacement of Accounting Research Bulletin ARB No. 51

.186 In these proposed Statements, the FASB plans to revise the existing guidance on the application of the purchase method. Among the main proposals is that:

1. All acquisitions of businesses be measured at the fair value of the business acquired

2. Substantially, all the assets acquired and liabilities assumed of the acquired business be recognized and measured at their fair values at the acquisition date

3. Entities that follow U.S. GAAP and international standards apply substantially the same accounting requirements for their business combinations

.187 Exposure drafts on business combinations—purchase method procedures and noncontrolling interests—were issued on June 30, 2005. Auditors should visit the FASB Web site for expected issuance dates.

Proposed FASB Statement, The Hierarchy of Generally Accepted Accounting Principles

.188 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 the "Auditing Pipeline—Nonpublic Companies" section) to ensure that each of the documents has a uniform effective date. Readers should be alert for the issuance of a final Statement.

FASB Project on Derivative Disclosures

.189 FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* has been criticized by certain analysts, auditors, investors, and others for lacking transparent disclosures, allowing a user of the financial statements to assess the overall risk of derivatives on a reporting entity from both a quantitative and qualitative perspective. An exposure draft was issued on December 8, 2006, titled *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*. The comment deadline was March 2, 2007. The objective of this project is to provide guidance on enhanced disclosure requirements as well as balance sheet and income statement display of derivatives accounted for in accordance with FASB Statement No. 133. The proposed disclosures will be effective for both interim and annual reporting periods ending after December 15, 2007, with early application encouraged. At initial adoption, disclosures for earlier periods presented for comparative purposes will be encouraged but not required. Disclosures for earlier periods presented for comparative purposes will be required beginning in the first year after the year of initial adoption. Auditors can monitor the progress of this project on the FASB's Web site.

Exposure Draft of a Proposed SOP, Clarification of the Scope of the Audit and Accounting Guide Audits of Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies

.190 The proposed SOP (referred to hereafter as the Investment Companies Guide SCOPE SOP) provides specific conditions for determining whether an entity is within the scope of the AICPA Audit and Accounting Guide *Investment Companies* (the Investment Guide). For those entities that are investment companies under the Investment Companies Guide SCOPE SOP, the SOP also addresses the retention of the specialized industry accounting for investment companies 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).

.191 Readers should be alert to the fact that the Investment Companies Guide SCOPE SOP would reconcile and conform SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, and the AICPA

Audit and Accounting Guide *Health Care Organizations* (the Health Care Guide) to clarify that NPOs, including health care NPOs, that are parent companies of, or equity method investors in for-profit entities that apply investment company accounting pursuant to the Investment Companies Guide SCOPE SOP, should consider whether investment company accounting should be retained in the financial statements of the NPO parent company or equity method investor pursuant to the Investment Companies Guide SCOPE SOP.

.192 Specifically, for those entities that are investment companies under the Investment Companies Guide SCOPE SOP, the Investment Companies Guide SCOPE SOP also addresses the retention of that specialized industry accounting by a parent company in consolidation. For example, NPOs with a controlling financial interest in a for-profit entity, through direct or indirect ownership of a majority voting interest in that entity, that applies investment company accounting pursuant to the Investment Companies Guide SCOPE SOP should consider whether investment company accounting should be retained in the financial statements of the parent NPO pursuant to the Investment Companies Guide SCOPE SOP.

.193 Also, for those entities that are investment companies under the Investment Companies Guide SCOPE SOP, the SOP also addresses the retention of that specialized industry accounting 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. For example, NPOs with investments in the common stock of a for-profit entity that applies investment company accounting pursuant to the SOP, wherein the NPO's investment qualifies for the equity method in conformity with APB Opinion No. 18, should consider whether investment company accounting should be retained in the financial statements of the investor's NPO pursuant to the Investment Companies Guide SCOPE SOP.

.194 Furthermore, Chapter 8 of the NPO Guide permits investment portfolios (other than assets covered by FASB Statement No. 124, which must be reported at fair value) to be reported at fair value in certain circumstances. NPOs that report investment portfolios at fair value in conformity with the NPO Guide would be permitted to continue to do so.

.195 AcSEC expects to issue the SOP in the second quarter of 2007, effective for FY beginning on or after December 15, 2007, with earlier application encouraged. Readers should be alert to the issuance of the final SOP.

AICPA Audit and Accounting Products and Services

AICPA

Web Site

.196 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.

Order Department (Service Center Operations)

.197 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.

Industry Conference

.198 The AICPA National Not-For-Profit Industry Conference will be held on June 19–June 21, 2007, in Washington, D.C. at the Grand Hyatt Washington. For further information, call the AICPA CPE Conference Hotline at (888) 777-7077 or for a detailed brochure, log onto www.cpa2biz.com/conferences.

Accounting and Auditing Technical Hotline

.199 The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

.200 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.

AICPA Products of Interest to Not-for-Profit Organizations

.201 The AICPA offers a number of products specific to the NPO industry. Among the available products are the following:

- Paperback, *Using Competition for Performance Improvement: A Resource for Practitioners Advising Governments and Not-for-Profits* (product no. 056507kk)
- Paperback, *Guide to Fraud in Governmental and Not-for-Profit Environments* (product no. 091021kk)
- Paperback, *Using the AICPA Audit and Accounting Guide "Not-for-Profit Organizations"*
- Paperback, *Beyond Vision and Mission—Reaching Operational and Financial Goals in Governments and NPOs* (product no. 056514kk)
- NPO Audit Committee Toolkit available at www.aicpa.org/audcommctr/homepage.htm. A professionally printed soft-cover book version of this Toolkit is also available for purchase (product no. 991004kk).
- *Checklists and Illustrative Financial Statements for Not-for-Profit Organizations* (product no. 008986kk), a nonauthoritative publication designed to help those preparing reports and financial statements of NPOs.
- *Accounting Trends and Techniques—Not-for-Profit Organizations* is a comprehensive Practice Aid (product no. 006616kk) that illustrates a wide variety of financial statement formats and disclosures for NPOs.
- Technical Practice Aids (TPAs) Sections 6140 and 6960 include questions and answers specifically pertaining to NPOs. TPAs are available both as a subscription service and in paperback form (product no. 005145kk).

Continuing Professional Education Courses

.202 The AICPA offers a number of continuing professional education (CPE) courses related to NPOs, many of them available for both group study and self-study. Among the available titles are the following:

- Accounting and Reporting Practices of Not-for-Profit Organizations (product no. 743274kk)
- Form 990: AICPA's Answer to Unlocking the Tax Complexities (product no. 731058kk)

- Clever Cases on Current Complexities Confronting Governments & Not-for-Profits (product no. 731913kk)
- **New!** Religious and Other Faith-Based Nonprofits: Management, Tax, and Accounting (product no. 733170kk)
- Governmental & Nonprofit Annual Update (2007–2008 Edition) (product no. 731933kk)
- Not-For-Profit Organizations Strategic Briefing—2006/2007 CDROM (product no. 780081hskk)
- Fraud in the Governmental and Not-For-Profit Environments: What a Steal! (available in text [product no. 731922kk] and DVD [product no. 180923kk])
- Advanced Accounting and Auditing Problems for NPOs (product no. 731122kk)
- Advanced Auditing of HUD-Assisted Projects (product no. 730192kk)
- Applying A-133 to Nonprofit and Governmental Organizations (product no. 730207kk)
- Audits of HUD-Assisted Projects (product no. 730297kk)
- Analytical Procedures for Nonprofit Organizations (product no. 730223kk)
- Cost Allocation in Nonprofits: Who Gets It (product no. 730415kk)
- Managing Nonprofit Organizations Like a Business (product no. 730345kk)
- Nonprofit Auditing and Accounting Update (2007–2008 Edition) (available in text [product no. 732092kk] and DVD [product no. 182073kk])
- Auditing Nonprofits: Tips and Traps (product no. 731523kk)
- Private Foundations: Mastering the Unique Tax Aspects (product no. 732272kk)
- Solving Complex Single Audit Issues for Government and Nonprofit Organizations (product no. 734410kk)
- Nonprofit Organizations: Guide to Advanced Tax Planning (product no. 736768kk)
- Workpaper Techniques for Government and Nonprofit Organizations (product no. 732635kk)
- The 2007 Revised Yellow Book: Government Auditing Standards (product no. 736115kk)
- Not-for-Profit Accounting & Reporting: From Start to Finish (product no. 732980kk)

.203 For more information about AICPA CPE courses, call the AICPA Member Service Center at (888) 777-7077 or visit the AICPA Web site at www.aicpa.org.

Online CPE

.204 AICPA CPExpress (formerly 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 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 reSOURCE: Accounting and Auditing Literature

.205 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.

References for Additional Guidance

.206 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. 022336kk), and AICPA *Compilation and Review Alert—2006/07* (product no. 022307kk). These Alerts may be obtained by calling the 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. The 2007/08 versions of these publications will be issued later this year.

.207 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.

.208 This Audit Risk Alert replaces *Not-for-Profit Organizations Industry Developments—2006*. *The Not-for-Profit Organizations Industry Developments* Audit Risk Alert is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Alert would be appreciated. You may e-mail these comments to ccole@aicpa.org or write to:

Christopher Cole, CPA, CFE
AICPA
Technical Manager
Accounting and Auditing Publications
220 Leigh Farm Road
Durham, NC 27707-8110

.209

Appendix—Useful Internet Web Sites

If used properly, the Internet can be a valuable tool for auditors. Through the Internet, auditors can access a wide variety of global business information. For example, information is available relating to industry statistics, resources for not-for-profit organizations (NPOs) and their finance professionals, professional news, state CPA society information, Internal Revenue Service (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.

A number of resources provide direct information, whereas others may simply point to information inside and outside of the Internet. Auditors can use the Internet to:

- Obtain audit and accounting research information
- Obtain texts, such as audit programs
- Discuss audit issues with peers
- Communicate with audit clients
- Obtain information from a client's Web site
- Obtain information on professional associations

There are caveats to keep in mind when using the Internet. Reliability varies considerably. Some information on the Internet has not been reviewed or checked for accuracy; caution is advised when accessing data from unknown or questionable sources. Although a vast amount of information is available on the Internet, much of it may be of little or no value to auditors. Accordingly, auditors should learn to use search engines effectively to minimize the amount of time browsing through useless information. The Internet is best used in tandem with other research tools, because it is unlikely that all desired research can be conducted solely from Internet sources.

The following listing summarizes the various Web sites of many of the organizations referred to in this Audit Risk Alert, as well as others that auditors of NPOs may find useful.

Name of Site	*Content*	*Internet Address*
American Institute of CPAs	Information for CPAs on accounting, auditing, industry activities, the activities of the AICPA, and other matters	www.aicpa.org
Accountant's Home Page	Resources for accountants and financial and business professionals	www.computercpa.com
Action Without Borders	Includes a directory of NPOs and volunteering resources, a newsletter on NPO issues, job postings and frequently asked questions.	www.idealist.org
American Society of Association Executives	Provides resources to assist association executives and individuals from for-profit companies that provide products and services to the association community	www.asaecenter.org

(continued)

Name of Site	*Content*	*Internet Address*
BBB Wise Giving Alliance	Promotes giving and helps contributors obtain accurate information about charitable organizations	www.give.org
Board Source	Resources to help strengthen NPO 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 NPOs	www.compasspoint.org
Council on Foundations	Includes research, publications, and other information of interest to foundations and corporate donors	www.cof.org
CPAnet	Links to other Web sites of interest to CPAs	www.cpanet.com
Department of Housing and Urban Development:	Information on programs, resources, and other matters	www.hud.gov
Office of Inspector General		www.hud.gov/offices/oig
Real Estate Assessment Center		www.hud.gov/offices/reac
Financial Accounting Standards Board	Information on the activities of this standard-setting body	www.fasb.org
FedWorld.Gov	U.S. Department of Commerce sponsored site providing access to government publications	www.fedworld.gov
The Foundation Center	Information for NPOs, donors, and researchers	www.fdncenter.org
Giving Institute	American Association of Fund-Raising Counsel sponsored site providing information trends in giving and sources of support	www.aafrc.org
Government Accountability Office	Policy and guidance materials, reports on federal agency major rules	www.gao.gov
Guidestar	Information on NPOs and news and resources for NPOs and donors	www.guidestar.org
Hoovers Online	Online information on various companies and industries	www.hoovers.com
Independent Sector	A forum to encourage giving, volunteering, NPO initiative, and citizen action	www.independentsector.org

(continued)

Name of Site	*Content*	*Internet Address*
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
Management Assistance Program for Nonprofits	Includes the Nonprofit Manager's Library and other resources	www.mapfornonprofits.org
National Association of College and University Business Officers	Provides information geared to colleges and universities, including accounting tutorials on specific situations encountered in higher education accounting	www.nacubo.org
National Committee On Planned Giving	Provides information and resources regarding charitable planned gifts	www.ncpg.org
Public Company Accounting Oversight Board (PCAOB)	Information on accounting and auditing, the activities of the PCAOB, and other matters	www.pcaobus.org
The National Center for Charitable Statistics	Provides statistics on revenue and expenses of NPOs	http://nccs.urban.org
The Nonprofit Resource Center	Information and links to other sites covering financial management, governance, legal, and other matters	www.not-for-profit.org
The Nonprofit Risk Management Center	Provides information to help NPOs control their risks	www.nonprofitrisk.org
The Nonprofit Times Online	Articles from the *Nonprofit Times* newspaper and links to other sites	www.nptimes.com
Tax Analysts Online	Provides information on current tax developments	www.tax.org
U.S. Department of Education	Information on programs, resources, and other matters	www.ed.gov
U.S. Tax Code Online	A complete text of the U.S. Tax Code	www.fourmilab.ch/uscode/26usc
U.S. Office of Management and Budget	OMB information and literature	www.whitehouse.gov/OMB
Vision Project	Information on the profession's Vision Project	www.cpavision.org

[*The next page is 8461.*]

AAM Section 8130

High-Technology Industry Developments—2006/07

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

NOTICE TO READERS
HIGH-TECHNOLOGY INDUSTRY DEVELOPMENTS—2006/07

This Audit Risk Alert is intended to provide auditors of financial statements of the high-technology industry with an overview of recent economic, technical, and professional developments that may affect the audits 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 generally accepted 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 Karin Glupe, CPA
Technical Manager
Accounting and Auditing Publications

How This Alert Can Help You[1]

.01 This Audit Risk Alert can help you plan and perform your high-technology industry audits. The knowledge delivered by this Alert can assist you in achieving a more robust understanding of the high-technology business environment in which your clients operate—an understanding that is more clearly linked to the assessment of the risk of material misstatement of the financial statements. Also, this Alert delivers information about emerging practice issues and about current accounting, auditing, and regulatory developments.

.02 If you understand what is happening in the high-technology industry and if you can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert assists you in making considerable strides in gaining that industry knowledge and understanding it.

.03 This Alert is intended to be read in conjunction with the AICPA general *Audit Risk Alert—2006/07* (product no. 022336kk).

[1] This Alert is intended to assist auditors of both public and nonpublic companies. As such, references to AICPA professional standards, that is, generally accepted auditing standards (GAAS) and Public Company Accounting Oversight Board (PCAOB) professional standards, are included. In referring to AICPA professional standards, this Alert cites the applicable sections of the AICPA *Professional Standards* publication. In referring to PCAOB standards, this Alert cites the applicable sections of the AICPA's publication entitled *PCAOB Standards and Related Rules*. In those cases in which the standards of the AICPA and those of the PCAOB are the same, this Alert cites the applicable section of the AICPA *Professional Standards* publication only.

.04 ***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*.

New Auditing, Attestation, and Quality Control Pronouncements, and Other Guidance

.05 Presented below is a list of auditing, attestation, and quality control pronouncements and other guidance issued since the publication of last year's Alert. The AICPA general *Audit Risk Alert—2006/07* (product no. 022336kk) contains a summary explanation of most of these issuances. For information on auditing, attestation, and other standards and guidance issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org and the Public Company Accounting Oversight Board (PCAOB) Web site at www.pcaobus.org. The PCAOB sets standards for auditors of public companies and other Securities and Exchange Commission (SEC) registrants only. 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.

SAS No. 102 (December 2005)	*Defining Professional Requirements in Statements on Auditing Standards*
SAS No. 103 (December 2005)	*Audit Documentation*
SAS No. 104 (March 2006)	*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 (March 2006)	*Amendment to Statement on Auditing Standards No. 95,* Generally Accepted Auditing Standards
SAS No. 106 (March 2006)	*Audit Evidence*
SAS No. 107 (March 2006)	*Audit Risk and Materiality in Conducting an Audit*
SAS No. 108 (March 2006)	*Planning and Supervision*
SAS No. 109 (March 2006)	*Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
SAS No. 110 (March 2006)	*Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
SAS No. 111 (March 2006)	*Amendment to Statement on Auditing Standards No. 39,* Audit Sampling
SAS No. 112 (May 2006)	*Communicating Internal Control Related Matters Identified in an Audit*
SSAE No. 13 (December 2005)	*Defining Professional Requirements in Statements on Standards for Attestation Engagements*
Revised AICPA Ethics Interpretation No. 101-15 (December 2005)	"Financial Relationships"

AICPA "Conceptual Framework for AICPA Independence Standards" (Adopted by the Professional Ethics Executive Committee in January 2006)	"Conceptual Framework for AICPA Independence Standards"
Revised AICPA Ethics Interpretation No. 501-1 (January 2006)	"Response to Requests by Clients and Former Clients for Records"
Ethics Ruling No. 113 under Rule 102 (January 2006)	"Acceptance or Offering of Gifts or Entertainment"
Ethics Ruling No. 114 under Rule 101 (January 2006)	"Acceptance or Offering of Gifts and Entertainment to or from an Attest Client"
PCAOB Auditing Standard No. 4 (approved by the SEC in February 2006) (Applicable to audits conducted in accordance with PCAOB standards only)	*Reporting on Whether a Previously Reported Material Weakness Continues to Exist*
PCAOB Conforming Amendment (approved by the SEC in February 2006) (Applicable to audits conducted in accordance with PCAOB standards only)	*Conforming Amendment to PCAOB Related Auditing and Professional Practice Standards Resulting from the Adoption of the Auditing Standard No. 4*
PCAOB Rules (approved by the SEC in April 2006) (Applicable to audits conducted in accordance with PCAOB standards only)	*Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees*
PCAOB Staff Audit Practice Alert No. 1 (July 2006) (Applicable to audits conducted in accordance with PCAOB standards only)	*Matters Related to Timing and Accounting for Option Grants*
AICPA Audit and Accounting Practice Aid (Nonauthoritative)	*Alternative Investments—Audit Considerations*

(continued)

AICPA Audit and Accounting Practice Aid (Nonauthoritative)	*Independence Compliance: Checklists and Tools for Complying With AICPA and GAO Independence Requirements*
COSO Guidance (July 2006)	*Internal Control Over Financial Reporting—Guidance for Smaller Public Companies*

.06 For summaries of the above standards and other guidance, visit the applicable Web site. The standards and interpretations promulgated by the AICPA Auditing Standards Board (ASB) are now available free of charge by visiting the AICPA's 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 Service Center Operations at (888) 777-7077 or going online at www.cpa2biz.com.

New Accounting Pronouncements and Other Guidance

.07 Presented below is a list of accounting pronouncements and other guidance issued since the publication of last year's Alert. The AICPA general *Audit Risk Alert—2006/07* (product no. 022337kk) contains a summary explanation of most of these issuances. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the Financial Accounting Standards Board (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*.

Financial Accounting Standards Board (FASB) Statement No. 155 (February 2006)	*Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*
FASB Statement No. 156 (March 2006)	*Accounting for Servicing of Financial Assets—an amendment to FASB Statement No. 140*
FASB Statement No. 157 (September 2006)	*Fair Value Measurements*
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 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/ 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). A number of the recently issued FSPs address issues relating to FASB Statement No. 123(R).
AICPA Statement of Position (SOP) 06-1 (April 2006)	*Reporting Pursuant to the Global Investment Performance Standards*
AICPA TPA section 5600.07–.17 (November 2005)	*Q&As on Lease Accounting*

AICPA TPA section 2130.09–.37 (November 2005)	*Q&As related to SOP 03-3,* Accounting for Certain Loans or Debt Securities Acquired in a Transfer
AICPA TPA section 6910.16–.20 (January 2006)	*Non-Registered Investment Partnerships*
AICPA TPA section 1400.29 (April 2006)	*Consolidated Versus Combined Financial Statements under FASB Interpretation No. 46(R),* Consolidation of Variable Interest Entities
AICPA TPA section 1400.30 (April 2006)	*Stand-Alone Financial Statements of a Variable Interest Entity*
AICPA TPA section 1400.31 (April 2006)	*GAAP Departure for FIN 46(R)*
AICPA TPA section 1500.06 (April 2006)	*Application of FASB Interpretation No. 46(R),* Consolidation of Variable Interest Entities, *to Income Tax Basis Financial Statements*
AICPA TPA section 1400.32 (June 2006)	*Parent-Only Financial Statements and Relationship to GAAP*
SEC Rules, Regulations, Accounting Bulletins, etc. (Various dates)	Go to www.sec.gov for a complete list of all SEC Guidance.

.08 For summaries of the above standards and other guidance, visit the applicable Web site. To obtain copies of AICPA standards and other guidance, contact Service Center Operations at (888) 777-7077 or go online at www.cpa2biz.com.

Current Economic and Industry Developments

General Industry Trends and Conditions

.09 Worldwide information technology (IT) spending is expected to increase approximately 5.5 percent in 2006, according to IDC, a global market research firm based in Framingham, Massachusetts. IDC estimates that while there will be an increased momentum in software, there will be an offsetting moderation in spending on PCs and peripherals. Forrester Research, Inc. (Forrester) believes that the U.S. IT industry will experience a slight slowdown in 2007 and 2008, but that there will be a revival in tech spending in 2009 and 2010 as companies will have absorbed the previous boom's Internet technologies and will be poised to develop newer technologies.

.10 Lower-cost technology should heighten demand for computer chips, software, and wireless devices, but may also result in slower revenue growth. IDC has forecasted an average of only 6 percent industry growth from 2006 to 2008, as compared to a 10 percent annual rate in the 1990s.

.11 The tech job market has picked up once again despite fears of outsourcing and the fallout from the tech recession. In 2005, approximately 125,000 tech jobs were created, according to Moody's. The industry now appears to be reaching a steady pace of creating an average of 150,000 jobs a year. A series of shocks, including the terrorist attacks on September 11, 2001, the war in Iraq, and the technology industry recession, led companies to cut back spending on labor. Recently, however, a gradual catch-up process has taken place, as revenues and profits within the technology industry have started to increase again.

What Is High Technology, and What Are Its Industry Segment Conditions?

.12 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 (SIC) codes. These sectors fall into three broad categories, namely, high-technology manufacturing, communications services, and software and computer-related services.

.13 High technology is a lot like quality—people know it when they see it—but it is not easy to define. This means the definition of the high-technology industry varies greatly depending on the combination of products and services selected to define the industry. For the purposes of this Alert, we will use a definition that segments the industry into five classifications, namely, PCs; semiconductors; mainframes, servers, and storage; networking and telecommunications equipment; and software and services.

Personal Computers

.14 The worldwide PC market performed well in 2005, as PC shipments increased 15.5 percent from 2004. In addition, the Europe, Middle East, and Africa regions surpassed the United States as the largest PC market, based on 2005 shipments, according to Gartner, Inc. Shipments in Europe, the Middle East, and Africa totaled 72.6 million units in 2005, versus shipments to the United States of 67.2 million units.

.15 Worldwide PC shipments totaled 54.9 million units in the second quarter of 2006, which was an 11 percent increase over the same period last year. Demand for mobile PCs remained strong during the first quarter, and demand for desktop PCs also increased, due to renewed price competition by Intel and AMD. However, according to Gartner, the PC industry will experience slower growth overall in 2006. While mobile PC growth remains strong, desk-based PC replacement activity will soon peak and then subside, thereby hurting the overall PC industry's growth potential. Gartner has predicted that worldwide PC shipments will therefore only increase by approximately 11 percent in 2006, as compared to the 15.5 percent growth rate experienced in 2005. IDC has similar expectations. IDC expects worldwide PC shipments to grow 10.5 percent in 2006 over 2005, helped in part by strong sales in emerging markets. IDC further estimates that PC spending will only grow approximately 2 percent in 2006, as price competition continues.

.16 Short product life cycles are a fundamental characteristic of this industry sector. For example, the life cycle of a desktop PC is thought to be two years or less, and it is estimated that up to 50 percent of profits from PCs and related products are generated in the first three to six months of sales. As a result, computer makers face the risk of inventory obsolescence. (See the "Inventory Valuation" section later in this Alert for a discussion of this issue.)

Semiconductors

.17 Worldwide semiconductor revenue totaled $235 billion in 2005, which was a 5.7 percent increase from 2004, according to Gartner; total worldwide semiconductor revenues for 2005 surpassed the industry's previous record of $223 billion, set in 2000. This increase in revenues is largely the result of an increase in popularity of MP3 players, which require flash memory semiconductors. The entire flash memory segment of the semiconductor industry increased 71 percent between 2004 and 2005, according to Gartner.

.18 Gartner expects the semiconductor industry to experience modest growth over the next few years and expects worldwide semiconductor revenue to reach $257.7 billion in 2006. For the second quarter of 2006, worldwide semiconductor sales were $58.9 billion, an increase of 9.4 percent over the same time period last year. As chipmakers such as Intel and AMD have slashed prices on their chips, this price slump was offset by an increase in the total number of PCs sold, and strong demand for cell phones and MP3 players. According to Gartner, however, a slight slowdown in the semiconductor industry is expected in 2007, followed by a cyclical market peak in 2008.

.19 In a sign that the semiconductor industry is maturing, more chip equipment companies are starting to issue dividends or buy back shares of their stock. The industry's largest company, Applied Materials, began issuing a dividend for the first time in company history in the first quarter of 2005.

.20 For electronics and semiconductor manufacturing, approximately 55 percent to 60 percent of the world's outsourcing will be based in China by the end of 2006, according to market research service In-Stat. Semiconductor manufacturers already regard China as very important to their growth; China's semiconductor market is the third largest in the world.

.21 Advances in computing, digital media processing, and wireless technology have enabled the semiconductor industry to create lifestyle-changing devices. PCs still account for the largest proportion of chip demand, although that percentage has decreased in recent years. In the past, governments, the military, and businesses consumed the majority of IT resources. But as consumers buy more of the computing power created each year, IT companies will have to create IT products with features that appeal to consumers. According to Gartner, 45 percent of the semiconductor chips made in the world today are for consumer devices, and, by 2013, consumer devices will account for more than half of semiconductor chips made in the world, thereby outpacing the use of commercial chips.

Mainframes, Servers, and Storage

.22 Worldwide server shipments in 2005 increased 12.7 percent in 2005 as compared to 2004, according to Gartner. Worldwide server revenues grew 4.5 percent in 2005. A good environment for hardware and software replacement and migration is helping fuel new enterprise spending for IT infrastructure, according to IDC analysts. IDC anticipates growing demand in emerging markets, such as Eastern Europe and Asia, as well as in mature markets such as the United States and Western Europe. Worldwide server shipments for the second quarter of 2006 grew 12.8 percent over the same time period last year, according to Gartner.

.23 From a regional perspective, the United States will continue to hold the greatest share of the worldwide server market, followed by Western Europe and Asia and the Pacific Rim (excluding Japan). IDC expects the strongest growth over the next five years to be in Central and Eastern Europe, as well as Asia and the Pacific Rim region.

.24 In terms of products, a key growth area will be the server blade (or modular) market, which is expected to reach $9 billion by 2008. According to Gartner, the blade market continued to remain strong in the first quarter of 2006, with volumes increasing 46 percent over the same period last year. IDC believes the blade computing market is a new area of opportunity for server vendors and will bring dramatic changes to the server landscape while creating new areas of demand for server management, virtualization, network equipment, and clustering.

.25 Servers based on the Linux operating system will have comparable market share numbers in 2008, representing approximately 29 percent of all server unit shipments and about $9.7 billion in revenues. Microsoft Windows-based servers are expected to capture 60 percent of all server unit shipments in 2008 and represent the largest server-operating environment in terms of revenues with $22.7 billion. IDC anticipates Windows and Linux servers combined to total more than 50 percent of server market revenues in 2008, up from just 37 percent in 2003.

.26 Worldwide external controller-based disk storage revenue totaled $3.8 billion in the first quarter of 2006, an 8.6 percent increase over the first quarter of 2005, according to Gartner. The data storage industry has remained very competitive; as new electronic products are becoming more commonplace (for example, cellular phones, digital cameras, and laptop PCs), new markets for the data storage sector have opened up. Hard disk drive and flash memory suppliers have been particularly successful in recent years, due to the proliferation of new consumer electronic devices; these suppliers have experienced improvements in average selling prices and a reduction in excess inventory levels. Market research firm IDC estimates that worldwide shipments of flash memory cards will increase at a compound annual growth rate of 32 percent through 2008.

.27 Data storage companies have attempted to gain market share through cost cutting and new product releases that focus on the low- and mid-range segments of the storage markets. According to IDC, sales of low-end external disk storage systems are expected to grow by more than 23 percent annually through 2009. The industry is also emphasizing research and development (R&D) to help create products with improved functionality and lower cost applications.

.28 Standard and Poor's believes that consolidation within the storage industry will increase. Many storage providers generate and possess large amounts of cash and typically have little or no debt; thus, they have the means to acquire companies that will improve their competitive positioning.

.29 As with other segments of the high-technology industry, there is the potential for rapid inventory obsolescence. As demand for new types of servers and storage systems increases, older types may become obsolete. As a result, you may need to consider an increased level of risk associated with inventory valuations. (For a further discussion, see the section entitled "Inventory Valuation" later in this Alert.)

Networking and Telecommunications Equipment

.30 Worldwide mobile phone sales totaled 816.6 million units in 2005, a 21 percent increase from 2004, according to Gartner. In addition, the six leading vendors of mobile phones increased their market share, to the detriment of smaller vendors. 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. In the second quarter of 2006, mobile phone sales totaled 229 million units, which was an 18.3 percent increase from the same period last year, according to Gartner. Demand for mobile phones in emerging markets such as the Middle East and Africa has increased in recent years. 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.

.31 *Convergence* seems to be the new buzzword for the wireless telecommunications industry. Cell phones now have increased and multiple functionalities and can now function in sync with, or in place of, PCs and TVs. As various wireless technologies converge on a single mobile device, their use is expected to increase dramatically. According to Forrester, approximately 5 million people in the United States watched video on their cell phones in 2005, and that number could double by the end of 2006. Furthermore, consultancy Informa expects that by 2010, more people worldwide will watch mobile TV broadcasts than there are U.S. TV households today.

.32 Prices of wireless calls continue to drop, as phone companies use price cuts to compete with cable providers. Wireless phone calls are becoming so inexpensive that, consultancy In-Stat predicts, by 2009, one-third of all mobile subscribers will use their cell phones as their primary phones. As per-subscriber phone call revenue keeps dropping, content owners (including record labels, movie studios, and broadcasters) want cell phone service providers who use their content to share revenues. Therefore, wireless carriers have begun outsourcing the creation of new wireless technologies (for example, videos viewed through cell phones) to software developers under a shared revenue/shared business risk model.

.33 In the United States, competition between telecom companies and cable companies continues to intensify, as their service offerings have become increasingly intertwined. For instance, cable companies are beginning to offer inexpensive Internet-based phone services. Telephone companies have argued that cable companies should be subject to the same regulations as telephone companies, but the Federal Communications Commission (FCC) and Congress believe that less regulation for cable will help drive competition.

.34 Internet protocols (IP) that allow telephony and voice communications, will drive voice/data convergence activity in greater than 95 percent of large companies by 2010, according to Gartner. Gartner also estimates that by 2010, 40 percent of companies will have integrated their entire voice and data networks into a single network, and that more than 95 percent of both large and midsized companies will have begun consolidating their networks.

.35 Broadband services continue to gain traction, particularly for the wireless technology known as WiMAX (worldwide interoperability for microwave access). In the United States, it is possible that WiMAX would be universally available by the end of 2007.

.36 Merger and acquisition (M&A) activity has significantly increased over the past few years, as highlighted by several large deals (including SBC's purchase of AT&T, Verizon's purchase of MCI, and Sprint's merger with Nextel). Continued consolidation could lead to higher prices and less competition, or conversely, large companies could invest in new technology that could help small and medium-sized businesses if these smaller businesses can access larger companies' Internet and phone networks. Gartner estimates that by 2009, half of all large network service providers will have merged or been acquired.

.37 Standard & Poor's sees continued growth in telecom's wireless, digital subscriber line (DSL), and long-distance customer bases as a result of bundling efforts. Also, Standard & Poor's expects telecom companies to continue looking outside of their traditional services for growth, by offering higher speed data and video offerings, and take aggressive actions to keep customers loyal.

.38 Standard & Poor's also expects 8 percent to 10 percent industry growth in enterprise networking and telecommunications, as telecom service providers continue to upgrade their communications infrastructure to better handle data and mobile applications. The market's underlying growth driver is the demand for bandwidth, which creates the need for new networks and upgrades to existing networks. As consumers become more interested in higher speed connections and video-on-demand, these applications will drive more demand for bandwidth.

Software and Services

.39 Forrester breaks the U.S. software market into three broad segments:

1. Purchases of commercial software, whether in prepackaged or in customizable forms.
2. Purchases of custom-developed software by IT services companies.
3. The value of internally developed software.

.40 If people think about software today, they primarily think of commercial software from leading software vendors, such as Microsoft, IBM, Oracle, SAP, Computer Associates International, Symantec, Veritas, BMC Software, and Adobe Systems, to name just a few of the largest of thousands of software vendors. Commercial software includes both packaged off-the-shelf software and component-based software that can be configured and customized by the purchaser.

.41 Twenty years ago, custom-developed software still dominated the commercial software segment, especially for enterprise operations and applications. However, the role of custom-developed software has steadily diminished as commercial packaged and semi-packaged software has grown in sophistication and scope. The packaged application software segment is expected to reach more than $120.6 billion in 2009, for a compound annual growth rate of 5.6 percent, according to IDC.

.42 According to Standard & Poor's, the enterprise or corporate software industry should see growth rates only in the mid-single digits for the next few years, due to the fact that no new must-have technologies are seen on the horizon. Enterprise customers now are focused on return on investment when purchasing software, and in this buyers' market, software vendors are facing intense competition and pricing pressure.

.43 The vulnerability of computer systems has become more apparent in recent years, as the threat of terrorist attacks, power outages, computer viruses, and other events that could compromise computer security become more noticeable. Therefore, sales of security software are expected to remain strong in upcoming years; IDC projects a compound annual growth rate of 14 percent through 2009, with revenue exceeding $19.2 billion that year.

.44 M&A activity in the software industry has accelerated in recent years, most notably with the acquisition of PeopleSoft by Oracle, and the merger of Symantec Corp. and Veritas Software Corp. IDC believes that the recent surge in M&A activity will continue, as a result of intense pricing pressure experienced by software companies and because corporate clients are reducing the number of vendors with which they conduct business. However, Standard & Poor's Equity Research Services expects fewer large, multi-billion dollar deals as occurred in past years. Instead, M&A activity will largely be confined to smaller transactions, priced below $1 billion, which will allow the acquirer to take advantage of a complementary technology or specific market segment. The reasons for this shift are that companies are discovering that significant resources and operations are required to derive benefits from large acquisitions, and that customers and investors are sometimes wary of such large deals.

.45 Internet companies are also making a comeback; according to IDC, the percentage of the U.S. population with Internet access rose from 46 percent in 2000 to 71 percent in 2003, and annual growth to 80 percent was expected in 2006. Many domestic Internet companies have been looking abroad for new growth opportunities. There have been some notable acquisitions involving European Internet companies, but Asian Internet companies have remained the main focus of potential acquisitions. It is also expected that as these newly merged companies begin to integrate operations, Internet companies will also spend more money on marketing initiatives and R&D to create new offerings.

.46 Standard and Poor's believes that the Internet is likely to become one of the primary distribution channels for software. The popularity of the Internet has enabled movement away from reliance of proprietary software toward the more cost-effective open source alternative. The open source movement has gained popularity largely due to the growth of the Linux operating system in the enterprise market. Revenues for Linux and other open source alternatives are expected to see a compound annual growth rate ranging from 30 percent for system infrastructure software to 48 percent for application software through 2009, according to IDC.

.47 As technology becomes more complex, computer services have become increasingly more important to the customers of hardware and software companies. The commercial computer services industry includes two subcategories: business services and IT services. Business services include business consulting and business process outsourcing. IT services include application management, system infrastructure, network and desktop outsourcing, project-oriented services, support, and training. For the IT services market, outsourcing is expected to be the fastest growing segment over the next several years, outpacing other segments such as business consulting, support, and training. IDC estimates that overall spending on worldwide IT services will grow at a 7 percent compound annual growth rate through 2009, reaching $803.9 billion. Business process outsourcing is also expected to continue to grow; IDC projects annual growth of that segment of 11 percent through 2009.

Audit Issues and Developments

Assessing Audit Risks in the Current Environment

.48 The proper planning and execution of an audit has always required that auditors have an understanding of the high-technology industry and the nature of the client's business. Auditors of high-technology companies will need to obtain an understanding of the client's products, services, and distribution processes, and the terms and conditions of sales arrangements. Such an understanding enhances the ability to plan and perform auditing procedures. For most audit firms, obtaining this understanding means that the most experienced partners and managers must become involved early and often in the audit process.

.49 You should keep the following points in mind as you plan and perform audits of high-technology clients:

- Understand how your client is affected by changes in the current business environment.
- Understand the stresses on your client's internal control over financial reporting, and the impact on effectiveness.
- Identify key risk areas, particularly those involving significant estimates and judgments.
- Approach the audit with objectivity and skepticism, setting aside prior experiences with or belief in management's integrity.
- Pay special attention to complex transactions, especially those presenting difficult issues of form versus substance.
- Consider whether additional specialized knowledge is needed on the audit team.
- Make management aware of identified audit differences on a timely basis.
- Question the unusual, and challenge anything that does not make sense.
- Foster open, ongoing communications with management and the audit committee, including discussions about the quality of financial reporting and any pressure to accept less than high-quality financial reporting.
- When faced with a "gray" area, perform appropriate procedures to test and corroborate management's explanations and representations, and consult with others as needed.

.50 Specific points to keep in mind with respect to high-technology clients include:

- Consider the inappropriate use of "bill-and-hold" accounting, for example, in circumstances in which the customer has not requested the delay in shipment or provided a ship date that is unreasonably delayed under the circumstances.
- Identify "round-trip" transactions. (See the "Accounting Issues and Developments" section later in this Alert for a detailed discussion of these transactions.)
- Consider nonmonetary transactions.
- Pay attention to whether persuasive evidence of the arrangement exists at the time revenue is recognized and whether legal title to the goods has been transferred and the customer has all the risks and rewards of ownership at that time.
- Consider customers' rights of return, particularly those of distributors, and whether all the requirements of FASB Statement of Financial Accounting Standards No. 48, *Revenue Recognition When Right of Return Exists*, have been satisfied for revenue recognition.

Audit Planning

.51 Guidance for auditors regarding the specific procedures that should be considered in planning an audit, among other matters, is provided in AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1; for audits conducted in accordance with PCAOB Standards: AICPA, *PCAOB Standards and Related Rules*). AU section 311 states that the auditor should obtain a knowledge of matters that relate to the nature of the entity's business, organization, and operating characteristics, and consider matters affecting the industry in which the entity operates, including, among other matters, economic conditions as they relate to the specific audit. For audits of high-technology companies, you should consider obtaining information relating to:

- The types of products being developed and marketed as well as their corresponding life cycles
- Whether those products are relatively standard or require significant customization
- Whether the company has a practice of allowing customers to return products for new or upgraded models
- Whether the company sells standalone products or a bundle of products and services (that is, multiple-element arrangements)
- The company's current marketing programs, for example, pricing incentives and the nature of any incentives that may affect the timing of revenue recognition
- Whether the company 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
- Factors used by stock analysts to value the entity
- The general terms of the company's arrangements with distributors and value-added resellers (VARs), if the company uses them
- The kind of arrangements and warranty provisions the company 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

Risk Assessment Standards

.52 In March 2006, eight Statements on Auditing Standards were issued 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 are effective for audits of financial statements for periods beginning on or after December 15, 2006, but earlier application is permitted. You should not underestimate the standards' significant effect on your audits. The eight SASs consist of:

- 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

.53 The 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.

.54 In most cases, implementation of the new 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.

.55 The AICPA Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk) may be helpful in determining the necessary revisions to your audit methodologies. Also, at the end of 2006 the AICPA will issue a companion Audit Guide entitled *Assessing and Responding to Audit Risk in a Financial Statement Audit*. This Guide will help auditors interpret and implement the risk assessment standards. Moreover, the Guide will contain case studies and illustrations. The Audit Guide and Audit Risk Alert can be obtained by calling AICPA Service Center Operations at (888) 777-7077 or by going online at www.cpa2biz.com.

The Competitive Environment

.56 Currently, the high-technology industry is extremely competitive, as discussed in the "Current Economic and Industry Developments" section above. Industry participants use a variety of pricing mechanisms and other product offerings to gain market share and increase their customer base. A number of segments of the industry—most notably, the PC segment—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.

.57 Rapid innovation and substantial technological change also characterize the industry. New industry players and products continuously 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.

.58 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 generally leads to a greater risk of material misstatement to the financial statements.

Outsourcing

.59 High-tech companies are increasingly outsourcing various business functions, primarily to remain competitive and improve profit margins. Outsourced functions can include finance, accounting, data entry, transaction processing, manufacturing, human resources, and call center operations. Gartner estimates that by 2015, 30 percent of traditional IT services jobs will be handled by people based in emerging markets, such as India, China, Russia, and Brazil.

.60 Such outsourcing may result in less control of business functions, which in turn could result in weakened internal control and security over systems. In addition, the privacy of customer financial and other personal data could be compromised. Also, internal controls are at risk of being weakened by inadequate training at the entity handling the outsourced work.

.61 Auditors should consider and comply with the auditing requirements of AU section 324, *Service Organizations* (AICPA, *Professional Standards*, vol. 1; and for audits conducted in accordance with PCAOB Standards: AICPA, *PCAOB Standards and Related Rules*), as amended. In response to the increased legal risks associated with outsourcing significant business activities, auditors should consider complying with the auditing requirements of AU section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional Standards*, vol. 1), and AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1).

.62 Auditors of public companies and other issuers should comply with Appendix B of 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*), and the related PCAOB Staff Questions and Answers available at www.pcaobus.org.

Impairment or Disposal of Assets

.63 If a high-tech company decides to move a manufacturing plant to an overseas location, certain long-lived assets within the old manufacturing plant may be deemed to be impaired. FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, provides the primary guidance on accounting for the impairment of long-lived assets. In general, the accounting for the impairment of long-lived assets depends on whether the asset is to be held and used or held for disposal. Long-lived assets to be held and used should be reported at cost, less accumulated depreciation, and should be evaluated for impairment if circumstances indicate that impairment may have occurred. Long-lived assets to be disposed of by sale (assets for which management has committed to a plan of disposal) generally should be reported at the lower of the carrying amount or fair value, less costs to sell.

.64 The movement of a plant to an overseas location likely would be deemed an unusual or infrequent event. Unusual or infrequent (but not both) transactions are to be presented in the income statement as separate elements of income from continuing operations, as required by Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*. The presentation should not imply that the amounts are extraordinary items because they would not meet the criteria of being both infrequent and unusual. Clients may present plant closings on the face of the income statement as a component of continuing operations, such as "provision for plant closing." Disclosures stating the effect and nature of the transaction or event can be made in the financial statement footnotes using captions, such as unusual items or nonrecurring items, as well as on the face of the income statement, as stated above.

.65 Assets that are to be abandoned, exchanged for a similar productive asset, or distributed to owners in a spin-off are to be considered as held and used until they are disposed. If the asset is to be abandoned, the depreciable life is revised in accordance with FASB Statement No. 154, *Accounting Changes and Error Corrections*. If the asset is to be exchanged for a similar productive asset or distributed to owners in a spin-off, an impairment loss is to be recognized at the date of exchange or distribution, if the carrying amount of the asset exceeds its fair value at that date.

Accounting for Exit Activities and Personnel Reductions

.66 An increase in the outsourcing of jobs may result in significant reductions in domestic personnel. In such cases, auditors should ensure that they have properly accounted for employee-related termination charges, such as severance packages, voluntary separation charges, fees for outplacement services offered to terminated employees, and bonuses and educational allowances offered to assist employees in finding new jobs.

.67 Accounting literature that may need to be considered when employee layoffs occur includes:

- FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. This Statement addresses financial accounting and reporting for costs associated with exit or disposal activities; the Statement requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred, and establishes that fair value is the objective for initial measurement of the liability.

- FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*. This Statement establishes standards for accounting for curtailments and termination benefits, among other issues. Practitioners should refer to paragraphs 6 through 14 for guidance on curtailments, and paragraphs 15 through 17 for guidance on termination benefits.

- FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*. This Statement requires recording as a loss the effect of curtailments, such as the termination of employees' services earlier than expected. Refer to paragraphs 96 through 99 for guidance on how to account for plan curtailments. The Statement also provides guidance on how to measure the effects of termination benefits in paragraphs 101 and 102.

- FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits—an amendment of FASB Statements No. 5 and 43*. This Statement requires that entities providing postemployment benefits to their former or inactive employees accrue the cost of such benefits. Accrual would occur in accordance with FASB Statement No. 5 when four conditions are met. Inactive employees include those who have been laid off, regardless of whether they are expected to return to work. Postemployment benefits that can be attributed to layoffs can include salary continuation, supplemental unemployment benefits, severance benefits, job training and counseling, and continuation of benefits, such as health care and life insurance. FASB Statement No. 112 does not require that the amount of postemployment benefits be disclosed; however, financial statement disclosure should be made if an obligation for postemployment benefits is not accrued because the amount cannot be reasonably estimated.

- FASB Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits*. This Statement standardizes the disclosure requirements for pensions and other postretirement benefits.

Among other disclosures, the Statement requires the disclosure of the amount of any gain or loss recognized as a result of a settlement or curtailment. Additionally, the cost of providing special or contractual termination benefits recognized during the period and a description of the nature of the event are required to be disclosed.

Expanding Into Nontraditional Areas

.68 High-tech companies that add or expand products, services, and businesses may generate audit risks and risks to themselves. You should 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. You may want to assess management's level of expertise in the new areas of business and consider that assessment in the determination of your audit procedures.

- Management may not properly implement industry-specific accounting principles related to the new areas. You should determine that proper accounting principles are being applied concerning the new areas of business.

- 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. You should consider this when planning and performing the audit. Guidance for internal control is provided in AU section 319, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1; and for audits conducted in accordance with PCAOB Standards: AICPA, *PCAOB Standards and Related Rules*).

- The company may fail to comply with regulations attendant to the new area of business (such as FCC regulations). The company's failure to comply with such regulations may result from unfamiliarity with the regulations and a lack of expertise in the new area. You may want to inquire about the regulations that exist in new business areas (to the extent necessary to perform a proper audit). AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1), describes an auditor's responsibilities regarding violations of laws or governmental regulations.

.69 You may want to assess management's depth and a company's strategic plans when a client enters complicated, new areas of business. If you require the help of a specialist, you should consider the guidance in AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1).

Increased Merger and Acquisition Activity

.70 With M&As of high-tech companies on the rise, auditors may need to refamiliarize themselves with the accounting standards relevant to this area. Additionally, if your audit engagements involve an M&A transaction, you should be prepared to conduct the necessary audit procedures.

Applicable Accounting Guidance

.71 FASB Statement No. 141, *Business Combinations*, addresses financial accounting and reporting for business combinations, including the application of the purchase method, and the accounting for goodwill and other intangible assets acquired.

Possible Internal Control Weaknesses

.72 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.

.73 You should take these issues into account in your consideration of internal control and your assessment of control risk. These possible gaps and deficiencies in internal control may affect the nature, timing, and extent of audit testing and may represent reportable conditions or weaknesses in internal control that should be communicated to management and the audit committee. Auditors should refer to the guidance set forth under AU section 319.

Increased Fraud Risks

.74 Employees may have an increased opportunity to commit fraud when entities merge. With major changes in the company'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. You should refer to the guidance set forth in AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1; and for audits conducted in accordance with PCAOB Standards: AICPA, *PCAOB Standards and Related Rules*), when assessing the risk of fraud.

Spring Loading and Premerger Outlays

.75 An entity acquiring another entity may try to worsen the reported financial performance of the purchased company during the period immediately preceding the acquisition date, the *stub period*. By worsening the financial performance of the acquired company before the acquisition, management will find it much easier to report "improved" performance after the acquisition, thus demonstrating the positive effects of the business combination and providing an increase in reported earnings. This practice is often referred to as *spring-loading*. Generally, the practice involves accelerating the purchased company's payment of payables and other obligations, and writing down investments and other assets on the purchased company's books. Some of these practices, such as paying down payables, may not necessarily violate the letter of any generally accepted accounting principles (GAAP) standard. However, other financial engineering techniques do violate GAAP because they may involve the deliberate inflation of reserves and allowances recorded on the acquired company's books. These inflated reserves are then reversed in the period following the acquisition providing a generous burst of earnings growth. Accounts that can be manipulated in this manner include:

- Reserves for merger costs
- Inventory obsolescence allowance
- Pension allowances
- Restructuring reserves
- Reserves for workers' compensation and medical insurance

You should be on the lookout for these kinds of accounting practices and determine that the appropriate accounting treatment in accordance with GAAP is being followed.

.76 AU section 315, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1; and for audits conducted in accordance with PCAOB Standards: AICPA, *PCAOB Standards and Related Rules*), says the successor auditor must obtain sufficient competent evidential matter to afford him or her a reasonable basis for expressing an opinion of the financial statements under audit, including the opening balances. The predecessors' working papers alone are not sufficient evidential matter. The successor must use his or her judgment and evaluate the results of those working papers as they pertain to the opening balances. The successor also should consider other audit evidence available, such as the predecessor audit report, the results of inquiries with the predecessor auditor and audit procedures performed in the current year's engagement that may provide evidence about opening balances or consistency. Also, the successor may apply procedures to the account balances at the beginning of the period, such as vouching for fixed assets from prior years.

Compliance With the Sarbanes-Oxley Act

.77 Management of public companies may fail to consider the effect of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) and related SEC regulations on the merger. For example, a company may encounter a serious challenge if it acquires a privately held company that has not had to comply with Sarbanes-Oxley. Necessary internal controls may not be in place at the acquired entity. Auditors of public companies need to pay special attention to the proper compliance with Sarbanes-Oxley at the acquired entity and should consider the guidance contained in PCAOB Auditing Standard No. 2.

Revenue Recognition

.78 Revenue recognition continues to pose significant audit risk to auditors. The high-technology industry is one of the more challenging industries when it comes to the topic of revenue recognition.

.79 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*. The criteria, namely, 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 four basic criteria for revenue recognition in AICPA SOP 97-2, *Software Revenue Recognition*, should be a foundation for all basic revenue recognition principles. Those criteria are:

- Persuasive evidence of an arrangement exists.
- Delivery has occurred.
- The vendor's fee is fixed or determinable.
- Collectibility is probable.

.80 The SEC continues to see instances of questionable and inappropriate revenue recognition practices. Significant issues encountered recently include:

- Complex arrangements that provide for separate, multiple deliverables (for example, multiple products and/or services), at different points in time, during the contract term.
- Nonmonetary (for example, barter) transactions in which fair values are not readily determinable with a sufficient degree of reliability.

.81 The SEC has requested that the Emerging Issues Task Force (EITF) address certain of these issues to clarify the application of GAAP in these transactions. However, the SEC staff generally believes that the existing accounting literature provides analogous guidance for a number of these issues, including SOP 97-2; APB Opinion No. 29, *Accounting for Nonmonetary Transactions*; SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*; FASB Concept Statement No. 5; and FASB Concept Statement No. 6, *Elements of Financial Statements*.

.82 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.
- *Licensing Arrangements.* During the tech downturn, software vendors were willing to relax the terms of the licensing agreements, in order to hold on to their customers. However, as corporate spending on software has increased, licensing fees have also increased, and now are, on average, 20 percent of the purchase price of an application. Software vendors are now paying closer attention to the terms of their licensing agreements with customers, and are now more willing to confront late-paying customers. Gartner believes that the cost of software licenses could increase by 50 percent by 2006. You may need to pay close attention to the terms of licensing agreements, and the revenue recognized as a result of licensing fees.

AICPA's Audit Guide on Revenue Recognition

.83 The AICPA Audit Guide *Auditing Revenue in Certain Industries* (the Guide) assists auditors in auditing assertions about revenue in selected industries not covered by other AICPA Audit and Accounting Guides. You can look to this Guide for descriptions and explanations of auditing standards, procedures, and practices as they relate to auditing assertions about revenue in both the computer software and high-technology manufacturing industries.

.84 This Guide:

- Discusses the responsibilities of management, boards of directors, and audit committees for reliable financial reporting.
- Summarizes key accounting guidance regarding whether and when revenue should be recognized in accordance with GAAP.
- Identifies circumstances and transactions that may signal improper revenue recognition.
- Summarizes key aspects of the auditor's responsibility to plan and perform an audit under GAAS.
- Describes procedures that the auditor may find effective in limiting audit risk arising from improper revenue recognition.

.85 You can order the AICPA Audit Guide *Auditing Revenue in Certain Industries* (product no. 012516kk) from the AICPA at (888) 777-7077 or go online at www.cpa2biz.com.

Inventory Valuation

.86 The primary literature on inventory accounting is Accounting Research Bulletin (ARB) No. 43, *Restatement and Revision of Accounting Research Bulletins*, as amended, Chapters 3A and 4, which provide the following summary:

> Inventory shall be stated at the lower of cost or market, except in certain exceptional cases when it may be stated above cost. Cost is defined as the sum of the applicable expenditures and charges directly or indirectly incurred in bringing inventories to their existing condition and location. Cost for inventory purposes may be determined under any one of several assumptions as to the flow of cost factors (such as first-in, first-out; average; and last-in, last-out).

.87 Whether inventory is properly stated at lower of cost or market can be a very significant issue for high-technology audit clients because of the rapid changes that can occur in many areas of the industry, and the need for entities to keep up with the newest technology. Examples of factors that may affect inventory pricing include:

- A competitor's introduction of a technologically advanced version of the product that may decrease the salability of a client's products.
- Changes in the products promoted by the industry as a whole, such as a shift from analog to digital technology, which may affect salability.
- Changes in foreign economies that could result in situations such as a slowdown of sales to that region or lower priced imports from that region.
- Changes in technology to produce high-technology products that can give competitors a selling-price advantage.
- Changes in regulations that could affect the competitive environment.
- The entity's own product changes that may not be well researched as a result of the pressure to introduce new products quickly, resulting in poor sales or high returns.

.88 The highly competitive environment and the rapid advancement of technological factors contribute to the common problem of rapid inventory obsolescence in the high-technology industry. As such, you should consider whether the carrying amount of inventories is appropriate.

.89 You can look at many factors in determining the proper valuation of inventories. A few examples of factors that may be useful include the following:

- Product sales trends and expected future demand
- Sales forecasts prepared by management as compared with industry statistics
- Anticipated technological advancements that could render existing inventories obsolete or that could significantly reduce their value
- Inventory valuation ratios, such as gross profit ratios, inventory turnover, obsolescence reserves as a percentage of inventory, and days' sales in inventory
- New product lines planned by management and their effects on current inventory

- New product announcements by competitors
- Economic conditions in markets in which the product is sold
- Economic conditions in areas in which competitive products are produced
- Changes in the regulatory environment
- Unusual or unexpected movements, or lack thereof, of certain raw materials for use in work-in-process inventory
- Levels of product returns
- Pricing trends for the type of products sold by the client
- Changes in standards used by the industry

.90 These are not the only issues of importance to consider. You may need to address many other issues, including the client's taking of physical inventories in high-technology entities. Consider guidance set forth in AU section 331.09–.13, *Inventories* (AICPA, *Professional Standards*, vol. 1). Among the issues for your consideration are the following:

- When addressing a number of difficult types of inventory, such as chemicals used in the process, you may need to take samples for outside analysis. The work of a specialist may also be needed, in which case you should follow the guidance set forth in AU section 336.
- The extent to which raw materials have been converted to work-in-process will need to be determined to assess the value of the work-in-process.
- Indications of old or neglected materials or finished goods need to be considered in the valuation of the inventory.
- The client's inventory held by others, as well as field service inventories for use in servicing the client's products, will need to be considered.

.91 In addition, the SEC staff believes that inventory reserves create a new cost basis and thus cannot be subsequently reversed into income as a change in estimate if, for example, demand were forecasted to pick up and thereby a previously established excess and obsolete inventory reserve were deemed no longer necessary.

.92 There are also risks posed by the use of contract manufacturers. In many of those circumstances, the hardware vendor will provide the contract manufacturer with a guarantee against its loss due to excess raw material inventory (and, possibly, against the value added in the manufacturing or assembly process) that would occur if the vendor were to reduce purchases beyond a certain point. Such a guarantee may represent a contingent loss that needs to be recognized or disclosed under FASB Statement No. 5. The disclosure requirements of FASB Statement No. 47, *Disclosure of Long-Term Obligations*, also need to be considered.

Foreign Currency Hedges

.93 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 company generates a significant portion of its sales from outside the United States, and expenses can also be affected if the company 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

Income Statement Classification

.94 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 need to be particularly concerned about income statement misclassifications designed to increase reported revenue (for example, reporting agency transactions on a gross basis and showing sales discounts as a marketing expense rather than a revenue reduction). Several EITF consensus provisions provide guidance on the proper classification of certain revenue and expense items. For example, consider the following:

- EITF Issue No. 99-17, "Accounting for Advertising Barter Transactions"
- EITF Issue No. 99-19, "Reporting Revenue Gross as a Principal versus Net as an Agent"
- EITF Issue No. 00-10, "Accounting for Shipping and Handling Fees and Costs"
- EITF Issue No. 00-14, "Accounting for Certain Sales Incentives"
- EITF Issue No. 00-25, "Vendor Income Statement Characterization of Consideration Paid to a Reseller of the Vendor's Products"
- EITF Issue No. 01-9, "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)"
- EITF Issue No. 02-16, "Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor"
- EITF Issue No. 03-10, "Application of EITF Issue No. 02-16 by Resellers to Sales Incentives Offered to Consumers by Manufacturers"

.95 SEC registrants should apply the guidance provided in SEC Regulation S-X regarding classification of amounts in financial statements.

Round Tripping

.96 Round tripping is another technique used to artificially inflate revenues and has appeared in several restatement scenarios. It involves transactions in which the company sells products and services to the same entity from which it buys products and services. Often, the transactions occur in close temporal proximity and completing one transaction is dependent on completing the other. The fair value of both transactions may be overstated such that the company can report higher revenue at the "cost" of increased expenses. In addition, the products and services purchased back may not be used in the same period the revenue is recognized, resulting in more than a basic incorrect grossing-up of the income statement.

Nonmonetary or Barter Transactions

.97 Abuses in the area of nonmonetary or barter transactions have also been a focus of several recent restatements. It is very common for telecommunications companies to "swap" network capacity; some of these companies in the past may have inappropriately inflated their operating results by recognizing revenue for the network capacity sold, and recording a long-term fixed asset for the capacity purchased. In order for a network capacity swap transaction to be appropriately accounted for as revenue and a capital expenditure at fair value:

- The network capacity received in the exchange cannot be sold in the same line of business as the network capacity given up in the exchange.
- The network capacity received must be a productive asset that is dissimilar to the network capacity given up.
- There must be determinable fair values of the assets exchanged.

Capacity swap arrangements typically include complex terms that require professional judgment to determine proper accounting treatment.

.98 Other principle issues for barter transactions are whether there is a legitimate business purpose for the transaction and whether there is sufficient objective evidence of fair values. Also of concern are "disguised" barter transactions that escape analysis because of the presence of "boot" or as a result of a time lapse between transactions that are, in fact, negotiated together. Abuses are seen most often in situations in which there is little hard inventoriable cost associated with the deliverables.

.99 In December 2004, the FASB issued FASB Statement No. 153, *Exchanges of Nonmonetary Assets—an amendment of APB Opinion No. 29*, which affected the accounting for nonmonetary exchanges. APB Opinion No. 29 provided an exception to the basic measurement principle (fair value) for exchanges of similar productive assets; such exception required that some nonmonetary exchanges, although commercially substantive, be recorded on a carryover basis. FASB Statement No. 153 eliminates the exception to fair value for exchanges of similar productive assets and instead creates a general exception for exchange transactions that do not have commercial substance—that is, transactions that are not expected to significantly change the cash flows of the reporting entity. By focusing the exception on exchanges that lack commercial substance, the FASB believes this financial reporting more faithfully represents the economics of the transactions.

Telecommunications Industry Purchase and Sale Agreements

.100 The expansion of fiber optics communications has increased the frequency of transactions involving the "sale" of network capacity. The granting of the right to use such capacity for a defined period of time is often referred to as an *indefeasible right of use* (*IRU*). Accounting by the purchaser of the network capacity is fairly straightforward: The amount paid for the capacity would be recorded as an asset, and that asset would be amortized over the term of the agreement. For the provider of the capacity, however, the question of when to recognize revenue can become rather complex.

.101 The first step in determining when to recognize revenue is to evaluate whether the contract is a lease or an arrangement to provide a service. To the extent that a network capacity contract grants to the purchaser the right to use specific assets for a period of time, providers of the capacity have concluded that such a contract meets the definition of a lease. If the purchaser is not granted the right to use specific identifiable assets, the contract is considered to be an arrangement for the provision of services. Under GAAP, revenue generated from long-term service contracts is typically recognized over time as performance occurs.

.102 For capacity contracts that meet the definition of a lease, the appropriate lease classification must then be determined (for example, a sales-type lease or an operating lease). For a network capacity transaction to be appropriately classified and accounted for as a sales-type lease, certain criteria must be met; otherwise, the transaction must be classified as an operating lease. Such criteria differ depending on whether the leased asset is considered equipment or real estate. A lease of real estate must transfer title to the lessee in order to be classified as a sales-type lease by the lessor; however, equipment leases need not transfer title in order to be classified and accounted for as sales-type leases. In addition, FASB Interpretation No. 43, *Real Estate Sales*, which provides interpretive guidance on the definition of real estate for accounting evaluations, states that assets subject to telecommunications capacity agreements are to be treated as real estate for accounting purposes. Prior to this Interpretation, the assets subject to telecommunications capacity agreements were generally viewed as equipment, and such agreements were therefore classified as sales-type leases.

.103 In addition, as the industry has evolved, many capacity arrangements have become more flexible and no longer grant the purchaser the right to use identifiable assets for a specific period of time. Such contracts are not considered to be leases, but are instead considered contracts for the provisions of services. Therefore, sales-type lease accounting may not apply for more recent capacity contracts.

Quantifying Financial Statement Misstatements

.104 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*. 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.

.105 There have been two common approaches 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 effect of errors in the current year income statement that result from the correction of an error existing in previously issued financial statements.

.106 The SEC staff believes that registrants must quantify the impact of correcting all misstatements, including both the carryover and the reversing effects of prior year misstatements, on the current year financial statements. The staff believes that this can be accomplished by quantifying errors under both a balance sheet and income statement approach, and by evaluating errors measured under each approach. Thus, a registrant's financial statements would require an adjustment when either approach results in quantifying a material misstatement after considering all relevant quantitative and qualitative factors.

.107 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 the SAB. 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.

Employee Stock Options

.108 Knowledgeable workers are the prime assets of high-technology businesses and are the key to wealth creation. Accounting for their compensation sometimes raises difficult accounting issues if high-technology companies include stock options in employee compensation packages. High-technology companies grant stock options to essential employees to attract, motivate, and retain them, in addition to granting stock options, awards of stock, or warrants to consultants, contractors, vendors, lawyers, finders, lessors, and others. Issuing equity instruments makes a lot of sense, partly because of the favorable accounting treatment and partly because the use of equity conserves cash and generates capital.

.109 In reaction to increased scrutiny from the press, Congress, regulators, and others, the FASB issued a revised standard, FASB Statement No. 123(R), *Share-Based Payment*, in December 2004. The Statement addresses the accounting for employee stock options. It also addresses the accounting for transactions in which a company incurs liabilities that are based on the fair value of the company's equity instruments or that may be settled by issuing equity instruments in exchange for employee services. The Statement only affects employee stock options (and related liabilities); it does not affect the accounting for similar transactions involving parties other than employees. It also does not affect the accounting for employee stock ownership plans (ESOPs), which are subject to SOP 93-6, *Employers' Accounting for Employee Stock Ownership Plans*. Generally, the approach in the Statement is similar to the approach described in FASB Statement No. 123, *Accounting for Stock-Based Compensation*. However, the Statement requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values.

.110 The main purpose of this Statement is to recognize the cost of employee services received in exchange for equity instruments and related liabilities in an entity's financial statements. Key provisions of the Statement are as follows:

- For public entities, the cost of employee services received in exchange for equity instruments is measured using the fair value of those instruments on the grant date. The compensation cost is then recognized over the requisite service period (usually the vesting period). Generally, no cost is recognized if the equity instruments do not vest.
- For public entities, the cost of employee services received in exchange for liabilities is measured at the fair value of the liabilities initially, then remeasured at each reporting date through the settlement date. The pro rata change in the fair value of the liability during the requisite service period is recognized over that period. After the requisite service period is complete, the change in fair value is recognized in the financial statements in the period of the change.
- On the grant date, the estimated fair value of employee stock options and similar instruments is determined using options pricing models (unless observable market prices are available).
- If an equity award is modified after the grant date, incremental compensation cost is recognized. This amount is the difference between the fair value of the modified award and the fair value of the original award immediately before the modification.
- If the terms of employee share purchase plans are no more favorable than those available to all holders of the same class of shares, and substantially all employees can participate on an equitable basis, those plans are not considered compensatory.
- Excess tax benefits, as defined by the Statement, are treated as additional paid-in capital. Cash retained as a result of those benefits is reported in the statement of cash flows as cash from financial activities. The write-off of deferred tax assets as a result of unrealized tax benefits associated with recognized compensation is reported as income tax expense.
- The Statement allows nonpublic companies to elect to use the intrinsic method to measure the cost of employee stock options and similar instruments, as well as liability instruments. Public companies may also use the intrinsic method if it is not reasonably possible to estimate grant-date fair value.
- The notes to the financial statements of all entities should include information that users need to understand the nature of employee stock options and similar instruments and the effect those instruments have on the financial statements.

.111 The SEC issued SAB No. 107, *Share-Based Payment*, in April 2005, to help public companies implement the provisions of FASB Statement No. 123(R). The SAB does not alter any conclusions in FASB Statement No. 123(R), but states that amounts represented in financial statements for stock option expenses are highly judgmental estimates. For example, because the grant-date fair value estimate required by FASB Statement No. 123(R) is not intended to predict the ultimate value realized by an option holder, the staff will not object to reasonable fair value estimates made in good faith, even if subsequent events indicate other estimates would have been more accurate. See the SEC Web site at www.sec.gov/interps/account/sab107.pdf for complete information.

.112 Some tech companies have chosen to accelerate the vesting periods of their stock options to avoid expensing the options. Some have also cut back on the number of options they grant, to limit the dilution caused by the granting and exercising of large blocks of options. Others have started granting restricted stock in place of granting stock options.

.113 You should continue to discuss the implications of this Statement with your high-technology clients. For information on this Statement and other accounting standards issued subsequent to this Alert, please refer to 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*.

Backdating and "Spring-Loading" of Stock Options

.114 In 2006, one of the accounting issues that bubbled up was the issuance of stock option grants to executives and other employees, and the timing of those issuances. As of September 2006, the SEC had over 100 companies under investigation for backdated stock options.

.115 When options are backdated, the grant date for an award is set to an earlier date with a lower strike price, than the day on which the option was actually approved. As the stock rises, the value of the options likewise rises, thereby giving executives a potential gain on their options when they vest.

.116 Most back-dating of options occurred five to ten years ago, when issuing options as a form of compensation became popular among tech companies. However, new rules mandated by the Sarbanes-Oxley Act of 2002 largely put an end to the use of back-dating, as public companies are now required to report option grants within two business days. Many of the options issued that were back-dated, though, are still outstanding. Additionally, certain option granting practices that have a financial reporting consequence may have continued even after 2002.

.117 One area of concern is whether the options were tax deductible or not when granted. Nonqualified options are considered incentive compensation, and generally the difference between the strike price and the fair market value at date of exercise is ordinary income to the employee and an equal deductible expense by the employer at the date of exercise. Accordingly for tax purposes, back-dating a nonqualified option to garner a more favorable exercise price generally has the effect of the employee reporting more income and the company taking a greater deduction at the exercise date.

.118 The rules are different and the effect of back-dating is different if the option is intended to qualify as an incentive stock option (ISO). The employer does not receive a deduction, and the employee does not report income for either the grant or exercise of a qualified ISO. (Note, however, for alternative minimum tax purposes, the difference between the strike price and fair market value at date of exercise is a preference item in the year of the exercise.) However, if back-dating results in a strike price of less than 90 percent of the fair market value of the stock at the date of grant, the ISO is disqualified and for tax purposes is treated as a nonqualified option, as discussed above.

.119 Another area of concern is whether the income statement prepared in accordance with GAAP reflects the appropriate measurement of stock option compensation expense. According to a letter issued from the Office of the Chief Accountant of the SEC dated September 19, 2006 (the SEC letter), which summarizes the staff's views regarding the accounting for stock options, the measurement date for determining the cost of a stock option is the first date on which both of the following are known: (*a*) the number of options that an individual employee is entitled to receive and (*b*) the option or purchase price. Therefore, dating the underlying stock option grant documents as of a date prior to the date on which the terms of the award and its recipient are determined does not affect the appropriate measurement date under APB Opinion No. 25, *Accounting for Stock Issued to Employees*, which was the accounting standard in effect at the time backdating was done. Readers can access the SEC letter at http://www.sec.gov/info/accountants/staffletters.shtml.

.120 The SEC letter also states that if a company operated as if the terms of its awards were not final prior to the completion of all required granting actions (such as by changing the option terms), the staff believes the company's measurement date for all of its awards (including those awards that were not changed) would be delayed until the completion of all required granting actions.

.121 Companies that have engaged in backdating could face penalties and fines from the IRS and SEC, and may owe back taxes. They also may have to restate their financial statements, to reflect the proper amount of compensation expense that resulted from the issuance of the backdated options.

.122 With the explosion of option grants in the mid-1990s, "spring-loading" also became a common form of compensation, especially for high-tech companies. Spring-loading is the intentional issuance of option awards just ahead of positive company news that is likely to raise the price of the stock. Therefore, once the news is released, executives can see the value of their options increase. Currently, legal opinions differ regarding the legality of spring-loading, and companies and their auditors should be aware of the legal issues that could arise from spring-loading.

.123 According to the SEC letter, questions have also been raised as to whether companies who engage in option timing techniques would need to adjust the market prick of the stock at the measurement date to accurately measure compensation cost. It is the SEC staff's view that compensation cost must be computed on the measurement date by reference to the unadjusted market price of a share of stock of the same class that trades freely in an established market, in accordance with APB Opinion No. 25.

.124 You should pay close attention to the timing of option grants when conducting your audit. Particular attention should be paid to one-time grants that appear out of sync with earlier awards, especially if such grants were issued just ahead of positive company news.

.125 You should also ensure that the proper controls are in place to prevent option grant abuses such as backdating. For instance, the board of directors should set the date and price of all option awards they approve, and this information should be reflected in the board minutes. Boards should also ensure that SEC form 4 is filed within two business days of the option grant. To remove any suspicion of backdating or spring loading, companies should also consider instituting a policy whereby options are only granted at set times during the year. You should also be aware of the risks if option granting authority is delegated to management.

.126 PCAOB Practice Alert No. 1, "Matters Relating to Timing and Accounting for Options Grants," discusses factors that may be relevant to auditors in assessing the risks related to the timing of option grants. This Practice Alert provides detailed auditing guidance related to this issue and can be obtained at www.pcaobus.org/news_and_events/news/2006/07-28_release.pdf.

Research and Development Costs

.127 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 R&D activity. According to paragraphs 8a and 8b 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.

.128 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. 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.

.129 Some high-technology companies acquire their assets through M&As. One purpose of these business combinations is to acquire in-process R&D. You may need to hire a technology specialist to determine which acquired technology objects have alternative future uses. For clients with technology with alternative future uses, you should verify that they are properly valued and capitalized.

.130 The AICPA Practice Aid, *Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices, and Pharmaceutical Industries* (product no. 006609kk), may be helpful in valuing these intangible assets. The Practice Aid can be obtained by calling AICPA Service Center Operations at (888) 777-7077 or by going online at www.cpa2biz.com.

On the Horizon

.131 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 process. Presented below is brief information about some ongoing projects that may be relevant to your high-technology engagements. Refer to the AICPA general *Audit Risk Alert—2006/07* (product no. 022336kk) for additional summaries of some of the more significant ongoing projects and exposure drafts outstanding. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP, GAAS, or PCAOB Standards.

.132 The following table lists the various standard-setting bodies' Web sites, where information may be obtained on outstanding exposure drafts and from which copies of exposure drafts may be downloaded. 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 and other issuers, the Public Company Accounting Oversight Board (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
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/members/div/ethics/index.htm
PCAOB	www.pcaobus.org

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 expedite your submission. Include your full name, mailing address and, if available, your membership and subscriber number in the message.

Auditing Pipeline—Nonpublic Companies

.133 The proposed standards discussed in this section apply to auditors of nonissuers only. 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 Quality Control Standards, A Firm's System of Quality Control

.134 The ASB has issued an exposure draft for a proposed Statement on Quality Control Standards (SQCS) that would replace all existing SQCSs. The proposed SQCS establishes standards and provides guidance for a CPA firm's responsibilities for its system of quality control for its accounting and auditing practice. It deals comprehensively with a firm's quality control practices in the areas of audits, reviews, and compilations and other attestation engagements. The proposed SQCS places an unconditional obligation on a firm to establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and applicable regulatory and legal requirements, and that the reports issued by the firms or engagement partners are appropriate in the circumstances. A final standard is expected in the second quarter of 2007.

Proposed SAS, Omnibus—2006

.135 The ASB has issued an exposure draft of a proposed SAS entitled *Omnibus—2006*. The Omnibus includes proposed revisions to various existing SASs:

- The proposed SAS Omnibus will amend the general and reporting standards that were not amended by SAS No. 105, *Amendment to Statement on Auditing Standards No. 95*, Generally Accepted Auditing Standards. The Omnibus will also amend those SASs that quote the generally accepted auditing standards to conform them with the changes in SAS No. 105 and to the changes proposed in this Statement.

- The Omnibus will include a proposed amendment to SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*. This proposed amendment will 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.

- SAS No. 103, *Audit Documentation*, amended SAS No. 1, *Codification of Audit Standards and Procedures* ("Dating of the Independent Auditor's Report"), to change the date of the auditor's report from the date of completion of fieldwork to require that the auditor's report 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. The proposed Omnibus will include amendments to remove references to the "completion of fieldwork" throughout the codification of SASs.

- The proposed Omnibus will include a proposed amendment to SAS No. 85, *Management Representations*, as amended. This proposed amendment will align the date of the representation letter with the requirement in SAS No. 103 that the auditor's report not be dated prior to the date on which the auditor has obtained sufficient appropriate audit evidence.

Readers should be alert for the issuance of a final standard.

Proposed SAS, The Auditor's Communication With Those Charged With Governance

.136 The ASB has issued an exposure draft of a proposed SAS that would replace SAS No. 61, *Communication With Audit Committees*, as amended. SAS No. 61 currently establishes 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. The proposed SAS broadens the applicability of the SAS to audits of the financial statements of all nonissuers and establishes a requirement for the auditor to communicate with those charged with governance certain significant matters related to the audit.

.137 The proposed SAS identifies specific matters to be communicated, many of which are generally consistent with the existing requirements in SAS No. 61. However, the proposed SAS includes certain additional matters to be communicated and provides additional guidance on the communication process. In particular, the proposed SAS:

- Requires the auditor to determine the appropriate person(s) in the entity's governance structure with whom to communicate particular matters. That person may vary depending on the nature of the matter to be communicated.
- Recognizes the diversity in governance structures among entities (including the existence of audit committees or other subgroups charged with governance) and encourages the use of professional judgment in deciding with whom to communicate particular matters.
- Recognizes the unique considerations for communicating with those charged with governance when all of those charged with governance are involved in managing the entity, which may be the case with some small entities.
- Adds requirements to communicate an overview of the planned scope and timing of the audit, and representations the auditor is requesting from management.
- Provides additional guidance on the communication process, including the forms and timing of communication. Significant findings from the audit are required to be communicated in writing, while other communications may be oral or in writing.
- Requires the auditor evaluate the adequacy of the two-way communication between the auditor and those charged with governance.
- Establishes a requirement to document significant matters communicated to those charged with governance.

.138 In addition to the proposed SAS, the exposure draft includes a proposed amendment to SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, as amended. The proposed amendment requires the auditor to communicate to those charged with governance events or conditions that cause an auditor to conclude that there is substantial doubt about the entity's ability to continue as a going concern as well as management's plans for addressing such events or conditions.

.139 Readers should be alert for the issuance of a final standard in the fourth quarter of 2006.

Amendment to SAS No. 69, The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles, for Nongovernmental Entities*

.140 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 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 FASB proposed statement, which can be obtained at www.fasb.org. This project is therefore on hold awaiting FASB finalization of the hierarchy.

Accounting Pipeline

Proposed FASB Statement, The Hierarchy of Generally Accepted Accounting Principles

.141 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. Readers should be alert for the issuance of a final Statement.

Proposed FASB Statements, Business Combinations, *and* Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries

.142 In these proposed Statements, the FASB plans to revise the existing guidance on the application of the purchase method. The following are among the main proposals:

1. That all acquisitions of businesses be measured at the fair value of the business acquired.
2. That substantially all of the assets acquired and liabilities assumed of the acquired business be recognized and measured at their fair values at the acquisition date.
3. That entities that follow U.S. GAAP and international standards apply substantially the same accounting requirements for their business combinations.

.143 The FASB's goal is to issue the two final Standards in the second quarter of 2007. The target effective date for the two proposed Statements will be reviewed near the end of redeliberations.

Proposed FASB Statement, Accounting for Transfers of Financial Assets

.144 The exposure draft *Accounting for Transfers of Financial Assets* is a revision of a June 2003 exposure draft, *Qualifying Special-Purpose Entities and Isolation of Transferred Assets*, and would amend FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The proposed Statement seeks to (*a*) clearly specify the circumstances that require the use of a qualifying special-purpose entity (SPE) in order to derecognize all or a portion of financial assets, (*b*) provide additional guidance on permitted activities of qualifying SPEs, (*c*) eliminate the prohibition on a qualifying SPE's ability to hold passive derivative financial instruments that pertain to beneficial interests held by a transferor, and (*d*) revise the initial measurement of interests related to transferred financial assets held by a transferor. The effective dates associated with this proposed Statement vary; refer to the exposure draft for further information.

.145 Readers should be alert for the issuance of a final Statement, which is expected in the second quarter of 2007. See the FASB Web site at www.fasb.org for complete information.

Proposed FASB Statement, The Fair Value Option for Financial Assets and Financial Liabilities

.146 In January 2006, the FASB published an exposure draft of a proposed Statement, *The Fair Value Option for Financial Assets and Financial Liabilities*. This proposed Statement would create a fair value option under which an entity may irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and financial liabilities on a contract-by-contract basis, with changes in fair value recognized in earnings as those changes occur.

.147 Current GAAP requires some assets or liabilities to be reported using the fair value measurement attribute, while other related assets or liabilities are required to be reported using another measurement attribute. This mixed-attribute accounting leads to volatility in reported earnings. Creation of the fair value option would permit an entity to mitigate that volatility by enabling entities to achieve an offset accounting effect for the changes in the fair values of related assets and liabilities without having to apply complex hedge accounting provisions.

.148 Adoption of this proposed Statement would be required as of the beginning of an entity's first fiscal year that begins after December 15, 2006, with earlier adoption permitted as of the beginning of an entity's earlier fiscal year that begins after issuance of the final Statement. As of the date of initial adoption, an entity would be permitted to elect the fair value option for any existing financial asset or financial liability within the scope of the proposed Statement. The adjustment to reflect the difference between the fair value and the carrying amount of the existing financial assets and financial liabilities for which an entity irrevocably elected the fair value option as of the date of initial adoption would be accounted for as a cumulative-effect adjustment to retained earnings. Retrospective application of the accounting provisions in the proposed Statement would not be permitted.

.149 Readers should be alert for the issuance of a final Statement, which is expected in the fourth quarter of 2006.

Proposed FASB EITF Issues

.150 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.

Proposed FASB Staff Positions

.151 A number of proposed FASB Staff Positions are in progress addressing issues related to FASB Statements No. 123(R), and No. 126. Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/proposed_fsp.shtml for complete information.

Resource Central

.152 Presented below are various resources that practitioners engaged in the high-technology industry may find beneficial.

Publications

.153 The following publications deliver valuable guidance and practical assistance as potent tools to be used on your engagements (product numbers appear in parentheses):

- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (2006) (product no. 012523kk)
- Audit Guide *Auditing Revenue in Certain Industries* (2006) (product no. 012516kk)

- Audit Guide *Audit Sampling* (2001) (product no. 012530kk)
- Audit Guide *Analytical Procedures* (2006) (product no. 012556kk)
- Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (2006) (product no. 012776kk)
- *Accounting Trends & Techniques—2006* (product no. 009896kk)
- Practice Aid *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* (product no. 006701kk)
- Practice Aid *Fraud Detection in a GAAS Audit, Revised Edition* (006615kk)
- General *Audit Risk Alert—2006/07* (product no. 022336kk)

Audit and Accounting Manual

.154 The *Audit and Accounting Manual* (revised as of July 1, 2006) (product no. 005136kk) is a valuable nonauthoritative practice tool designed to provide assistance for audit, review, and compilation engagements. It contains numerous practice aids, samples, and illustrations, including audit programs; auditor's reports, checklists, and engagement letters; management representation letters; and confirmation letters.

Educational Courses

.155 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry. Visit www.cpa2biz.com for a complete list of CPE courses.

Hotlines

Accounting and Auditing Technical Hotline

.156 The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

.157 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

.158 Further information on matters addressed in this Audit Risk Alert is available through various publications and services offered by a number of organizations. Some of those organizations are listed in the following table.

Name of Site	*Content*	*Internet Address*
Accountants World	Online community of independent accountants providing resources and tools	www.accountantsworld.com
AccountingWeb	Online community for the accounting profession	www.accountingweb.com

(continued)

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
CPAnet	Online community and resource center for the accounting profession	www.cpanet.com/
Economy.com	Source for analysis, data, forecasts, and information on the United States and world economies	www.economy.com
Federal Reserve Bank of New York	Key interest rates	www.ny.frb.org/index.html
Financial Accounting Standards Board	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
FirstGov	Portal through which all government agencies can be accessed	www.firstgov.gov
Government Accountability Office (formerly General Accounting Office)	Policy and guidance materials, reports on federal agency major rules	www.gao.gov
Hoovers Online	Online information on various companies and industries	www.hoovers.com
International Accounting Standards Board	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org
International Federation of Accountants	Information on standards-setting activities in the international arena	www.ifac.org
Public Company Accounting Oversight Board	Information on accounting and auditing, the activities of the PCAOB, and other matters	www.pcaobus.org
Securities and Exchange Commission	The SEC Digest and Statements, EDGAR database, current SEC rulemaking	www.sec.gov
Tax Analysts Online	Information on current tax developments	www.tax.org
U.S. Tax Code Online	A complete text of the U.S. Tax Code	www.fourmilab.ch/ustax/ustax.html
WebCPA	Provides online business news for the tax and accounting community	www.webcpa.com

* * * * * * *

.159 This Audit Risk Alert replaces *High-Technology Industry Developments—2005/06*. *High-Technology Industry Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Alert would also be appreciated. You may e-mail these comments to kglupe@aicpa.org or write to:

Karin Glupe
AICPA
Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881

[*The next page is 8481*.]

AAM Section 8140

Real Estate Industry Developments—2006/07

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

NOTICE TO READERS
REAL ESTATE INDUSTRY DEVELOPMENTS—2006/07

This Audit Risk Alert is intended to provide auditors of financial statements of real estate organizations with an overview of recent economic, technical, and professional developments that may affect the audits 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 Statement 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.

Amy M. Eubanks, CPA
Technical Manager
Accounting and Auditing Publications

Acknowledgements

The AICPA staff wishes to thank J. Russell Madray, CPA, for his valuable contribution to and insight into this Audit Risk Alert.

How This Alert Helps You

.01 This Audit Risk Alert helps you plan and perform your real estate industry audits. The information delivered by this Alert assists you in achieving a more comprehensive 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 your client's financial statements. Moreover, this Alert delivers information about emerging practice issues and information about current accounting, auditing, and regulatory developments.

.02 If you understand what is happening in the real estate 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.

.03 This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2006/07* (product no. 022337kk). 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.

.04 ***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*.

Economic and Industry Developments

.05 AU sections 311A and 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1; and for audits conducted in accordance with Public Company Accounting Oversight Board [PCAOB] standards: AICPA, *PCAOB Standards and Related Rules*, respectively), provides guidance for auditors regarding the specific procedures that should be considered in planning an audit. These sections state that the auditor should obtain a knowledge of matters that relate to the nature of the entity's business, its organization, and its operating characteristics. The auditor should also consider matters affecting the industry in which the entity operates, including, among other matters, economic conditions as they relate to the specific audit.

.06 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, will help you better assess risks of material misstatement of the financial statements, and will ultimately strengthen the integrity of your audits.

The State of the Economy

.07 In planning audits, auditors need to 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 company's financial statements being audited.

.08 A number of factors that could upset economic growth, possibly affecting your client's operations and therefore possibly affecting audit risk, include:

- Rising interest rates during most of the year
- Unstable oil prices
- Dangerously high and rising consumer debt levels
- Inflation concerns
- A softening housing boom in some markets

.09 The U.S. real gross domestic product (GDP), which is the broadest measure of economic activity, increased at an annual rate of 5.6 percent during the first quarter of 2006 but slowed to a growth rate of 2.6 percent in the second quarter and 2.0 percent in the third quarter of 2006, according to the Bureau of Economic Analysis. The deceleration in growth from the first to the second quarter is due, among other factors, to downturns in personal consumption expenditures for durable goods, in equipment and software, and in federal government spending; decelerations in personal consumption expenditures for nondurable goods and in exports; and a decrease in residential fixed investment. The continued deceleration in growth into the third quarter is due, among other factors, to an acceleration in imports; a larger decrease in residential fixed investment; and decelerations in private inventory investment, personal consumption expenditures for services, and state and local government spending that were partly offset by upturns in equipment and software, personal consumption expenditures for durable goods, and federal government spending.

.10 The unemployment rate has remained relatively unchanged during 2006 holding between 4.4 and 4.8 percent, down from rates experienced in the prior year and the lowest since 2001. As of November 2006, the unemployment rate was 4.5 percent.

.11 After a period of rising rates, the Federal Reserve Board kept its target for the federal funds rate at 5.25 percent during its last four meetings (August through December 2006). The Federal Reserve stated, "Economic growth has slowed over the course of the year, partly reflecting a substantial cooling of the housing market. Although recent indicators have been mixed, the economy seems likely to expand at a moderate pace on balance over coming quarters." The Federal Reserve cautioned that "Readings on core inflation have been elevated and the high level of resource utilization has the potential to sustain inflation pressures. However, inflation pressures seem likely to moderate over time, reflecting reduced impetus from energy prices, contained inflation expectations, and the cumulative effects of monetary policy actions and other factors restraining aggregate demand."

Economic Impact of Hurricanes Katrina and Rita

.12 It has been over a year since Hurricanes Katrina and Rita hit the Gulf Coast region causing catastrophic damage. The natural disaster disrupted the nation's economic growth and destroyed housing, commercial, and public property. A year later, the United States has experienced a mild hurricane season and the Gulf Coast region continues to rebuild and real estate markets recover from the short-term economic disruption caused by the hurricanes.

General Industry Trends and Conditions

.13 As of the writing of this Alert, several of the real estate segments (office, industrial, multifamily, and hospitality) have been showing positive signs of growth, such as lower vacancy rates and rising rents. However, the retail market is lagging behind other commercial real estate sectors, and the housing market is slowing. The office market continues to recover with falling vacancy rates, strong absorption, modest construction, and some spikes in rental rates. The industrial sector is moving from a recovery phase into an expansionary phase, as global trade increases and with it, the need for space. The hospitality market continues to rebound to pre-September 11, 2001, levels with strong occupancy and increasing room rates. The retail market is experiencing weakening absorption and disconcerting vacancy rates due to higher interest rates, fluctuating oil prices, and a slowing housing market. The housing market's five years of growth is slowing and the multifamily market is improving as potential homebuyers stay in rentals as a result of the slowing housing market. In addition, real estate investment trusts (REITs) have continued to outperform the Standard & Poor's 500 and the Dow Jones Industrial for the seventh consecutive year.

Industry Segment Conditions

Office Market Conditions

.14 The office market continues to recover from its downturn in the early 2000s. Vacancy rates are falling, absorption is strong, construction is modest, and rental rates are rising in some markets. According to the commercial real estate services firm, Grubb & Ellis Company (Grubb & Ellis), the U.S. office vacancy rate at the end of the third quarter of 2006 was 13.9 percent, compared to 14.1 percent in the prior quarter and 15.1 percent in the year-ago quarter. Although vacancy rates still remain above the generally accepted equilibrium rate of 10.0 to 12.0 percent, the rates continue to decline from the 17.9 percent high in the first quarter of 2004.

.15 During the year, several markets experienced declining vacancy rates including Denver, San Antonio, San Francisco, and Miami, posting declines of 3 to 4 percentage points. A few markets experienced increasing vacancy rates, led by Westchester County, New York, with a vacancy rate up to 16.7 percent. According to Grubb & Ellis, the high vacancy rates in Westchester County are a result of corporate downsizings in that market.

.16 The absorption rate (the rate at which rentable space is filled) grew stronger as demand continued to outrun new supply during 2006. Tenant demand for space has been the strongest during 2006 in Chicago, Dallas-Fort Worth, and New York City. However, the suburban New York City markets of Westchester

County and Long Island have posted the largest negative absorption rates during the year. According to Grubb & Ellis, third-quarter net absorption of 17.6 million square feet far outpaced the 6.1 million square feet of new space delivered during the quarter, which helped fuel the falling vacancy rate. Grubb & Ellis cited five markets that absorbed at least 1.0 million square feet during the third quarter of 2006. They include Dallas-Fort Worth (absorption of 1.7 million square feet), Boston, Houston, Los Angeles, and Denver. Seattle and Phoenix just missed the 1.0 million square foot threshold.

.17 At the end of the third quarter of 2006, competitive office space under construction crept higher to 65.2 million square feet, an increase of 2 percent from the prior quarter and 26 percent from the year-ago quarter. Despite the large year-over-year gain, space under construction is barely over halfway back to its prior high of 125.0 million square feet experienced in the third quarter of 2000.

.18 Average asking rental rates continue to increase. According to Grubb & Ellis, as of the third quarter of 2006, Class A space rates increased 7.1 percent and class B space rates increased 5.5 percent over the past four quarters. Class A rates for available space ended the third quarter of 2006 at $31.36 and class B rates ended at $24.19 per square foot per year, full service gross. Several markets posted double-digit increases in Class A asking rates during the third quarter, led by San Mateo (19.1 percent) and San Francisco (16.7 percent). Seven of the top ten rent gainers were in California, with Manhattan, Phoenix, and Austin also included in this elite group. Rental rates remained relatively flat in a number of other markets during the year including Atlanta, Northern and Central New Jersey, Cleveland, Detroit, and Westchester County.

.19 While the office market continues in a state of recovery, slower year-to-date recovery can be linked to the softening housing market and rises in the federal funds rate from mid-2004 through mid-2006. Despite the slowdown, many experts believe the impact of the softening housing market will only be modest and not significant enough to derail the recovery of the office market.

Industrial Market Conditions

.20 The industrial market continues to show positive results moving from a recovery phase in 2005 to an expansionary phase in 2006. Global trade and an increase in imports continue to create the need for space. U.S. vacancy rates continue to decrease. The U.S. vacancy rate at the end of the third quarter of 2006 was 7.7 percent, the lowest level since the third quarter of 2001. This is down from the second quarter rate of 7.9 percent. Grubb & Ellis noted the decreasing vacancy rate is significant in three respects: (1) the economic pullback of the last few months has had little impact on demand for space, at least so far; (2) developers are being prudent in adding new space; and (3) the quarterly drop of 20 basis points breaks a string of three consecutive quarters when vacancy fell by 10 basis points, suggesting that the market has the potential for further tightening.

.21 Markets experiencing the lowest vacancy rates include Calgary, driven by a boom in oil and other commodities, and Los Angeles and the Inland Empire area of Southern California, due to port-related demand and limited land availability. The highest vacancy rates are occurring in Raleigh-Durham and Atlanta. Raleigh-Durham is still recovering from the technology bust several years ago.

.22 Much like the office sector, demand is outpacing new supply. Absorption of 52.4 million square feet during the third quarter of 2006 set a new high in the current expansion cycle, just above the 52.3 million square feet absorbed in the third quarter of 2005. New supply added to the market of 26.5 million square feet was barely half the total square feet absorbed. According to Grubb & Ellis, the amount of space under construction at the end of the third quarter pulled back very slightly following nine consecutive quarterly increases, which indicates good news for the market as it represents a hint of restraint on the part of lenders and developers responding to the economic slowdown of the last few months.

.23 After the average asking rent for warehouse-distribution space rose during the first half of 2006, the rate fell 8 cents in the third quarter to $4.45 per square foot per year net-net-net (NNN). This rate is still 1.9 percent above the year-ago level.

.24 In regards to the factors contributing to the declining rent rate, Grubb & Ellis noted:

- Certain markets and submarkets have seen a lot of new construction; and landlords have made some adjustments in their asking rents, even though demand has been strong.
- The average size of warehouse construction projects has grown dramatically from 119,350 square feet in 2002 to 215,821 square feet in 2006. Larger buildings tend to command lower rental rates per square foot.
- Warehouse-distribution projects are increasingly being built in the hinterlands where land is cheap, allowing landlords to be competitive with rents. This new construction is putting a lid on the average rental rate, though individual projects are penciling out and earning competitive returns for their owners.

.25 Experts believe the industrial market will meet optimistic forecasts set at the beginning of 2006 and that the long-term forecast is bright, especially as the U.S. appetite for trade grows.

Retail Market Conditions

.26 Retail market performance is lagging behind the other commercial real estate sectors. Higher interest rates, fluctuating oil prices, and an unsteady housing market are affecting consumer confidence and thus affecting the retail market. During the first two quarters of 2006, absorption showed signs of weakness. The *Wall Street Journal* reported that tenants absorbed 4.9 million square feet during the second quarter of 2006, compared with only 3.3 million during the first quarter. Both figures are well below the two-year average of approximately 7.0 million square feet per quarter.

.27 Availability in the retail market continues to increase. Vacancy rates were 7.6 percent in the first quarter and 8.5 percent in the second quarter of 2006. Although these rates are well below the double digit rates seen in 2002, some experts believe they are still a cause for concern.

.28 According to Colliers International, a global partnership of independently owned commercial real estate firms, rents continue to increase at a 3 to 4 percent annual rate, similar to that recorded a year ago. Three retail categories identified for their growth potential include value-oriented/discount, upscale, and ethnically targeted stores. Changes in economic factors, such as interest rates, high oil prices, the job market, disposable income, consumer confidence, and the housing market will greatly influence the retail sector's performance over the remainder of the year.

Residential Market Conditions

.29 ***Housing.*** After five years of record sales and growth, the housing market is slowing. It remains to be seen how bad the market will actually become and when it will hit bottom. So far the downturn resembles a correction more than a crash on a national level, slowing economic growth rather than sending it into a recession.

.30 The sellers market is transitioning into a buyers market. Falling demand and increases in supply cause house prices to decline. According to the National Association of Realtors (NAR), there were 3.9 million existing homes on the market in August 2006, up 38.0 percent from a year earlier. This represented a 7.5-month supply of existing homes; the highest supply level estimated by NAR since April 1993. By the end of October 2006, there was inventory of 3.85 million existing homes, representing a 7.4-month supply with the current pace of sales. Meanwhile, the inventory of new homes on the market climbed in October 2006 to 558,000 homes, a 7-month supply. One year ago, inventory levels of new homes were only at a 4.5-month supply.

.31 According to NAR, total existing home sales decreased during September 2006 to a seasonally adjusted annual rate of 6.21 million, but rose 0.5 percent in October 2006 to a seasonally adjusted annual rate of 6.24 million units. This is still well below the 7.05 million-unit pace experienced in October 2005. October 2006 existing home sales were down in all regions compared to October 2005 by 8.8 to 18.9 percent. Likewise, new home sales also fell in October 2006. Sales of single-family homes decreased in October 2006 to a seasonally adjusted annual rate of 1.004 million, down 25.4 percent from the prior year.

.32 A survey from the U.S. Census Bureau showed that 35 percent of American homeowners with mortgages in 2005 spent 30 percent or more of their household income on housing costs, including loan payments, real estate taxes, insurance, and utilities. This compared to only 30 percent of American homeowners with mortgages in a 2003 study. Such strain on household income contributes to slow or decreasing house prices. During most of the first half of 2006, mortgage rates were on the rise. However, as of the week ended December 7, 2006, the 30-year fixed mortgage rate dropped to 6.11 percent, the lowest rate since the week of January 19, 2006. Despite decreases in mortgage rates for the latter part of the year, housing activity continues to slow.

.33 House prices have begun to adjust in some markets and will likely continue due to the buildup of inventory and decrease in demand discussed previously. According to NAR, the national median existing home price for all housing types was $221,000 in October 2006, down 3.5 percent from the year earlier when the median price spiked to $229,000. The median price for existing home sales in October 2006 is down from a year ago by 7.0 percent in the South, 1.2 percent in the Midwest, 0.6 percent in the West, and 5.2 percent in the Northeast. However, despite rising inventory levels of new homes, the median price of new homes actually increased in October 2006 to $248,500, up nearly 14 percent from September 2006. Some experts believe builders are able to continue to sell new homes at a higher price due to other incentives being offered such as upgrades in amenities and paying portions of closing costs.

.34 NAR projects new home sales will continue to decline in 2007, but that existing home sales will rise gradually in 2007 from current levels with overall annual totals comparable to 2006. NAR also predicts the median existing and new home prices will increase only marginally in 2007. Moody's Economy.com, a leading independent provider of economic, financial, country, and industry research, projects that the median sales price for an existing home will decline in 2007 by 3.6 percent. Other sources predict median house prices will decline by more than 10.0 percent over the next few years in 20 metropolitan (metro) areas. Some predict prices may keep falling into the year 2009. Markets that have appreciated most rapidly over the past five years are now showing the fastest decline in appreciation rates. Metro areas that did not begin appreciating until later in the housing boom are still experiencing appreciation, an indication the market correction may take some time to run its course. Experts seem to agree the areas most prone to decline are in California and Florida.

.35 ***Multifamily.*** The multifamily market continues to experience improving fundamentals as vacancy rates decline and rents rise. During 2006, the multifamily market benefited from the slowing housing market. Rising mortgage rates during the early part of 2006 made rentals more attractive than buying a home, leaving potential homebuyers in rentals. During the first quarter of 2006, apartment rents rose at the fastest pace in five years. According to the National Multi-Family Housing Counsel, the average monthly apartment rent was $952, up 5.0 percent from the prior year quarter. This was the fastest pace since rents rose 8.3 percent during the first quarter of 2001. NAR estimates that average rent will increase to 4.8 percent during the fourth quarter of 2006 compared to 2.9 percent during the same quarter of 2005.

.36 The multifamily market has also experienced declining vacancy rates. Vacancy rates declined 11 consecutive quarters to 5.4 percent at the end of the third quarter of 2006. Several metro markets have experienced sub-2.5 percent vacancy rates during the year including Albuquerque, Los Angeles, Las Vegas, Orlando, Norfolk, Northern New Jersey, San Francisco, San Jose, and Washington. Multifamily net absorption is expected to be 262,800 units in 59 of the tracked metro areas during 2006, compared to 351,000 units in 2005.

.37 In past years, declining vacancy rates and rising rents were due, in large part, to condominium conversions. Developers were converting apartments into condominiums at a frenzied pace and decreasing rental supply. However, condominium conversion activity has declined notably during 2006 due to slowing condominium sales. Some properties originally purchased for conversion are actually reverting back into multifamily rentals. The potential return of unsold condominium units to the rental marketplace, coupled with significant new additions to the existing apartment stock may present a risk of eventual oversupply to the multifamily sector and curtail rent increases.

Hospitality Market Conditions

.38 According to Lodging Econometrics (LE), the industry authority for hotel real estate, all but eight markets fully recovered in 2005 to pre-September 11, 2001, operating levels. LE concluded that five more markets are expected to fully recover by the end of 2006 (Chicago, Dallas, Denver, Atlanta, and Nashville), and the remaining three should recover in 2007 (Boston, Detroit, and San Francisco).

.39 The market continued to experience strong occupancy and record gains in room rates during the first half of 2006. During the first half of 2006, overall occupancy was 63.5 percent, a 2.1 percent increase from the same period in 2005. The West South Central region of the United States experienced the highest gain in occupancy (6.7 percent increase) during this same period, as compared to the prior year. This region, which includes Texas, Oklahoma, Louisiana, and Arkansas, experienced increases due to the influx of evacuees and relief workers resulting from Hurricane Katrina. NAR forecasts occupancy rates will average 68.4 percent in 2006, the highest since 2001.

.40 Revenue per available room (RevPAR) increased 8.4 percent in 2005, according to Pricewaterhouse-Coopers' (PwC's) Hospitality and Leisure Group. This represents the largest increase since 1984. During the first quarter of 2006, RevPAR increased 9.7 percent. The mid-scale-without-food-and-beverage segment led the industry during this period, posting a RevPAR gain of 13.0 percent, followed by upscale segments with RevPAR increase of 11.3 and luxury segments with RevPAR increase of 11.2 percent. RevPAR is estimated to increase by 8.4 percent in 2006, according to PwC's Hospitality and Leisure Group.

.41 Low supply growth and steady demand have also allowed increases in the overall average daily rate (ADR). During the first half of 2006, the overall ADR was $96.56, a 6.8 percent increase from the same period in 2005, when overall ADR was $90.42. The luxury segment posted the highest increases rising 7.2 percent followed by the budget segment with a 7.0 percent increase.

.42 Supply growth, which has been slow over the past few years, is expected to increase. At the end of the second quarter of 2006, the total construction pipeline was at 3,436 projects (463,629 rooms), according to LE. This is a new high for this cycle but is still approximately 15.0 percent below the high set in 1998. LE also believes supply will continue to rise and the construction pipeline peak of 1998 could be exceeded in 2007 if rising interest rates do not curtail development. Increases in supply could weaken occupancy levels; however, many experts believe demand will remain ahead of supply resulting in continued growth.

.43 The hospitality market continues to benefit from the growing global economy, which has increased consumer and business travel. However, as the housing market slows and oil prices potentially rise again, one must consider the effect on discretionary spending and its impact on travel and thus the hospitality market.

Real Estate Investment Trusts

.44 For the seventh consecutive year, REITs have outperformed all other stock groups and stock indexes. Year-to-date through November 30, 2006, the FTSE National Association of Real Estate Investment Trust

(NAREIT) All REIT Index[1] climbed in excess of 37.0 percent. REITs have been outperforming the stock market since 2000, and during the technology crash, REITs rose while the Dow lost percentage points. REIT performance, of course, varies by real estate segment in response to how economic changes are affecting each segment. Consistent with strong performance in multifamily, office, and industrial real estate, these REITs have posted high growth in year-to-date returns as well. Even in the current market, REITs specializing in manufactured homes have jumped 13.3 percent year-to-date through November 30, 2006.

.45 According to INVESCO, an institutional investment manager, REIT performance accelerated during the third quarter of 2006 as a result of improving fundamentals and falling long-term interest rates. INVESCO projects that moderate economic growth with below-average construction levels should allow REIT earnings to grow at a favorable pace in the near future.

.46 REITs, which were originally viewed as just a fixed-income vehicle, are now being recognized for their capital appreciation benefits. Many investors also continue to use REITs as an investment diversification strategy, and the pace of institutional investments in REITs continues to be strong. In an INVESCO third quarter 2006 report, the investment management firm explained that forces similar to those that led to the acceptance of REITs within the United States are now driving the evolution of securitized real estate markets across the globe. On a global basis, the securitized real estate market has more than doubled in size versus 10 years ago, with listed real estate assets now exceeding $1.0 trillion. However, only six of the top ten countries around the globe, as measured by the value of their real estate assets, have passed some form of tax-efficient REIT legislation. With several large markets, including Japan, having just permitted the formation of REITs in the last five years, significant potential remains for the growth in market capitalization of listed real estate as other countries like Germany, the United Kingdom, Italy, and Spain finally introduce REIT structures. INVESCO further explains that, assuming all countries reach at least the same level of listed real estate as the United States, the total combined value of real estate listed on global stock exchanges could grow by more than 50.0 percent, surpassing $1.6 trillion. Despite this large increase, the value of listed real estate would still only represent 3.8 percent of the total market capitalization of the global stock markets (up from 2.5 percent currently).

.47 Another interesting development in the world of REITs is the recent increase in privatizations. Globally, there have been an increasing number of public REITs acquired by private companies. According to Ernst & Young's Autumn 2006 publication, *Global Real Estate Newsline*, globally in 2005, there were eight announced deals valued at $20.7 billion. There were nearly $18.0 billion announced deals in the first half of 2006. Some REITs view privatization as a way to maximize shareholder value and gain flexibility in long-term business planning or diversify into new geographic markets. Some smaller cap REITs are also using privatization as an exit strategy. Experts expect more REIT mergers and acquisitions during the remainder of 2006.

Regulatory and Legislative Issues

Banks in Real Estate

.48 For the past two centuries, the U.S. Congress has mandated the separation of banking and commerce determining that real estate brokerage and management was commerce rather than financial in nature. The Gramm-Leach-Bliley Act of 1999 significantly changed the way the financial services industry is organized and how it functions, but Congress still maintained a separation of banking and commerce. However the Gramm-Leach-Bliley Act did authorize the Federal Reserve and the U.S. Department of Treasury to periodically update a list of activities that federally regulated financial holding companies and national bank subsidiaries could legally engage.

[1] 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. Effective March 6, 2006, the FTSE Group assumed responsibility for the calculation and distribution of NAREIT's domestic indexes, which were renamed the FTSE NAREIT U.S. Real Estate Index Series.

.49 Subsequently, on January 3, 2001, the Board of Governors of the Federal Reserve and the U.S. Department of Treasury published a joint proposal for public comment that would allow financial holding companies and financial subsidiaries of national banks to engage in real estate brokerage and management. Readers can access the proposal at www.federalreserve.gov/boarddocs/press/boardacts/2000/20001227/attachment.pdf. Since then, the real estate industry has managed to hold off banks. Each year since 2001, a law or resolution has passed (generally attached to an appropriations bill) to delay or bar implementation of the proposed regulations.

.50 Meanwhile, the Community Choice in Real Estate Act, which would prohibit national banking conglomerates from engaging in real estate brokerage or property management and removes the powers of the Federal Reserve and the Treasury Department to regulate these real estate activities, is pending in both the House of Representatives and the Senate. Despite a broad bi-partisan base of support, the bill remains pending in committee.

.51 On June 14, 2006 the House of Representatives (again) approved a one-year prohibition in the Transportation-Treasury-Housing and Urban Development Appropriation bill prohibiting the Federal Reserve and Treasury Department from finalizing the rule allowing bank conglomerates to engage in real estate brokerage. On July 20, 2006, the Senate Appropriations Committee (again) approved a permanent prohibition as part of their Transportation-Treasury-Housing and Urban Development Appropriation bill. The House and Senate will come together and negotiate the differences in the two appropriations bills (one-year prohibition versus permanent provisions). NAR has commented that it expects this to occur later this year.

.52 The real estate community, of course, strongly supports the Community Choice in Real Estate Act and seeks a permanent prohibition to keep banks out of real estate. NAR has commented that allowing banks in real estate would cause an unfair competitive environment for real estate management firms not affiliated with banks and lead to conflicts of interest, fewer competitive loans, and higher rates to consumers among other things. Auditors should remain alert to the status of this issue as it could increase competition in the real estate industry and potentially affect the financial performance of your clients.

Commercial Real Estate Lending Under Increased Scrutiny

.53 Real estate lending has come under increased scrutiny from federal regulators lately, prompting concern that changes in policy could adversely affect the real estate market. The Federal Bank and Thrift Agencies have become concerned over high and increasing concentrations of commercial real estate (CRE) loans some financial institutions (institutions) are holding and the potential for these concentrations to make institutions more vulnerable to cyclical CRE markets. According to the FDIC, CRE debt has grown to $2.3 trillion in 2006, compared to $952.0 billion in the late 1980s, with increased growth in just the last two years. Comptroller of the Currency, John C. Dugan, noted in a November 5, 2006, news article posted in the *Chicago Tribune*, that 35 percent of the banks it oversees hold CRE loans exceeding 300 percent of capital. Many of those are smaller institutions. Regulators perceive banks have relaxed their underwriting standards excessively to attract CRE business in the current competitive market. Federal Reserve Board Governor, Susan Bies, noted that aggregate CRE concentrations for small-to-medium sized U.S. banks, relative to capital, are twice the exposures before the substantial real estate downturn in the late 1980s. However, many people in the real estate community believe that similar guidance issued by financial institution regulators in the 1980s contributed to the real estate credit crunch of the early 1990s.

.54 CRE loan repayment is primarily dependent upon rental income or from proceeds of the sale, refinancing, or permanent financing of the property, thus exposing the financial institutions to unanticipated earnings and capital volatility if the CRE market were to experience a downturn. In response, the four agencies charged with regulating the banking industry—the Federal Reserve Board, the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS)—proposed guidance regarding concentrations in CRE lending. *Concentrations in Commercial*

Real Estate Lending, Sound Risk Management Practices, issued on January 10, 2006, proposed criteria for identifying institutions with CRE concentrations that may warrant greater supervisory scrutiny. The guidance focused on CRE loans that are particularly vulnerable to cyclical CRE markets that it defined as those in which the source of repayment is primarily dependent upon rental income or from proceeds of the sale, refinancing, or permanent financing of the property. This included loans to REITs and unsecured loans to developers that closely correlate to the inherent risk in CRE markets.

.55 The proposed guidance provided that if an institution has loans for construction, land development, and other land (as defined in the guidance) in excess of 100 percent of capital or total CRE loans in excess of 300 percent of capital, the institution should have heightened risk management practices and capital levels higher than the regulatory minimums and levels that are appropriate based upon the risk in its CRE loan portfolios.

.56 The Real Estate Roundtable, an organization of executives from the nation's top public and privately held real estate ownership, development, lending, and management firms, has a working group of its Real Estate Capital Policy Advisory Committee (RECPAC) who reviewed and commented on the proposed lending guidance. In addition to the real estate industry, the proposed guidance prompted much debate and comment from financial institutions. Comptroller Dugan stated, in an April 2006 press release, "Our message is not, 'Cut back on commercial real estate loans.'" However, there is concern for the real estate industry on how the guidance could affect CRE lending practices. A contraction of available bank credit for CRE could lead to higher borrowing costs for the credit that is available and potentially lead to a decline in property values.

.57 After an extended comment period, the OCC, Federal Reserve Board, and FDIC issued final guidance on December 6, 2006. The issuing agencies noted in the final guidance (of the same title as the proposed guidance) that they made significant changes to the proposed guidance to clarify the purpose and scope of the guidance. In a joint press release the day of issuance, the agencies noted the guidance is intended to help ensure that institutions, pursuing a significant commercial real estate lending strategy, remain healthy and profitable while continuing to serve the credit needs of their communities. The final guidance reminds institutions that strong risk management practices and appropriate levels of capital are important elements of a sound lending program and builds upon existing regulations to emphasize risk management practices that allow an institution to pursue CRE lending in a safe manner.

.58 One of the real estate industry's primary concerns was that the proposed concentration thresholds, discussed previously, would be enacted as limits or perceived to be *de facto* limits on an institution's CRE lending activity. This was also an expressed concern in many financial institutions' comments. The final guidance still contains the proposed concentration thresholds, but stresses the levels are included as part of the agencies' supervisory oversight criteria. The concentration thresholds are to be used by examiners as a starting point for identifying potential CRE concentrations and are not established limits on CRE lending.

.59 This guidance is effective immediately upon publication in the Federal Register and can be accessed at www.fdic.gov/news/news/press/2006/pr06114.html. Auditors should remain alert to how financial institutions perceive and respond to this guidance and how examiners apply the guidance, as it could potentially discourage some institutions from becoming involved in or continuing to participate in increased levels of CRE lending. This could affect the availability and cost of borrowing for your clients, directly affecting their operations and financial performance.

Audit and Accounting Issues and Developments

Assessing Audit Risks in the Current Environment

.60 The proper planning and execution of an audit has always required you to have a thorough understanding of the real estate industry and the nature of your client's business. For most audit firms, this in-depth understanding means that the most experienced partners and managers will be involved early and often in the audit process. In today's environment, an auditor's judgment, knowledge, and experience are even more important than in the past.

.61 As discussed earlier in the "Economic and Industry Developments" section, the current state of the economy is uncertain. GDP third quarter expansion was only 2.0 percent, and after a period of rising interest rates, the federal funds rate has remained steady; however, there are concerns of inflationary pressures. The majority of real estate markets are experiencing solid performance in fundamentals with the exception of retail and housing. It is uncertain how the U.S. economy will perform and how the slowing housing market may affect other real estate markets and the economy as a whole.

.62 Periods of economic uncertainty often lead to challenging conditions for companies due to potential deterioration of operating results, increased external scrutiny, and reduced access to capital. During such times, an auditor should ensure audit planning reflects the risks present in the current environment and exercise heightened professional skepticism during the audit. Both of these aspects are discussed in the following sections.

Professional Skepticism

.63 The third general audit standard stipulates that due professional care be exercised in planning and performing an audit engagement (AICPA, *Professional Standards*, vol. 1, AU sec. 230A). Due professional care requires that you exercise professional skepticism in gathering and evaluating audit evidence. Although you neither assume that management is dishonest nor assume unquestioned honesty, you should consider the increased risk associated with the potential increases in external pressure faced by management during times of economic uncertainty.

.64 As a result of perceived external pressures, companies may be tempted to manage earnings by using nonrecurring transactions or through changes in the method of calculating key estimates, such as reserves, fair values, or impairments. Companies may also adopt inappropriate accounting practices resulting in improper recognition or omission of financial transactions. Material nonrecurring transactions may require special disclosure to facilitate the readers' understanding of the reported financial results; and the guidance in Financial Accounting Standards Board Statement of Financial Accounting Standards (FASB Statement) No. 154, *Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3*, should be applied in reporting the effects of changes in estimates. Inappropriate transactions or accounting practices that may result in errors requiring adjustments of financial statements might include premature recognition of revenue, failure to appropriately accrue for contingent liabilities that are probable and estimable, and failure to record unpaid purchase invoices. Additionally, you should be particularly skeptical of fourth-quarter events that result in significant revenue recognition, loss accrual, or noncash earnings.

.65 The appropriate level of professional skepticism is needed when corroborating management's representations. Management's explanations should make business sense. Additionally, you may need to consider corroborating management's explanations with members of the board of directors or audit committee.

Audit Planning

.66 As you prepare to conduct quarterly reviews and annual audits of real estate companies, consider that your clients are operating in an overall uncertain economy in which the housing market is slowing. This situation may directly or indirectly affect both residential and commercial real estate. You should gain an understanding of this environment to adequately plan and perform the audit, keeping in mind each segment of the real estate market may respond in differing ways to changes in the economy and specifically the housing market. For example, the multifamily market will often improve at the expense of the housing market while other markets may suffer along with the housing market. Many clients may experience effects related to shifts in demand, collectibility of accounts receivable, or valuation of their investments.

.67 In the "Regulatory and Legislative Issues" section, two ongoing issues were presented that could potentially affect the real estate industry in a great way. If either financial institutions were allowed into real estate development and management, or financial institutions significantly change their current real estate lending practices, increased competition and decreased availability of financing could occur, which may adversely affect your clients both operationally and financially. It is important that auditors keep abreast of current issues such as these to properly plan and perform the audit including identifying new or changing audit risks based upon each engagement's unique characteristics.

Evaluating Audit Risks

.68 Your evaluation of audit risk should start with a solid understanding of your client's business. To develop this understanding, you should be knowledgeable about the company's strategies for dealing with business conditions—both current conditions and those most likely to exist in the near future. In the real estate industry, business conditions vary greatly across property types and geographic markets. The risks associated with the development and management of office space are different from those faced by a company involved in the residential housing market. Even the risks associated with being in a strong performing office market such as Dallas-Fort Worth are different from risks associated with office market operations in Westchester County, New York, where vacancy rates are very high. A warehouse facility in the Northeast may face different issues than does a similar facility located on the Pacific Coast, and a company operating in the hospitality market in a region that has fully recovered from September 11, 2001, will operate differently than one in a region such as Boston or San Francisco still trying to recover to pre-September 11, 2001, levels. For this reason, you should be knowledgeable about property types and the markets in which your clients operate.

.69 Audit risk can be altered when a real estate company enters into new property types or new geographic markets. You should be aware that current economic conditions might force your real estate clients to expand beyond their traditional sphere of operations. During audit planning, you should identify new property types or geographic locations and carefully assess the risks associated with the client's change in operating strategy.

.70 In March 2006, the AICPA Auditing Standards Board (ASB) issued eight Statements on Auditing Standards (SASs), No. 104 through No. 111, collectively referred to as the risk assessment standards. The new standards will change many of the planning and risk assessment procedures auditors perform during an audit. Further discussion of the risk assessment standards is included in the "Recent Auditing and Attestation Pronouncements and Related Guidance" section of this Alert.

Auditing Estimates

.71 The real estate industry uses estimates in a variety of ways. For example, supplemental current values of real estate assets and the recognition and measurement of impairment losses both require management to make estimates of future events or assumptions about current conditions.

.72 When auditing estimates, you should be familiar with SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), and Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.

.73 As previously discussed, certain segments of the real estate industry are currently in decline. In these segments, management may feel increasing pressure to produce positive financial results. Certain estimates, for example, expected future cash flows used in the determination of possible asset impairment, require management to make assumptions about future events and conditions. Be skeptical of cash flow and other performance projections that assume overly optimistic upward trends will occur.

.74 Pay close attention to the underlying assumptions used by management when auditing accounting estimates. Management is responsible for making the estimates included in the financial statements. Those estimates may be based in whole or in part on subjective factors, such as judgment based on experience with past as well as current events, and with conditions it expects to exist. You should be alert to the possibility of management's overreliance on economic information based on favorable conditions to predict future outcomes.

Transactions Involving Off-Balance-Sheet Arrangements, Including Variable Interest Entities

.75 For a variety of legitimate business reasons, many real estate companies create and use affiliated entities to facilitate, among other things, leasing arrangements and joint ventures. These separate entities are often created for asset protection and income and estate tax planning purposes. Typically, these entities have multiple owners and, very commonly, the entities are owned by related parties. For example, real estate developers often form separate legal entities to own property to be developed in order to isolate the developer's other assets from the project to be developed in the event the project was unsuccessful. In the past, reporting entities have not been consolidating these affiliated entities into the financial statements unless they had a "controlling interest" in the entities, defined as more than 50 percent ownership of the voting interests. Since many of the affiliated entities are not formed as voting interest entities, the accounting literature did not require entities to consolidate the affiliated entities. As a result, in many circumstances, commonly controlled (and other related) entities were not reflected in one set of financial statements. Essentially, rather than reflecting assets, liabilities, revenues, and expenses within the financial statements, the notes to financial statements included a disclosure of transactions between and among the related entities.

New Principles for Consolidation

.76 In January 2003, the FASB issued Interpretation No. (FIN) 46, *Consolidation of Variable Interest Entities—an interpretation of ARB No. 51*. Many variable interest entities had commonly been referred to as special-purpose entities or off-balance-sheet structures, but the guidance applies to a larger population of entities (referred to as variable interest entities [VIEs]). In December 2003, the FASB issued a revision to FIN 46 (with the same title) to clarify some of the provisions in the original document. The revised document (FIN 46(R)) was issued in response to input received from constituents regarding certain issues arising in implementing the original FIN 46. FIN 46(R) requires an analysis and consideration of consolidation in circumstances in which "substantive control" is evidenced by attributes and factors other than direct equity ownership. FIN 46(R) expands the definition of related parties, and requires the consolidation of certain insufficiently capitalized entities that are connected to the reporting entity through certain contractual or other interests. The interpretation incorporates a "principles-based" model that is used in determining when entities need to be consolidated. Examples of "connects" between and among reporting entities that could trigger the consolidation provisions within the new literature include:

- Equity investments in the affiliated entity
- Guarantees of the value of assets or liabilities of the affiliated entity
- Contracts to purchase assets or equity from the affiliated entity
- Contracts for services with the affiliated entity
- Synthetic lease agreements involving the affiliated entity
- Transfers or sales of assets to the affiliated entity

- Structures designed to house assets in the affiliated entity
- Providing administrative services for the affiliated entity
- Having loans to/from the affiliated entity

.77 Essentially, FIN 46(R) contains the requirement that we "look through" the form of transactions and arrangements and analyze the substance of the "connects" between and among affiliated entities. If there is an effort to structure a deal to circumvent the spirit of this accounting guidance, then the odds are significant that a variable interest in an affiliated entity exists and the entity would be a VIE subject to consolidation. FIN 46(R) became effective for private companies in calendar year 2005.

Importance in Real Estate

.78 FIN 46(R) already has had and will continue to have a significant impact on accounting in the real estate industry. Real estate entities subject to VIE evaluation include:

- Tax credit entities
- Homebuilders lot option contracts
- Traditional real estate joint ventures and partnerships
- Investors in those structures could also qualify as a "variable interest" and be primary beneficiaries under FIN 46(R). This could include:
  - Equity investors
  - Debt or loan providers
  - Developers
  - Real estate management companies
  - Leasing companies
  - Others with options to acquire either shares in the entities or assets of the entity

Potential VIE Real Estate Structures

.79 Typical of the structures that could qualify as VIEs are the tax credit entities. These are affordable housing partnerships, or U.S. Department of Housing and Urban Development (HUD) structures, as well as historic development partnerships. The former develops lower income housing and other projects; the latter is involved in the restoration of historical sites. These attract investors because of the tax benefits they offer. Since rents are set by formula, there is minimal profit or cash flow to the investor. So the incentive is to secure tax credits against future tax liabilities. There are also depreciation credits that can be realized, and those become tax deductions. A lot of these structures are turning out to be VIEs, because of the nonrefundable up-front fee paid by the entity, or others involved with the entity, to the developer investor (often the general partner) for services which return their initial capital investment.

.80 Also turning out to be VIEs are legal structures that are established for homebuilder lot options contracts. These enable landowners to put their land into a separate entity and then find buyers and builders. The buyer pays the owner a nonrefundable deposit on the land and has the option of developing sections of that property in future years. The option contract results in the builder, who has the right to the land, becoming a variable interest holder under FIN 46(R) and thus may have to consolidate.

.81 A third group of entities being affected is joint ventures and partnerships. Such entities generally divide into three categories:

1. Joint ventures that are set up to construct and sell properties. The participants usually include the developer, a provider of capital such as a bank, and an investor with sources of large development funds.

2. Joint ventures that construct and keep developed properties. Joining the participants in these entities are property managers as the partnership's purpose is to build, lease, and manage residential and commercial developments.

3. Joint ventures that invest in already constructed properties with the intention to resell those properties.

.82 These structures often include a "buy-sell clause" that controls the coming and going of investment partners in the venture or restrictions on the owner's ability to sell or transfer interest in the venture (known as a transfer restriction). This establishes a "related party concept" under FIN 46(R) and means that the entity is likely to be a VIE and that one of the partners will be the consolidating primary beneficiary.

New Consolidation Guidance Adds Another Dimension

.83 Beyond FIN 46(R), the real estate industry has to be aware of another interesting change in the landscape regarding consolidation accounting. For those non-VIE ventures, the newly amended AICPA SOP 78-9, *Accounting for Investments in Real Estate Ventures*, provides new guidance on whether a general partner controls a real estate venture. The issuance of FASB Staff Position (FSP) SOP 78-9-1, *Interaction of AICPA Statement of Position 78-9 and EITF Issue No. 04-5*, must be applied to all old and new non-VIE real estate ventures. FSP SOP 78-9-1 starts with the presumption of control by the general partners and provides two specific criteria for determining whether limited partners have either substantive "kick-out rights" or "substantive participating rights." This FSP removes the previous concepts of "important rights" in SOP 78-9 and conforms that guidance to the newly issued 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."

.84 The bottom line is that the real estate industry has another twist in consolidation accounting that applies to all non-VIE real estate ventures and many expect that the amended guidance would result in more partnerships consolidated by the general partner.

Synthetic Leases

.85 During the economic expansion of the late 1990s, synthetic leases became a popular form of financing for real estate entities. As the steamrolling economy fueled corporate expansion, companies looked for ways to take real estate off of their balance sheet and free up capital. And the synthetic lease was one way of doing this.

.86 However, FIN 46(R) will have a major impact on synthetic leases. Companies with existing synthetic leases will need to either consolidate these entities or convert them to another structure (for example, a sale-leaseback).

.87 As a result of FIN 46(R), you should review your client's participations in synthetic leases to evaluate whether they have been accounted for properly.

Recent Technical Practice Aids Related to FIN 46(R)

.88 The AICPA recently issued a number of Technical Practice Aids related to FIN 46(R). These and other Technical Practice Aids can be assessed online at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/recent_tpas.htm.

Sales of Condominiums

.89 In September, the FASB's EITF tentatively concluded that the continuing investment criterion in FASB Statement No. 66, *Accounting for Sales of Real Estate*, must be met to recognize profit on a percentage-of-completion basis for condominium sales. The tentative conclusion is addressed in EITF Issue No. 06-8, "Applicability of the Assessment of a Buyer's Continuing Investment under FASB Statement No. 66, *Accounting for Sales of Real Estate*, for Sales of Condominiums."

.90 Many homebuilders and lodging companies are entering into the condominium development market. Since condominium projects are generally long term in duration, individual units of the condominium are often sold during the construction phase. Paragraph 5 of FASB Statement No. 66 states the following:

> Profit on real estate transactions shall not be recognized by the full accrual method until all of the following criteria are met:
>
> a) A sale is consummated.
>
> b) The buyer's initial and continuing investments are adequate to demonstrate a commitment to pay for the property.
>
> c) The seller's receivable is not subject to future subordination.
>
> d) The seller has transferred to the buyer the usual risks and rewards of ownership in a transaction that is in substance a sale and does not have a substantial continuing involvement with the property.

.91 FASB Statement No. 66 provides specific guidance on the application of the consummation of a sale and the seller's continuing involvement for condominium projects. These two criteria may not be met for individual condominium units sold during the construction phase of the project because of the long-term nature of condominium development projects.

.92 FASB Statement No. 66 requires a condominium developer to recognize profit from the sale of individual condominiums during the construction phase on a percentage-of-completion basis if specified criteria are met, including collectibility of the sales price. The EITF's tentative conclusion would require a developer to evaluate a buyer's continuing investment during the construction period and to conclude that the condominium sales price was collectible before recognizing profit during the construction period.

.93 If adopted as a ratified consensus, this tentative conclusion would be effective for the first annual reporting period beginning after March 15, 2007. Early adoption would be permitted as of the beginning of the entity's fiscal year. Entities that have not accounted for sales of condominiums in a manner that is consistent with the consensus would recognize a cumulative effect adjustment to beginning retained earnings or to other components of equity or net assets. Comments received will be discussed at the November 16, 2006, EITF meeting.

Lease Accounting

.94 FASB Statement No. 13, *Accounting for Leases*, has been in existence for many years and is critical for accounting for leases in real estate. As discussed in the prior year's Alert, a number of Securities and Exchange Commission (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.

.95 In November 2005, the AICPA issued a Technical Practice Aid on lease accounting to clarify the requirements in the existing accounting standards. The Technical Practice Aid can be accessed at www.aicpa.org/download/acctstd/LEASE_TPAs_5600.07.pdf. It is considered nonauthoritative and not a source of established accounting principles. Issues discussed include the following:

- Lease term for accounting purposes
- Lease term for accounting purpose that differs from term stated in the lease
- Rent expense and rent revenue in an operating lease (general, scheduled increase in rental space, rent holiday, and scheduled rent increases)
- Amortization/depreciation of leasehold improvements in an operating lease
- Leasehold improvements and lease term in an operating lease
- Landlord incentive allowance in an operating lease
- Cash flows statement presentation of landlord incentive allowance in an operating lease

.96 In July 2006, the FASB took two major steps regarding lease accounting. First, the FASB announced that it was formally opening a project to reconsider the current accounting standards for leases. The goal of this project is to develop principles that would faithfully represent lease transactions in the financial statements of lessees and lessors and would reflect similarities and differences in the wide variety of leasing arrangements prevalent today. This project will be conducted jointly with the International Accounting Standards Board (IASB). Many expect the FASB to shift away from permitting off-balance-sheet treatment of many leases to an assets and liabilities model, which would put most leases on the lessee's balance sheet. The first major milestone of the project will be a Preliminary Views document expected to be released for constituent comment in 2008.

.97 Second, the FASB issued FSP FAS 13-2, *Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease Transaction*. This FSP amends FASB Statement No. 13 and applies to all transactions classified as leveraged leases in accordance with FASB Statement No. 13. Leveraged leases can provide significant tax benefits to the lessor, and the timing of cash flows relating to income taxes generated by a leveraged lease is an important assumption that affects the periodic income recognized by the lessor for the lease. The FSP will require companies to recalculate their leveraged leases if there is a change or projected change in the timing of cash flows relating to income taxes generated by the leveraged lease. In accordance with the FSP, companies must review the projected timing of income tax cash flows generated by a leveraged lease transaction annually or more frequently, if events or changes in circumstances indicate that a change in timing has occurred or is projected to occur. If, during the lease term, the projected timing of the income tax cash flows generated by a leveraged lease is revised, the rate of return and the allocation of income to positive investment years must be recalculated from the inception of the lease. The lessor must update all assumptions used to calculate total and periodic income when the lessor is performing a recalculation of the leveraged lease. The recalculation must include actual cash flows up to the date of the recalculation and projected cash flows following the date of recalculation. The guidance only applies to changes or projected changes in the timing of income taxes that are directly related to the leveraged lease transaction.

.98 The FSP must be applied to fiscal years beginning after December 15, 2006, and certain disclosures are required in the fiscal year of adoption. Earlier application is permitted as of the beginning of an entity's fiscal year, provided that the entity has not yet issued financial statements, including financial statements for any interim period, for that fiscal year. Auditors should refer to the full text of the FSP on the FASB's Web site.

Quantifying Misstatements

.99 On September 13, 2006, the 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*. Although the guidance is directed at registrants, it is also important for auditors 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.

.100 Two approaches have commonly been used to quantify such errors. Under one approach, the error is quantified as the amount by which the current year income statement is misstated (the rollover approach). The other common approach quantifies the error as the cumulative amount by which the current year balance sheet is misstated (the 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 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.

.101 The 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.

.102 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 the SAB. 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. Auditors should note that accounting standards setting bodies are also considering projects to propose concepts similar to those of SAB No. 108 for nonissuers.

Assessing Internal Control Deficiencies

.103 Several audit and accounting issues have been discussed. While considering how these affect your engagements and assessing the associated risks, also consider how your client's internal control affects these potential risks. As discussed in the next section, "Recent Auditing and Attestation Pronouncements and Related Guidance," the 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 supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, as amended.

.104 SAS No. 112 requires the auditor to evaluate identified control deficiencies and determine if they individually or when combined are significant deficiencies or material weaknesses. These terms are defined 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). The term *reportable condition* is no longer used. The SAS also requires that these communications now be in writing. Common control deficiencies may include:

- Segregation of duties issues (especially common among smaller companies)
- Potential for management override
- Inadequate process and controls over revenue recognition
- Lack of controls over the process by which estimates are determined and recorded
- Lack of a process and controls to properly identify, consolidate, and disclose VIEs

.105 The AICPA has published an Audit Risk Alert entitled *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk), which provides an overview of the standard's requirements. This Alert can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

Recent Auditing and Attestation Pronouncements and Related Guidance

.106 Presented below is a list of recent 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/Audit+and+Attest+Standards/. 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.

.107 The PCAOB establishes auditing and attestation standards for audits of public companies. Refer to the PCAOB Web site at www.pcaob.org for information about its activities. You may also review the *SEC and PCAOB Alert—2006/07* (product no. 022497kk), 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. 102, *Defining Professional Requirements in Statements on Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 120) Statement on Standards for Attestation Engagements (SSAE) No. 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 20) Issue Date: December 2005 (Not applicable to audits conducted in accordance with PCAOB standards)	These standards established two categories of professional requirements that are identified by specific terms. The words *must* or *is required* are used to indicate an unconditional requirement. The word *should* is used to indicate a presumptively mandatory requirement. (The words *may*, *might*, *could*, and *should consider* represent actions that auditors have a professional obligation to consider.) The provisions of SAS No. 102 and SSAE No. 13 were effective upon issuance. It is the ASB's intention to make conforming changes to AICPA literature over the next several years to remove any language that would imply a professional requirement where none exists.

(continued)

SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339) Issue Date: December 2005 (Not applicable to audits conducted in accordance with PCAOB standards)	SAS No. 103 supersedes SAS No. 96, *Audit Documentation*, and amends SAS No. 1, section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 530). 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. See the "Audit Documentation" section in this Alert.
SASs No. 104 through No. 111, the Risk Assessment Standards Issue Date: March 2006 (Not applicable to audits conducted in accordance with PCAOB standards)	See the "Risk Assessment Standards" section 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 (Not applicable to audits conducted in accordance with PCAOB standards)	The new standard supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, as amended. 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. Effective for periods ending on or after December 15, 2006.
SAS No. 113, *Omnibus Statement on Auditing Standards—2006* (AICPA, *Professional Standards*, vol. 1) Issue Date: November 2006 (Not applicable to audits conducted in accordance with PCAOB standards)	This standard: • Revises the terminology used in the 10 standards of SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150), 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 *completion of fieldwork* with the term *date of the auditor's report*; and • 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. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380) Issue Date: December 2006 (Not applicable to audits conducted in accordance with PCAOB standards)	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.
SSAE No. 14, *SSAE Hierarchy* (AICPA, *Professional Standards*, vol. 1, AT sec. 50) Issue Date: November 2006 (Not applicable to audits conducted in accordance with PCAOB standards)	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 attest 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).
AICPA Technical Practice Aid (TPA) 8100.01–.02 (Nonauthoritative)	"Determining the Effective Date of a New Statement on Auditing Standards for Audits of a Single Financial Statement" and "Determining the Effective Date of a New Statement on Auditing Standards for Audits of Interim Periods"
PCAOB Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist* Issue Date: February 2006 (Applicable to audits conducted in accordance with PCAOB standards only)	This standard applies if auditors report on the elimination of a material weakness in a company's internal control over financial reporting. The standard establishes a voluntary engagement that would be performed at the election of the company.
PCAOB Conforming Amendment to AT section 101.04*f*, *Attest Engagements* Issue Date: February 2006 (Applicable to audits conducted in accordance with PCAOB standards only)	*Conforming Amendment to PCAOB Auditing and Related Professional Practice Standards Resulting from the Adoption of the Auditing Standard No. 4* The conforming amendment states that Auditing Standard No. 4 must be used for reporting on whether a material weakness continues to exist for any purpose other than a company's internal use.

(continued)

PCAOB Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees Issue Date: April 2006 (Applicable to audits conducted in accordance with PCAOB standards only)	The rules include general rules with respect to ethics and independence, restrict certain types of tax services a registered public accounting firm may provide to its audit clients, and prohibit contingent fee arrangements for any services a registered public accounting firm provides to its audit clients, in order to maintain its independence.
PCAOB Report on the Initial 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: November 2005 (Applicable to audits conducted in accordance with PCAOB standards only)	This report reaffirmed and amplified previous guidance issued by the PCAOB in May 2005. The report focuses on reasons the PCAOB found audits performed were not always as efficient and effective as Auditing Standard No. 2 intended. The report also explains certain aspects of Auditing Standard No. 2 such as the terms *more than remote* and *strong indicators*.
PCAOB Overview of Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist* Issue Date: April 2006 (Applicable to audits conducted in accordance with PCAOB standards only)	This overview provides additional information on the provisions of Auditing Standard No. 4.
PCAOB Staff Questions and Answers, *Adjustments to Prior Period Financial Statements Audited by a Predecessor Auditor* Issue Date: June 2006 (Applicable to audits conducted in accordance with PCAOB standards only)	The guidance explains that if prior period financial statements that require adjustments were audited by a predecessor auditor, either the successor auditor or the predecessor auditor may audit the adjustments so long as the auditor is independent and registered with the PCAOB. The guidance continues to address questions regarding when the predecessor auditor audits the prior period financial statement adjustments; when the successor auditor audits the prior period financial statement adjustments; and when the successor auditor has not yet completed an audit of the current period financial statements.

PCAOB Staff Audit Practice Alert No. 1, *Matters Relating to Timing and Accounting for Options Grants* Issue Date: July 2006 (Applicable to audits conducted in accordance with PCAOB standards only)	This issuance was prompted by recent reports and disclosures about issuer practices related to the granting of stock options, including the "backdating" of such grants. The guidance identifies existing standards that could bear on auditors' work and applies them to the issues that have been raised regarding companies' stock option granting practices, but does not establish new requirements.
PCAOB Staff Questions and Answers, *Auditing the Fair Value of Share Options Granted to Employees* Issue Date: October 2006 (Applicable to audits conducted in accordance with PCAOB standards only)	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.

Audit Documentation

.108 In December 2005, the ASB issued SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339). This SAS supersedes SAS No. 96 of the same name. 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.

.109 The SAS also amends paragraphs .01 and .05 of 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 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, sufficient appropriate audit evidence includes, among other things, evidence that the audit documentation has been reviewed and that the company's financial statements, including disclosures, have been prepared and that management has asserted that they have taken responsibility for them. Consider how this guidance affects the process followed on your engagements including the review of audit documentation and financial statements; obtaining management's representations; and analyzing subsequent events and in turn how this affects the date of the audit report.

Risk Assessment Standards

.110 In March 2006, the AICPA ASB issued eight SASs that provide extensive guidance concerning the auditor's assessment of the risks of material misstatement in a financial statement audit, and the design and performance of audit procedures whose nature, timing, and extent are responsive to the assessed risks. Additionally, the SASs establish standards and provide guidance on planning and supervision, the nature of audit evidence, and evaluating whether the audit evidence obtained affords a reasonable basis for an opinion regarding the financial statements under audit. The following table lists the eight SASs and their effect 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")*	Amends SAS No. 1, *Due Professional Care in the Performance of Work* (AU section 230)
SAS No. 105, *Amendment to Statement on Auditing Standards No. 95*, Generally Accepted Auditing Standards	Amends SAS No. 95, *Generally Accepted Auditing Standards* (AU section 150)
SAS No. 106, *Audit Evidence*	Supersedes SAS No. 31, *Evidential Matter* (AU section 326A)
SAS No. 107, *Audit Risk and Materiality in Conducting an Audit*	Supersedes SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AU section 312A)
SAS No. 108, *Planning and Supervision*	Supersedes SAS No. 1, *Appointment of the Independent Auditor* (AU section 310); and supersedes SAS No. 22, *Planning and Supervision* (AU section 311A)
SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*	Supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AU section 319)
SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*	Supersedes SAS No. 45, *Substantive Tests Prior to the Balance Sheet Date* (AU section 313); and together with SAS No. 109, supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AU section 319)
SAS No. 111, *Amendment to Statement on Auditing Standards No. 39*, Audit Sampling	Amends SAS No. 39, *Audit Sampling* (AU section 350)

Key Provisions of the New Standards

.111 The SASs emphasize the link between understanding the entity, assessing risks, and the design of further audit procedures. The SASs introduce the concept of risk assessment procedures, which are deemed necessary to provide a basis for assessing the risk of material misstatement. Risk assessment procedures, along with further audit procedures, which consist of tests of controls and substantive tests, provide the audit evidence to support the auditor's opinion of the financial statements. According to the SASs, the auditor should perform risk assessment procedures to gather information and gain an understanding of the entity and its environment, including its internal controls. These procedures include inquiries, analytical procedures, and inspection and observation. Assessed risks and the basis for those assessments should be documented; therefore, auditors may no longer default to maximum control risk for an entity's risk assessment without documenting the basis for that assessment. The SASs also require auditors to consider and document how the risk assessment at the financial statement level affects individual financial statement assertions, so that auditors may tailor the nature, timing, and extent of their audit procedures to be responsive to their risk assessment. It is anticipated that generic audit programs will not be appropriate for all audit engagements, as risks vary between entities.

Effective Date and Implementation

.112 The SASs are effective for audits of financial statements for periods beginning on or after December 15, 2006; earlier application is permitted. In most cases, implementation of the SASs will result in an overall increased work effort by the audit team, particularly in the year of implementation. 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. 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.

New Companion Audit Guide

.113 In December 2006, the AICPA will publish the Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (product no. 012456kk). This Guide will help 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.

Recent Independence and Ethics Pronouncements

.114 The AICPA *Independence and Ethics Alert—2006/2007* (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.

.115 The AICPA general *Audit Risk Alert—2006/07* and other AICPA industry-specific Alerts contain summaries of recent pronouncements not included here. To obtain copies of other AICPA Alerts, contact AICPA Service Center Operations at (888) 777-7077 or go online at www.cpa2biz.com.

Recent Accounting Pronouncements and Related Guidance

.116 Presented below is a list of recent accounting pronouncements and related 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 *The CPA Letter* and *Journal of Accountancy*.

Recent Accounting Pronouncements and Related Guidance	
FASB Statement No. 155	*Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*
FASB Statement No. 156	*Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140*
FASB Statement No. 157	*Fair Value Measurements*
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)*
FASB Interpretation No. 48	*Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*
FASB EITF Issues	Go to www.fasb.org/eitf/agenda.shtml for a complete list of EITF Issues.
FASB Staff Positions	Go to www.fasb.org/fasb_staff_positions/ for a complete list of FSPs.

(continued)

AICPA Practice Guide	"Practice Guide on Accounting for Uncertain Tax Positions Under FIN 48"
AICPA TPA section 6910.21–.24 (Nonauthoritative)	Various Investment Company topics
AICPA TPA section 5700.01 (Nonauthoritative)	"Income Tax Accounting for Contributions to Certain Nonprofit Scholarship Funding Organizations"
AICPA TPA section 2210.28 (Nonauthoritative)	"Accounting for Certain Liquidated Damages"
AICPA TPA section 1400.32 (Nonauthoritative)	"Parent-Only Financial Statements and Relationship to GAAP"
AICPA TPA section 2130.09–.35 and 2130.36–.37 (Nonauthoritative)	Various topics on the application of SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*
AICPA TPA sections 1400.29–.31 and 1500.06 (Nonauthoritative)	Various topics regarding FIN 46(R) on variable interest entities
AICPA TPA section 6910.16–.20 (Nonauthoritative)	Nonregistered investment partnerships topics
AICPA TPA section 5600.07–.17 (Nonauthoritative)	Various lease topics
The Committee of Sponsoring Organizations of the Treadway Commission (COSO) *Internal Control Over Financial Reporting—Guidance for Smaller Public Companies*	The guidance provides a set of 20 basic principles representing the fundamental concepts associated with and drawn directly from the five components of internal control described in the COSO Internal Control Framework.

On the Horizon

.117 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. Read the AICPA general *Audit Risk Alert—2006/07* for a more complete list of ongoing auditing and accounting projects. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or generally accepted auditing standards (GAAS).

.118 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 beyond 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/
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—Nonpublic Companies

Proposed Amendment to SAS No. 69, The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles*

.119 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 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 FASB proposed Statement, which can be obtained at www.fasb.org.

Proposed SSAE 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 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). In May 2006, the PCAOB announced plans to amend certain aspects of PCAOB Auditing Standard No. 2 to improve its implementation. Because the forthcoming changes to the PCAOB Standard will be relevant to the revision of AT section 501, the ASB has decided to defer to issuance of final revised AT section 501 until the PCAOB issues their amendments and the ASB has time to consider them.

Auditing Pipeline—Public Companies

.121 Guidance issued by the PCAOB is included in the section of this Alert entitled "Recent Auditing and Attestation Pronouncements and Related Guidance." For pending projects for both the PCAOB and the SEC, readers may refer to the *SEC and PCAOB Alert—2006/07* (product no. 022497kk), mentioned previously.

Accounting Pipeline

.122 Presented below are accounting pronouncements currently in the exposure 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 below.

Proposed FASB Statement, The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115

.123 The fair value option project has two phases. This proposal represents Phase 1, which addresses the fair value option for certain financial assets and financial liabilities. Phase 2 will consider permitting the fair value option for certain nonfinancial assets and nonfinancial liabilities and some of the financial assets and financial liabilities excluded from the scope of Phase 1.

.124 The proposed Statement would create a fair value option under which an entity may irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and financial liabilities on a contract-by-contract basis, with changes in fair value recognized in earnings as those changes occur. The proposed Statement has specific financial presentation requirements to display fair values and those values that are measured using other measurement techniques. The proposed Statement would amend FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, to require that securities reported at fair value in accordance with FASB Statement No. 115 satisfy the specific financial statement presentation requirements. The planned effective date is for fiscal years beginning after December 15, 2006. Visit the FASB Web site at www.fasb.org for additional information.

Proposed FASB Statement, Earnings Per Share—an amendment of FASB Statement No. 128

.125 This proposed Statement would amend FASB Statement No. 128, *Earnings per Share*, to clarify guidance for mandatorily convertible instruments, the treasury stock method, contracts that may be settled in cash or shares, and contingently issuable shares. Specifically, the proposed Statement would:

- Amend the computational guidance for FASB Statement No. 128 for calculating the number of incremental shares included in diluted shares when applying the Treasury Stock method.
- Eliminate the provisions of FASB Statement No. 128 that allow an entity to rebut the presumption that contracts with the option of settling in either cash or stock will be settled in shares.
- Require that shares that will be issued upon conversion of a mandatorily convertible security be included in the weighted-average number of ordinary shares outstanding used in computing basic earnings per share from the date when conversion becomes mandatory.

Proposed FASB Statement, Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140

.126 The exposure draft *Accounting for Transfers of Financial Assets* (Transfers Project) is a revision of a June 2003 exposure draft, *Qualifying Special-Purpose Entities and Isolation of Transferred Assets*, and would amend FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125*. The proposed Statement seeks to:

1. Clearly specify the permitted activities of a qualifying special-purpose entity (QSPE).
2. Address practice issues related to which arrangements should be considered and how they should be considered in the legal isolation analysis.
3. Eliminate the prohibition on a QSPE's ability to hold passive derivative financial instruments that pertain to beneficial interests held by a transferor.
4. Revise the methodology used to initially measure at fair value interests related to transferred financial assets held by a transferor.
5. Clarify guidance related to when rollovers of beneficial interests are permitted within a QSPE.

.127 At its July 26, 2006 meeting, the FASB decided to combine the servicer discretion project (which addressed issues relating to the waiver of due-on-sale, collateral substitution, and foreclosed asset activities) into the Transfers Project. The FASB expects to issue a final Statement, which would amend FASB Statement No. 140, in the second quarter of 2007. See the FASB Web site for complete information.

Proposed FASB Statements, Business Combinations—a replacement of FASB Statement No. 141, *and* Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries—a replacement of ARB No. 51

.128 In these proposed Statements, the FASB plans to revise the existing guidance on the application of the purchase method. Among the main proposals is that:

1. All acquisitions of businesses be measured at the fair value of the business acquired.
2. Substantially all the assets acquired and liabilities assumed of the acquired business be recognized and measured at their fair values at the acquisition date.
3. Entities that follow U.S. GAAP and international standards apply substantially the same accounting requirements for their business combinations.

.129 Exposure drafts on business combinations—purchase method procedures and noncontrolling interests—were issued on June 30, 2005. Auditors should visit the FASB Web site for expected issuance dates.

Proposed FASB Statement, The Hierarchy of Generally Accepted Accounting Principles

.130 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*, AU sec. 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 SAS No. 69, subject to certain modifications. The FASB staff will coordinate with the AICPA (as previously discussed in the "Auditing Pipeline—Nonpublic Companies" section) to ensure that each of the documents has a uniform effective date. Readers should be alert for the issuance of a final Statement.

FASB Project on Derivative Disclosures

.131 FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* has been criticized by certain analysts, auditors, investors, and others for lacking transparent disclosures, allowing a user of the financial statements to assess the overall risk of derivatives on a reporting entity from both a quantitative and qualitative perspective. An exposure draft was issued on December 8, 2006, entitled, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*. The comment deadline is March 2, 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. The proposed disclosures will be effective for both interim and annual reporting periods ending after December 15, 2007, with early application encouraged. At initial adoption, disclosures for earlier periods presented for comparative purposes will be encouraged but not required. Disclosures for earlier periods presented for comparative purposes will be required beginning in the first year after the year of initial adoption. Auditors can monitor the progress of this project on the FASB's Web site.

Proposed FASB EITFs and FSPs

.132 ***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.

.133 ***Proposed FASB Staff Positions.*** A number of proposed FASB Staff Positions are currently in progress. Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/proposed_fsp.shtml for complete information.

Resource Central

.134 The following are various resources that practitioners engaged in the real estate industry may find beneficial.

Publications

.135

- Audit and Accounting Guide *Common Interest Realty Associations* (2006) (product no. 012576kk). This Guide summarizes applicable practices and delivers "how-to" advice for handling almost every type of financial statement. It describes relevant matters, conditions, and procedures unique to realty associations, and illustrates treatments of financial statements and reports to caution auditors and accountants about unusual problems.
- Audit and Accounting Guide *Construction Contractors* (2006) (product no. 012586kk). This Guide describes relevant matters, conditions, and procedures unique to realty associations, and illustrates treatments of financial statements and reports to caution auditors and accountants about unusual problems.
- Audit and Accounting Guide *Guide for the Use of Real Estate Appraisal Information* (1997) (product no. 013159kk). This Guide is as of May 1, 1997, and describes relevant matters, conditions, and procedures unique to the real estate industry, and illustrates treatments of financial statements and reports to caution auditors and accountants about unusual problems.
- Audit Guide *Analytical Procedures* (product no. 012556kk). You'll receive guidance on the effective use of analytical procedures with an emphasis on analytical procedures as substantive tests. This 2006 Guide includes SAS No. 56 concepts and definitions, a questions and answers section, an illustrative case study, and a new appendix that includes useful financial ratios.
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (2006) (product no. 012526kk). In this Guide, you'll find an overview of derivatives and securities in addition to case studies to help you better understand how to audit derivative instruments.
- Audit Guide *Auditing Revenue in Certain Industries* (2006) (product no. 012516kk). This Guide assists auditors in fulfilling their professional responsibilities with regard to auditing assertions about revenue. In this edition you'll find:

— Discussions on responsibilities of management, boards of directors, and audit committees for reliable financial reporting;

— Summaries on key accounting guidance regarding whether and when revenue should be recognized in accordance with GAAP or GAAS updated for SAS No. 99;

— Circumstances and transactions that may signal improper revenue recognition; and

— Procedures that the auditor may find effective in limiting audit risk arising from improper revenue recognition.

- Audit Risk Alert *Construction Contractors Industry Developments—2006/07* (product no. 022317kk). This Alert is intended to provide auditors of construction contractors with an overview of recent economic, industry, technical, and professional developments that may affect the audits they perform.

- General *Audit Risk Alert—2006/07* (product no. 022337kk). 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.

- *Compilation and Review—2006/07* (product no. 022307kk). This Alert updates CPAs on recent practice issues and professional standards that affect these types of engagements.

- *Independence and Ethics—2006/07* (product no. 022477kk). This Alert will inform you of recent developments in the area of independence and ethics for accountants. Specifically, this Alert will help you understand your independence requirements under the AICPA Code of Professional Conduct and certain other rule-making and standard-setting bodies. A compact "plain English" digest of AICPA independence rules is also included. This alert includes information on guidance on the performance of nonattest services to attest clients, SEC independence rules, PCAOB independence and ethics activities, and Government Accountability Office (GAO) independence rules.

- *SEC and PCAOB Alert—2006/07* (product no. 022497kk). This Alert will prove useful for accountants working in public companies, auditors of public companies, or just the interested accountant who would like to remain current on issues affecting public companies. This Alert provides preparers and auditors with a detailed overview of recent developments at the SEC and PCAOB with respect to financial reporting and auditing matters.

- *Checklist and Illustrative Financial Statements for Real Estate Ventures* (2006) (product no. 008977kk). This practice aid is invaluable to anyone who prepares financial statements and reports for real estate ventures. These disclosure checklists have been designed to help you prepare financial statements and assist you in determining the adequacy of disclosures in the financial statements you're auditing.

- *Checklist and Illustrative Financial Statements for Common Interest Realty Associations* (2006) (product no. 008907kk). This practice aid is invaluable to anyone who prepares financial statements and reports for common interest realty associations. These disclosure checklists have been designed to help you prepare financial statements and assist you in determining the adequacy of disclosures in the financial statements you're auditing.

- *Audit and Accounting Manual* (2006) (product no. 005136kk) is developed exclusively for small- and medium-size CPA practices. This unique manual explains and demonstrates useful techniques and procedures for conducting compilation, review, and audit engagements—from planning to internal control to accountants' reports.

- *Accounting Trends & Techniques, 60th Edition* (product no. 009898kk). This is the must-have resource for any CPA who frequently creates or uses financial reports. Filled with current reporting techniques and methods used by the nation's top organizations, this 650-page AICPA bestseller will provide the guidance you need to improve your accounting preparation and procedures.

AICPA reSOURCE: Accounting and Auditing Literature

.136 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's 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

.137 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 available titles, related to real estate, is a self-study course, *Real Estate Accounting and Auditing*, by Michael Ramos (product no. 730606kk). Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.138 AICPA CPExpress (formerly 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 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. Some topics of special interest to real estate company auditors are:

- *Planning the Audit of a Real Estate Entity's Financial Statements*
- *Auditing Real Estate Transactions*
- *Accounting for the Impairment of Completed Real Estate Projects*

.139 To register or learn more, visit www.cpa2biz.com.

Webcasts

.140 Stay plugged in to what's 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 on the discussion. If you cannot make the live event, each Webcast is archived and available on CD-ROM.

CFO Quarterly Roundtable Series

.141 The CFO 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

.142 The SEC Quarterly Update Webcast Series, brought to you each calendar quarter, showcases the profession's leading experts on what's "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's important. A must for both 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 Satisfaction Center

.143 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

.144 Do you have a complex technical question about GAAP, other comprehensive bases of accounting (OCBOA), 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

.145 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.

Real Estate Conference

.146 The AICPA sponsors an annual National Real Estate Conference in the fall. The Real Estate Conference is a two-day conference designed to update attendees on recent developments related to real estate accounting and auditing, tax, and management issues. It delivers solid news about the latest 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.

Web Sites

.147 The Internet covers a vast amount of information that may be valuable to auditors of real estate entities, including current industry trends and developments, market forecasts and analyses by property type, comparative financial and nonfinancial data (capitalization rates, occupancy statistics, and planned future development).

.148 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.landauer.com
Hospitality Trends	www.htrends.com
Institute of Real Estate Management	www.irem.org
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

.149 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.

.150 This Audit Risk Alert replaces *Real Estate Industry Developments—2005/06.*

.151 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 aeubanks@aicpa.org or write to:

Amy M. Eubanks, CPA
AICPA
The Palladian
220 Leigh Farm Road
Durham, NC 27707-8110

.152

Appendix

Additional Web Resources

Here are some useful Web sites that may provide valuable information to accountants.

Name of Web Site	Content	Web Site
Accountants World	Online community of independent accountants providing resources and tools	www.accountantsworld.com
AccountingWeb	Online community for the accounting profession	www.accountingweb.com
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	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
AuditNet	Electronic communications among audit professionals	www.auditnet.org
CPAnet	Online community and resource center for the accounting profession	www.cpanet.com
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

(continued)

Name of Web Site	Content	Web Site
FirstGov	Portal through which all government agencies can be accessed	www.firstgov.gov
Government Accountability Office	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
Hoovers Online	Online information on various companies and industries	www.hoovers.com
International Accounting Standards Board (IASB)	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org
International Federation of Acccountants	Information on standards-setting activities in the international arena	www.ifac.org
Public Company Accounting Oversight Board	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
Tax Analysts Online	Information on current tax developments	www.tax.org
CPA Vision Project	Information on the profession's Vision Project	www.cpavision.org
*Web*CPA	Online business news for the tax and accounting community	www.webcpa.com

[*The next page is 8571.*]

AAM Section 8160

Auto Dealership Industry Developments—2005/06

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

NOTICE TO READERS
AUTO DEALERSHIP INDUSTRY DEVELOPMENTS—2005/06

This Audit Risk Alert is intended to provide auditors of auto dealerships with an overview of recent economic, industry, technical, and professional developments that may affect the audits they perform.

This publication is an *Other Auditing Publication* as defined in AU sec. 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 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. This publication was reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA, and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Written by J. Russell Madray, CPA
Edited by Karin Glupe, CPA
Technical Manager
Accounting and Auditing Publications

Acknowledgements

The AICPA staff would like to thank J. Russell Madray for his development and preparation of this Alert. In addition, the AICPA staff wishes to thank Randal Lund who provided his valuable review.

How This Alert Helps You

.01 This Audit Risk Alert is intended to help you plan and perform your dealership audits. The knowledge that this Alert delivers can assist you in achieving a more robust understanding of the business environment in which your clients operate—an understanding that is more clearly linked to the assessment of the risk of material misstatement of the financial statements. Also, this Alert delivers information about emerging practice issues and current accounting, auditing, and regulatory developments.

.02 If you understand what is happening in the auto dealership industry, and if you can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert can assist you in making considerable strides in gaining that industry knowledge.

.03 This Alert describes trends and issues facing most dealerships in many of the markets in the country. Although this Alert focuses on the automobile dealership, the topics discussed here often can be applied to other types of dealerships, including boats, heavy trucks, farm machinery, and recreational vehicles. National trends and industry-wide benchmarks can help you identify unusual financial statement relationships at the planning or final review stages of an audit. Once they are identified, you can direct your audit attention to those areas. However, broad national trends have their limitations. Keep in mind that your clients will be affected much more by local economic, political, and industry conditions that exist in the specific markets your clients serve.

.04 This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2005/06* (product number 022336kk).

.05 ***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, SAS No. 54 is referred to as AU section 317 of the AICPA *Professional Standards*.

New Auditing and Attestation Pronouncements and Other Guidance

.06 Presented below is a list of auditing, attestation, and quality control pronouncements and other guidance issued since the publication of last year's Alert. For information on auditing and attestation standards, quality control standards, and other 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 and the PCAOB Web site at www.pcaobus.org (public company audits only). 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.

AICPA Audit Interpretation No. 1 of AU section 328, *Auditing Fair Value Measurements and Disclosures*, and AICPA Audit Interpretation No. 1 of AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (July 2005) (Not applicable to audits conducted in accordance with PCAOB standards)	"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," respectively.
AICPA Audit Interpretation No. 1 of AU section 625, *Reports on the Application of Accounting Principles* (January 2005) (Not applicable to audits conducted in accordance with PCAOB standards)	"Requirement to Consult With the Continuing Accountant"
AICPA Audit Interpretation No. 12 to AU section 623, *Special Reports* (amended January 2005) (Not applicable to audits conducted in accordance with PCAOB standards)	"Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis"

AICPA Audit Interpretation No. 14 to AU section 623, *Special Reports* (amended January 2005) (Not applicable to audits conducted in accordance with PCAOB standards)	"Evaluating the Adequacy of Disclosure and Presentation in Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting (OCBOA)"
AICPA Audit Interpretation No. 15 to AU section 623, *Special Reports* (January 2005) (Not applicable to audits conducted in accordance with PCAOB standards)	"Auditor Reports on Regulatory Accounting or Presentation When the Regulated Entity Distributes the Financial Statements to Parties Other Than the Regulatory Agency Either Voluntarily or Upon Specific Request"
AICPA Attest Interpretation No. 6 of AT section 101, *Attest Engagements* (December 2004) (Not applicable to audits conducted in accordance with PCAOB standards)	"Reporting on Attestation Engagements Performed in Accordance With Government Auditing Standards"
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 No. 05-01 (September 2005) (Nonauthoritative)	*Auditing Procedures With Respect to Variable Interest Entities*

(continued)

PCAOB Staff Questions and Answers	1. *Auditing Internal Control Over Financial Reporting*—The PCAOB has issued two sets of questions and answers in 2005 relating to the issuance of PCAOB No. 2—question 37, and questions 38–55
(Various dates) (Applicable to audits conducted in accordance with PCAOB standards only)	2. *Attest Engagements Regarding XBRL Financial Information Furnished Under the XBRL Voluntary Financial Reporting Program on the Edgar System*
AICPA Audit and Accounting Practice Aid (Nonauthoritative)	*The Auditor's Guide to Understanding PCAOB Auditing Standard No. 2*
AICPA Audit and Accounting Practice Aid (Nonauthoritative)	*SAS No. 70 Reports and Employee Benefit Plans*
AICPA Audit and Accounting Practice Aid (Nonauthoritative)	*Illustrative Disclosures on Derivative Loan Commitments*
AICPA Audit and Accounting Practice Aid (Nonauthoritative)	*Auditing Recipients of Federal Awards: Practical Guidance for Applying OMB Circular A-133—Third Edition*
Accounting Trends & Techniques (Nonauthoritative)	*Employee Benefit Plans*
Accounting Trends & Techniques (Nonauthoritative)	*Not-for-Profit Organizations*
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*
AICPA Toolkit (Nonauthoritative)	*The AICPA Audit Committee Toolkit: Not-for-Profit Organizations*
AICPA Toolkit (Nonauthoritative)	*The AICPA Audit Committee Toolkit: Government Organizations*
Statutory Framework (May 2005) (Nonauthoritative)	*A Statutory Framework for Reporting Significant Deficiencies in Internal Control to Insurance Regulators*

.07 The summaries provided above are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standards and other guidance. You should visit the applicable Web site for complete information.

.08 The standards and interpretations promulgated by the AICPA Auditing Standards Board (ASB) are now available free of charge by visiting the AICPA's 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 Service Operations Center at (888) 777-7077 or online at www.cpa2biz.com.

New Accounting Pronouncements and Other Guidance

.09 Presented below is a list of recently issued accounting pronouncements and other guidance issued since the publication of last year's Alert. For information on accounting standards issued subsequent to the publication of this Alert, please refer to the AICPA Web site at www.aicpa.org and the Financial Accounting Standards Board (FASB) Web site at www.fasb.org. You may also look for announcements of newly issued standards in *The CPA Letter* and the *Journal of Accountancy*.

FASB Statement of Financial Accounting Standards No. 152 (December 2004)	*Accounting for Real Estate Time-Sharing Transactions—an amendment of FASB Statements No. 66 and 67*
FASB Statement No. 153 (December 2004)	*Exchanges of Nonmonetary Assets—an amendment of APB Opinion No. 29*
FASB Statement No. 123 (Revised) (December 2004)	*Share-Based Payment*
FASB Statement No. 154 (May 2005)	*Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3*
FASB Interpretation No. 47 (March 2005)	*Accounting for Conditional Asset Retirement Obligations—an interpretation of FASB Statement No. 143*
FASB Emerging Issues Task Force (EITF) Issues (Various dates)	Go to www.fasb.org/eitf/ 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. Some of the recently issued FSPs address issues relating to FASB Statements No. 143 and No. 150, among others; and FASB Interpretation 46(R).
AICPA Statement of Position (SOP) 05-1	*Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts*
AICPA Technical Practice Aid 1200.06–.15 (February 2005) (Nonauthoritative)	"Accounting by Noninsurance Enterprises for Property and Casualty Insurance Arrangements That Limit Insurance Risk"

(continued)

AICPA Technical Practice Aid 5400.05 (September 2005) (Nonauthoritative)	"Accounting and Disclosures Guidance for Losses from Natural Disasters—Nongovernmental Entities"
AICPA Technical Practice Aid 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 6930.10 (August 2005)	"Accounting and Disclosure Requirements for Multiemployer Employee Benefit Plans Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003"

.10 The summaries provided above are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standards and other guidance. You should visit the applicable Web site for complete information. You can obtain copies of AICPA standards and other guidance by contacting the Service Operations Center at (888) 777-7077 or online at www.cpa2biz.com.

Industry and Economic Developments

.11 The sale of vehicles continues to constitute a significant portion of the U.S. economy, securing the importance of the role dealerships play in the national economy and local communities as well. In auditing a dealership, you should be aware of the general economic, regulatory, and professional developments that may affect your client. This section details some of the economic developments specific to the auto dealership industry.

Dealership Results in 2004

.12 The nation's franchised new car and light truck dealers recorded their fourth strongest year on record in 2004, selling 16.86 million vehicles, up from 16.6 million in 2003, according to National Automobile Dealers Association (NADA) Data, a comprehensive annual analysis compiled by NADA. Total dealership dollar sales volume exceeded $714 billion in 2004, up from $699 billion in 2003. Generous incentives, a recovering economy, relatively low borrowing rates, and enhanced dealership services contributed to the industry's moderate growth last year.

.13 According to the NADA Data report, the light truck category grew for the twelfth consecutive year, accounting for a record 8.3 million units sold, or 55.5-percent market share. The popularity of vans, pickups and, in particular, crossover utility vehicles (CUV), drove the light truck gains. CUV, van, and pickup sales continued to grow in the first quarter of 2005.

.14 The number of franchised new vehicle dealerships in the U.S. dropped very slightly in 2004 by 10 to 21,640. In addition, auctions continue to increase in importance as a source of used cars at dealerships, from less than 10 percent in the early 1980s to 33 percent in 2004.

New Vehicle Department

.15 New vehicle sales totaled 16.86 million units in 2004—almost 2 percent higher than in 2003. On a seasonally adjusted annual rate (SAAR) basis, sales volume was at or above 17 million units during the second quarter of 2004. Sales dropped off in October and November, but after a resurgent incentive campaign, sales recovered in December to reach 18.3 million units on a SAAR basis for the month. The popularity of vans, pickups, and, in particular, CUVs helped boost light-duty truck sales for the twelfth consecutive year to an all-time-high of 8.3 million units. Light trucks outsold cars, boosting their market share to more than 55.5 percent of total light vehicles sold in 2004. The average selling price of a new vehicle, including accessories and options, increased by 1.8 percent in 2004, after rising by 5.4 percent in 2003.

Used Vehicle Department and Service and Parts

.16 Dealers sold almost 20 million used vehicles last year. Of these, 11.8 million were retailed, and 7.9 million were wholesaled. The average selling price of a used unit retailed in 2004 was $14,250. New-car dealers acquired 55 percent of the used units they retailed from trade-ins and the remaining 45 percent from auctions, street purchases, or other sources. As a source of used cars, auctions have made the biggest inroads in the past decade—from less than 10 percent of the dealer's inventory in the early 1980s to 33 percent in 2004.

Service, Parts, and Body Shop

.17 Service and parts sales reached almost $85.5 billion in 2004, up slightly from 2003. In recent years, increased competition from independent service stations and quick-lube centers has cut into dealerships' service work, but dealers are fighting back. Last year's increase in service sales was powered by a strong light-vehicle market, a technologically advanced vehicle population, and more miles driven on average. New-car dealers have made a major investment in service and parts to beef up sales and customer satisfaction. Data from 2004 show that they provided 369,125 service stalls, employed 279,150 technicians, and carried a parts inventory valued at $5.6 billion.

.18 In recent years, more dealerships have opted to remain out of the body-shop business. Still, the total amount of body repair work performed by dealerships operating body-shop facilities continued its upward trend in 2004. Auto body work performed by all dealerships increased to just under $10 billion last year.

Finance, Insurance, and Service Contracts

.19 Aftermarket income (combined gross income from finance and insurance (F&I) and service contracts) was 26.2 percent of new and used vehicle department gross in 2004—up from 25.2 percent in 2003. This increase stemmed partly from more attention being paid to F&I by public groups and consolidators, higher finance penetration rates for both new and used cars, and a greater emphasis on customer satisfaction in F&I. Improvement in vehicle quality helped to bring a drop in service contract penetration from a high of 35.0 percent in 1986 to 20.1 percent in 1998. Nevertheless, it jumped in 2004 to 34.1 percent—the highest level since 1988. The increase was aided by a relatively low leasing rate during the year, innovative service plans, and the increased attention to F&I.

The Current Economic Environment

.20 Although no single variable can determine how the auto dealership industry will perform over time, history has shown that many economic factors influence buying decisions, such as disposable personal income; consumer confidence; the relationship between car prices, the rate of inflation, and real wage growth; and the availability, cost, and average maturity of consumer credit. Given the interrelationship of automobile sales and the economy, auditors of dealerships will benefit from having an understanding of general economic conditions and recent events that impact the general economy.

The Effect of Hurricane Katrina

.21 The physical and psychological damage caused by Hurricane Katrina (Katrina) is likely to reverberate across the global economy in ways that will curb growth well into 2006. Most economists predict, however, that Katrina will slow down, but not derail, U.S. economic growth.

.22 Katrina damaged approximately 230 General Motors, Ford, and Daimler Chrysler dealerships across the Gulf Coast, according to NADA. In Louisiana, about 60 auto dealerships that were severely damaged by Katrina remained closed as of September 2005, almost all of which were in the New Orleans area. Approximately 18,000 vehicles on Louisiana dealers' lots were destroyed, according to NADA. In addition, the storm put approximately 3,400 Louisiana dealership employees out of work.

.23 A spike in already-high energy costs in the United States and around the world tops the list of economic risks, especially since oil prices are unlikely to return to the levels of early 2004, when they were 50 percent lower than they are today. Katrina shut down large portions of oil and gas production in the Gulf of Mexico at a time when worldwide energy output was already stretched thin. Although the storm's impact was most acute in the United States, it also sent fuel costs higher around the globe, squeezing consumers in Europe and Asia and hurting everyone from truckers to fishermen to airlines. Nevertheless, most analysts agree that the sharp increase in gasoline prices was a "temporary disruption." Several refineries and pipelines are already back in operation. Initially, 25 percent of U.S. crude oil production and a large portion of refining capacity were knocked out by the storm. Much of the pressure on oil supplies has been relieved by the release of 60 million barrels from emergency supplies. The full extent of the damage to oil and natural gas infrastructure in the Gulf of Mexico is not yet known, but it is expected to be some time before output is back to normal. The same goes for the facilities that refine crude oil into gasoline, heating oil, and jet fuel.

.24 The storm also wiped away up to half a million jobs in New Orleans and other Gulf Coast areas. And the total cost to rebuild is almost certain to top $100 billion, only about a quarter of which is covered by insurance, according to an assessment by Risk Management Solutions of Newark, CA. The federal government has pledged billions of dollars of rebuilding funds, but it will take months for the basic recovery efforts to be completed before the money for reconstruction starts flowing. In Katrina's aftermath, economists believe that Hurricane Katrina could trim economic growth by a full percentage point in the second half of the year as soaring gasoline prices force consumers to cut back spending in other areas. In particular, higher gas prices have led some consumers to rethink their purchases of SUVs and other vehicles that are not fuel efficient. According to NADA, rising gas prices and a shift to more fuel-efficient vehicles hurt sales of SUVs in September 2005. GM sales fell 24 percent in September 2005 from a year earlier, and Ford sales fell 19.5 percent.

.25 However, the overall economic blow may not be as bad as first feared. Treasury Secretary John Snow and Federal Reserve Chairman Alan Greenspan have stated that it would not have a significant long-term effect on the U.S. economy, although growth will be slowed for a short period. Snow described the impact of the hurricane as mind-boggling and acknowledged that the U.S. economy is facing a challenging time. Still, he added that the adverse effect on economic growth would not exceed three to four months, given the inherent strength of the economy.

Current Economic Conditions of Auto Dealership Industry

.26 2004 ranked fourth among the best six years ever for new-unit sales by franchised new vehicle dealers. Sales in all departments increased for the year, and the U.S. economy grew by 4.4 percent in 2004, well ahead of the 3 percent growth observed in 2003. Consumer confidence measures rose through the second quarter of 2004 to peak in July, but modest employment gains, volatile energy prices, and conflict and political unrest in the Middle East were major concerns for the second half of 2004. Early 2005 showed modest improvements in consumer confidence, as vehicle sales were to be driven by generous incentives, such as cash rebates, low-rate financing, and attractive lease options. Analysts on Wall Street had expected a repeat of 2004 sales, but they came in slightly above NADA's 2005 estimate. In 2005, with a recovering economy and modest gains in employment nationwide, new-car dealers were able to maintain strong light-vehicle sales and profits.

.27 However, retail sales plunged in August 2005 by the largest amount in nearly four years, evidence that the economy was weakening even before Katrina struck. The Commerce Department reported that total sales fell by 2.1 percent in August, doubling the decline that analysts had been expecting. The 2.1-percent drop in total sales in August was the largest decline since a 2.9-percent plunge in November 2001, the period following the 2001 terrorist attacks. The worry is that consumer confidence could be jolted by soaring energy prices and an expected wave of Katrina-related job layoffs. The weakness in overall retail sales came from a 12-percent drop in sales of autos, which followed a 6.3-percent surge in July auto sales, reflecting attractive sales incentives offered to help reduce inventory levels of autos.

.28 AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1), requires the use of analytical procedures in the planning and overall review stages of all audits. The following key statistics relating to the overall performance of the U.S. economy may be useful to auditors in applying the provisions of AU section 329:

- Gross domestic product (GDP)—which measures the output of goods and services produced by labor and property located in the United States—increased at a rate of 3.8 percent in the first quarter of 2005, with the second-quarter rate recently revised downward to 3.3 percent. It would not be surprising to see U.S. GDP slow from recent full year 2005 projections of 3.7 percent toward a figure of 3.1 percent. Given recent events, economists are likely to revise down previous bullish and healthy third quarter U.S. GDP estimates (that averaged 4.5 percent) into the 3.0 to 3.5 percent range. However, the fourth quarter is likely to drop to a below-par 2.0 percent pace (or lower)—followed by a slowly recovering U.S. economy in the first half of 2006. Full-year 2006 estimates for U.S. GDP are likely to drop into the 3.1 to 3.3 percent range, from recently published 3.5 to 3.7 percent estimates.
- Consumer confidence,[1] a key predictor of household spending, plummeted in September 2005 after slightly rebounding in August. Katrina, coupled with rising gas prices and a less positive job outlook, pushed consumer confidence to its lowest level in almost two years. Contrary to the historically strong link between consumer confidence and vehicle sales, continuing incentives have helped to keep auto sales strong.
- Unemployment was 5.1 percent in September 2005; the unemployment rate had been trending downward in recent months, but September was the first month that reflected job losses due to Katrina. Auto dealerships continue to play a major role in the nation's employment. In 2004, the payroll for all dealerships combined represented 13 percent of the nation's total retail trade payroll.
- Interest rates have continued to climb from a 46-year low of 1 percent in June 2003. In September, the Federal Reserve raised interest rates for an eleventh consecutive month, to 3.75 percent, despite concerns the economy will slow after Katrina. Even though there are fears that Katrina will negatively affect consumer spending, the biggest driver of the economy, analysts see interest rates rising to between 4 percent and 4.5 percent in the near future. Quarter-percentage-point rate increases are expected to keep a lid on price growth without slamming the brakes on the economy, analysts said.

The Local Economy

.29 Significant local developments may affect dealership performance. Whenever a dealership operates in an area that is experiencing economic pressures, new car sales may be negatively affected. Certain regions may also be vulnerable to economic downturns in major local industries, whereas other regions may be susceptible to various natural disasters. For example, Katrina damaged about 230 Ford, General Motors, and Daimler Chrysler dealerships across the Gulf Coast region. Such events can affect sales in both positive and negative ways. Although the dealerships damaged in the hurricane may experience a downturn in sales, others will see an increase as many people look to replace their lost vehicles.

Relationships With Factories

.30 The factory[2]-dealer relationship can have a tremendous impact on the dealership. In effect, dealers just pass through a product from the factory to the consumer. In addition to providing the vehicles for

---

[1] As measured by the Conference Board. See www.conferenceboard.org for further information.

[2] For the purposes of this section, the word *factories* is synonymous with *manufacturers*.

dealers to sell, factories may also provide dealers' customers with financing or incentives such as factory rebates. In some cases, adverse relationships with the factory may affect the dealership's ability to continue as a going concern—for instance, if the factory discontinues a certain brand of vehicle that was largely profitable for the dealership, or if a dealer cannot meet customer demands because of a factory backlog. In reviewing such relationships, auditors should be aware of their responsibilities pursuant to AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1). AU section 341 states that typical signs of a going-concern issue include the inability to continue to meet obligations as they become due without substantial disposition of assets outside the ordinary course of business, or externally forced revisions of operations. Auditors also should consider whether management has made appropriate financial statement disclosures of concentrations in the available source of supply materials pursuant to SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties.*

Legislative and Regulatory Issues

Bankruptcy Bill

.31 In April, President Bush signed into law major reform legislation that will curb abuses in the bankruptcy system. The legislation marked the culmination of NADA's successful efforts to correct two specific problems faced by dealers.

.32 The first change would extend the federal timeframe (from 20 to 30 days) during which dealers may protect their interest in a vehicle if a consumer files for bankruptcy. The provision to extend the lien perfection period to 30 days will be particularly helpful to dealers with trade-ins since there are often delays beyond the control of dealers because of customers' misplaced titles and out-of-state titlework.

.33 The second change would crack down on debtors who have paid only the market value of the vehicle at the time of bankruptcy, not what is owed. The new law ensures that debtors must pay the contract amount of the loan if a car was purchased within 30 months of bankruptcy.

Repeal of Vicarious Liability Laws

.34 In August 2005, President Bush signed a new transportation bill that supersedes state and local vicarious liability laws. Under the previous vicarious liability laws, injured persons or the estates of persons killed in accidents could sue companies that held leases because the leasing companies were the legal owners of the vehicles. Such laws had forced dealerships to drop leasing in areas in which such laws were in effect, and resulted in multimillion-dollar awards resulting from lawsuits filed against auto makers, banks, and leasing companies whose lessees were involved in accidents. The elimination of vicarious liability will most likely lead to an increase in auto leasing.

Finance and Insurance Employees' Overtime Pay

.35 In decisions that will benefit new car and light truck dealers, the U.S. Ninth Circuit Court of Appeals ruled that F&I employees at dealerships are exempt from overtime pay under the Fair Standards Labor Act (FSLA). The Ninth Circuit opinion involved three cases that considered whether F&I managers, compensated almost entirely through commission, were exempt from the FSLA's overtime pay requirements. The court adopted the Department of Labor's long-standing view of Section 7(i)'s application to F&I employees who have a regular rate of pay of more than 1.5 times minimum wage, earn more than 50 percent of their income from commissions, and are employed by dealerships earning 75 percent of gross revenues from retail sales.

The Federal Trade Commission's Privacy Rule FAQs

.36 The Federal Trade Commission (FTC) has developed a series of frequently asked questions to help auto dealers comply with the Gramm-Leach-Bliley Act and the FTC's Privacy Rule. These frequently asked questions can be viewed at www.ftc.gov/bcp/conline/pubs/buspubs/autoglb.htm. The Privacy Rule applies to car dealers who:

- Extend credit to someone (for example, through a retail installment contract) in connection with the purchase of a car for personal, family, or household use;
- Arrange for someone to finance or lease a car for personal, family, or household use; or
- Provide financial advice or counseling to individuals.

.37 If your client engages in these activities, any personal information that the dealership collects to provide these services is covered by the Privacy Rule. Examples of personal information include someone's name, address, phone number, or other information that could be used to identify them individually. The Privacy Rule applies if the dealership collects personal information about someone in connection with the potential financing or leasing of a car, even if that person does not fill out a formal application. The Privacy Rule does not apply if a person buys a car with cash or arranges financing through another lender.

.38 Other business guidance is available on the FTC's Web site at www.ftc.gov/privacy/privacyinitiatives/financial_rule_bus.html.

New IRS Publications

.39 The Internal Revenue Service (IRS) has issued the *New Vehicle Dealership Audit Technique Guide 2004*. This publication, which received NADA guidance, discusses various tax issues for IRS employees who audit new automobile dealerships. The IRS also released an alert, *Electronic Records Retention Requirements for Auto Dealerships*, which lists common documents dealers will need during most IRS examinations. Both of these IRS publications are available at www.irs.gov.

New Look at the Corporate Average Fuel Economy Standards

.40 A bipartisan group of lawmakers plans to propose legislation that would raise corporate average fuel economy (CAFE) standards for cars and trucks to a combined 33 miles per gallon (mpg) by 2016. The light-truck standard for 2006 is 21.6 mpg. The car standard remains at 27.5 mpg. Under the proposed legislation, fuel economy for light trucks would be based on size and broken into six categories, with smaller vehicles required to be the most fuel-efficient. By 2011, the smallest light truck group would have to average 28.4 mpg, and large trucks would have to average 21.3 mpg. Similar boosts in fuel economy have been proposed in previous years; all were rejected, but gas prices were not more than $3 a gallon previously. In 2005, Congress enacted a comprehensive energy bill that does not include higher fuel economy standards. Nevertheless, the subject has suddenly resurfaced, amid soaring gasoline prices and fuel shortages in the aftermath of Katrina. The proposed legislation is likely to push the auto industry to apply fuel-saving technologies to future light truck and other vehicle models. These technologies would include more hybrid gas-electric vehicles, six-speed automatic transmissions that provide better gas mileage, and air conditioners that run on electricity instead being powered by the gas engine.

Current Audit and Accounting Issues and Developments

Assessing Audit Risks in the Current Environment

.41 The proper planning and execution of an audit have always required the auditor to have an understanding of the auto dealership industry and the nature of the client's business. Such an understanding enhances the auditor's ability to plan and perform auditing procedures. For most audit firms, this understanding means that the most experienced partners and managers must become involved early and often in the audit process.

.42 AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1), provides, among other matters, guidance for auditors regarding the specific procedures that should be considered in planning an audit in accordance with generally accepted auditing standards (GAAS). AU section 311 states that the auditor should obtain a knowledge of matters that relate to the nature of the entity's business, its organization, and its operating characteristics; and consider matters affecting the industry in which the entity operates, including, among other matters, economic conditions as they relate to the specific audit.

.43 You should keep the following points in mind as you plan and perform audits of auto dealerships:

- Understand how your client is affected by changes in the current business environment.
- Understand the stresses on your client's internal control over financial reporting, and how those stresses may affect internal control.
- Identify key risk areas, particularly those involving significant estimates and judgments.
- Approach the audit with objectivity and skepticism, setting aside prior experiences with or belief in management's integrity.
- Pay special attention to complex transactions, especially those presenting difficult issues of form versus substance.
- Consider whether additional specialized knowledge is needed on the audit team.
- Make management aware of identified audit differences on a timely basis.
- Question the unusual and challenge anything that does not make sense.
- Foster open, ongoing communications with management and the audit committee, including discussions about the quality of financial reporting and any pressure to accept less than high-quality financial reporting.
- When faced with a "gray" area, perform appropriate procedures to test and corroborate management's explanations and representations, and consult with others as needed.

Consideration of Fraud

.44 AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), is the primary source of authoritative guidance about an auditor's responsibilities concerning the consideration of fraud in a financial statement audit. AU section 316 establishes standards and provides guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud as stated in AU section 110.02, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1). Two types of misstatements are relevant to the auditor's consideration of fraud in a financial statement audit, namely misstatements arising from one of the following:

- Fraudulent financial reporting
- Misappropriation of assets

Considering Fraud Risk Factors

.45 You may identify events or conditions that indicate the incentives and pressures to perpetrate fraud, opportunities to carry out the fraud, or attitudes and rationalizations to justify a fraudulent action. Such events or conditions are referred to as *fraud risk factors*. Fraud risk factors do not necessarily indicate the existence of fraud; however, they coincide with the occurrence of fraud.

.46 Examples of fraud risk factors can be found in Appendix B, "Fraud Risk Factors," of this Alert.

Responding to the Results of the Assessment

.47 AU section 316.46–.67 provide requirements and guidance about your response to the results of the assessment of the risks of material misstatement attributable to fraud. You can respond to risks of material misstatement due to fraud in the following three ways:

1. A response that has an overall effect on how the audit is conducted—that is, a response involving more general considerations apart from the specific procedures otherwise planned.
2. A response to identified risks involving the nature, timing, and extent of the auditing procedures to be performed.
3. A response involving the performance of certain procedures to further address the risk of material misstatement attributable to fraud involving management override of controls, given the unpredictable ways in which such override could occur.

Evaluating Audit Evidence

.48 AU section 316.68–.78 provide requirements and guidance for evaluating audit evidence. You should evaluate whether analytical procedures that were performed as substantive tests or in the overall review stage of the audit indicate a previously unrecognized risk of material misstatement due to fraud. You also should consider whether responses to inquiries throughout the audit about analytical relationships have been vague or implausible, or have produced evidence that is inconsistent with other evidential matter accumulated during the audit.

.49 At or near the completion of fieldwork, you should evaluate whether the accumulated results of auditing procedures and other observations affect the assessment of the risks of material misstatement due to fraud made earlier in the audit. As part of this evaluation, the auditor with final responsibility for the audit should ascertain that there has been appropriate communication with the other audit team members throughout the audit regarding information or conditions indicative of risks of material misstatement due to fraud.

Practical Guidance

.50 The AICPA has issued additional guidance on the implementation of AU section 316, including *Fraud Detection in a GAAS Audit: SAS No. 99 Implementation Guide* (product no. 006613kk), and CPE courses entitled *Fraud and the Financial Statement Audit: Auditor Responsibilities Under SAS No. 99* (product no. 731810), *Auditing for Internal Fraud* (product no. 730237kk), and *Identifying Fraudulent Financial Transactions* (product no. 730245kk).

> **Help Desk**—The AICPA's Antifraud Resource Center, at www.aicpa.org/antifraud, is an online resource providing comprehensive tools, information, and resources devoted to the prevention, detection, and investigation of fraud.

Public Dealerships and the Effects of the Sarbanes-Oxley Act of 2002

.51 Although most auto dealerships are privately held, some are publicly held; therefore, management of these publicly held companies and their auditors must comply with the provisions of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley). Many experts in the accounting profession also expect Sarbanes-Oxley to have a profound effect on auditors of nonpublic companies in the future, if the legislation ultimately results in similar state legislative changes that apply to auditors of nonpublic companies.

.52 The Act establishes the Public Company Accounting Oversight Board (PCAOB) under the supervision of the Securities and Exchange Commission (SEC) to set auditing, quality control, ethics, independence, and other standards for auditors of public companies. In particular, Sarbanes-Oxley restricts the non-audit services (such as bookkeeping, internal auditing, actuarial services) that an audit firm may provide to public company audit clients. Certain services, such as tax services, may continue to be provided but only with the approval of the client's audit committee. Sarbanes-Oxley also requires the auditors of public companies to report on internal control over financial reporting in conjunction with the financial statement audit. It also increases the penalties for certain crimes, including securities fraud, fraudulent financial reporting, the destruction of key financial or audit documents, and the failure to certify financial statements. It bans personal loans to executives and requires chief executive officers (CEOs) and chief financial officers (CFOs) to reimburse the company for bonuses or other incentive-based or equity-based compensation received if earnings are restated due to securities fraud.

.53 Sarbanes-Oxley also requires the rotation of lead and reviewing audit partners on engagements every five years, and prohibits auditors from auditing public companies whose CEO, CFO, or controller worked for the audit firm during the preceding year.

.54 For further information regarding the Sarbanes-Oxley Act of 2002 and the PCAOB, visit www.pcaobus.org.

Dealer Incentives

.55 To entice customers to buy a new vehicle, dealerships continue to offer special incentives, such as free oil changes or free gas for a certain period of time. The EITF has discussed issues relating to certain sales incentives. Auditors should be aware and understand what incentive programs the dealership has, if any, and what consideration is being received from the vendor (such as cash or free parts) to determine whether any EITF Issues may apply.

.56 EITF Issue No. 01-9, "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products"),[3] addressed the accounting by a vendor for consideration given to a customer including both a reseller of the vendor's products and an entity that purchases the vendor's products from a reseller. That Issue provided accounting guidance on how a vendor should characterize consideration given to a customer and when to recognize and how to measure that consideration in its income statement.

.57 The following EITF Issues related to the accounting for sales incentives should also be considered:

- EITF Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables." Sometimes, a dealership will offer maintenance service contracts with the purchase of a vehicle. According to EITF Issue No. 00-21, revenue arrangements for the vehicle and the service contract should be divided into separate units of accounting, and the consideration for the vehicle and service contract should be allocated based on their relative fair values.

[3] The purpose of EITF Issue No. 01-9 is to codify and reconcile EITF Issue No. 00-14, "Accounting for Certain Sales Incentives" (paragraphs 10, 16, 22–25, 27, and 28); Issue 3 of EITF Issue No. 00-22, "Accounting for 'Points' and Certain Other Time-Based or Volume-Based Sales Incentive Offers, and Offers for Free Products or Services to Be Delivered in the Future" (paragraphs 30–33); and EITF Issue No. 00-25, "Vendor Income Statement Characterization of Consideration Paid to a Reseller of the Vendor's Products" (paragraphs 9–14 and 16–21). These EITF Issues address the accounting for consideration given by a vendor to a customer (including both a reseller of the vendor's products and an entity that purchases the vendor's products from a reseller.)

- EITF Issue No. 02-16, "Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor." Keep in mind that this EITF issue also covers other types of consideration such as interest credits and other rebates. Manufacturers often agree to grant advertising allowances to a dealership if the dealership advertises the manufacturer's vehicles. According to the guidance outlined in EITF Issue No. 02-16, if the cooperative advertising allowances can be characterized as a reimbursement to the dealership for a specific, incremental, identifiable cost incurred by the dealership, the allowances should be treated by the dealership as a reduction of the advertising costs in the dealership's income statement. Any material excess reimbursement received by the dealership should be treated as a reduction of the cost of sales. If the cooperative advertising allowances cannot be characterized as a reimbursement to the dealership for a specific, incremental and identifiable cost, the dealership should treat the allowances received as a reduction to inventory.

- EITF Issue No. 03-10, "Application of EITF Issue No. 02-16, *Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor*, by Resellers to Sales Incentives Offered to Consumers by Manufacturers."

Variable Interest Entities

.58 FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, issued in January 2003, affected the reporting of a large number of companies associated with special purpose entities (SPEs), entities established for a specific purpose). The concepts in FASB Interpretation No. 46 were very complex and far-reaching. In December 2003, the FASB issued FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities* (FASB Interpretation No. 46(R)), which revised and clarified certain of the concepts in the original document.

.59 FASB Interpretation No. 46(R) interprets Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements,* which, for approximately half a century, was the principal authoritative literature governing when an investor should consolidate an investee. FASB Interpretation No. 46(R) introduced a number of new concepts into the literature. As described by FASB Interpretation No. 46(R), a variable interest entity (VIE) is an entity for which a controlling financial interest is provided through ownership of interests other than voting stock. Rather, a controlling financial interest arises out of the economics—a holder of variable interests that is either exposed to a majority of the VIE's expected losses or is entitled to a majority of its expected residual rewards is the party with a controlling financial interest, even if none of the interests is in voting common stock. In applying FASB Interpretation No. 46(R), an investor and its related parties must first determine whether they have a variable interest. In essence, almost any asset, liability, or off-balance-sheet contractual arrangement between parties could qualify as a variable interest. However, a variable interest is distinguished from other assets, liabilities, and off-balance-sheet contractual arrangements by virtue of the fact that a variable interest under FASB Interpretation No. 46(R) is one that absorbs the variability in the entity's return.

.60 FASB Interpretation No. 46(R) is complex. Judgment is called for in analyzing entities with which a company has business arrangements to determine if those entities are VIEs and, if so, whether consolidation is required.

.61 If it is decided that a party has a variable interest and it is not immediately clear that the interest is so minor it could not possibly result in that party being required to consolidate the entity in which the variable interest is held, that party must determine whether the entity is a VIE. Paragraph 5 of FASB Interpretation No. 46(R) indicates that an entity is a VIE if any one of the following criteria is met:

1. The total equity investment at risk is insufficient to permit the entity to finance its activities without additional subordinated financial support provided by any parties, including equity holders.
2. As a group the holders of the equity investment at risk lack any one of the following three characteristics of a controlling financial interest:

a. The direct or indirect ability through voting rights or similar rights to make decisions about an entity's activities that have a significant effect on the success of the entity.

b. The obligation to absorb the expected losses of the entity.

c. The right to receive the expected residual returns of the entity.

In some situations, it will be easy to determine if any of these conditions is met. In most circumstances, however, that will not be the case.

Effective Dates

.62 FASB Interpretation No. 46(R) modified the effective date provisions in FASB Interpretation No. 46 as follows:

.63 For public entities that are small business issuers, FASB Interpretation No. 46(R) must be applied to all VIEs no later than the end of the first reporting period that ends after December 15, 2004 (the year ending December 31, 2004, for calendar-year companies), including those VIEs to which FASB Interpretation No. 46 had already been applied (for example, those created after January 31, 2003).

.64 For public entities that are not small business issuers, FASB Interpretation No. 46(R) must be applied to all VIEs no later than the end of the first reporting period that ends after March 15, 2004 (the quarter ending March 31, 2004, for calendar-year companies), including those VIEs to which FASB Interpretation No. 46 had already been applied.

.65 A nonpublic entity is required to apply FASB Interpretation No. 46(R) to all VIEs in which it holds variable interests by the beginning of the first reporting period beginning after December 2004 (January 1, 2005 for a calendar-year company). A nonpublic entity is required to apply FASB Interpretation No. 46(R) immediately to VIEs created after December 31, 2003.

.66 In addition, FASB Interpretation No. 46(R) required public companies to apply either FASB Interpretation No. 46 or FASB Interpretation No. 46(R) to entities that would have previously been evaluated under the accounting literature as SPEs by the end of the first reporting period ending after December 15, 2003.

FASB Staff Positions (FSPs)

.67 The FASB has also issued and proposed several FSPs related to Interpretation No. 46 that may be of interest to auto dealerships and their auditors. One such FSP that may be particularly relevant for auto dealerships is FSP FIN 46(R)-5, *Implicit Variable Interests under FASB Interpretation No. 46 (revised December 2003)*, Consolidation of Variable Interest Entities. Implicit variable interests commonly arise in leasing arrangements among related parties, and in other types of related party arrangements. The identification of an implicit variable interest involves determining whether an enterprise may be indirectly absorbing or receiving the variability of the entity. The determination of whether an implicit variable interest exists is a matter of judgment that depends on the relevant facts and circumstances. For example, an implicit variable interest may exist if the reporting enterprise can be required to protect a variable interest holder in an entity from absorbing losses incurred by the entity. The identification of variable interests (implicit and explicit) may affect (*a*) the determination as to whether the potential VIE should be considered a VIE, (*b*) the calculation of expected losses and residual returns, and (*c*) the determination as to which party, if any, is the primary beneficiary of the VIE. The entire content of FSP FIN 46(R)-5 and other FSPs are available on the FASB Web site at www.fasb.org.

Conclusion

.68 As a result of FASB Interpretation No. 46, you should review your client's participations in VIEs to evaluate whether these entities should be consolidated. In many cases, real estate partnerships, limited liability companies (LLCs), and other entities guaranteed by the operating entity (for example, the auto dealership) or its owner will have to be consolidated. To ensure compliance, review the full provisions of FASB Interpretation No. 46 and the related FSPs when accounting for your clients' partnerships and alliances.

Auto Dealership Merger and Acquisition Activity

.69 Although there haven't been many large transactions in recent years, dealerships are still being bought and sold at a brisk rate, primarily in private transactions in which independent dealer groups are purchasing other privately owned dealers. In 2005, General Motors began encouraging dealer franchises to consolidate under one owner. In addition, Daimler Chrysler AG's Chrysler Group plans to reduce the number of dealerships it has in big-city markets by 20 percent over the next five to seven years, attributable to Chrysler's view that certain urban dealerships are undersized, outdated, or too close to other Chrysler stores; this plan could mean that roughly 240 of Chrysler's 1,200 metropolitan dealerships could be closed or consolidated in future years. Most dealership purchases are asset deals rather than stock deals, and most deals are priced at some multiple of earnings.

Applicable Accounting Guidance

.70 FASB Statement No. 141, *Business Combinations*, addresses financial accounting and reporting for business combinations, including the application of the purchase method, and the accounting for goodwill and other intangible assets acquired.

Asset Valuation

.71 Inventory valuation is typically the most significant aspect of a dealership purchase. Generally, new vehicles are priced at what the purchaser would pay the manufacturer, taking into consideration all credits, incentives, and allowances. Prior-year models are generally discounted. Used vehicles are typically negotiated unit-by-unit, with the seller keeping units that the purchaser does not want and disposing of them at an auction. Parts are typically priced at current factory prices for useable and returnable parts.

.72 In many deals, the real estate is retained by the existing dealer and is leased long-term to the new dealer, with an option to buy in the future. Other deals include the outright sale of the real estate, under which the property is appraised and the fair market value is established. You may consider using the help of a specialist, to ensure the proper valuation of the real estate or other significant account, such as fixed assets. If you require the help of a specialist, you should consider the guidance in AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1).

Possible Internal Control Weaknesses

.73 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.

.74 You should take these issues into account in their consideration of internal control and their assessment of control risk. These possible gaps and deficiencies in internal control may affect the nature, timing, and extent of audit testing and may represent reportable conditions or weaknesses in internal control that should be communicated to management and the audit committee. Auditors should refer to the guidance set forth under AU section 319, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1; and for audits conducted in accordance with PCAOB standards: AICPA, *PCAOB Standards and Related Rules*).

Increased Opportunity for Fraud

.75 Employees may have an increased opportunity to commit fraud when entities merge. With major changes in the company'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. You should refer to the guidance set forth in AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1; and for audits conducted in accordance with PCAOB standards: AICPA, *PCAOB Standards and Related Rules*), when assessing the risk of fraud.

Spring Loading and Premerger Outlays

.76 An entity acquiring another entity may try to worsen the reported financial performance of the purchased company during the period immediately preceding the acquisition date, the *stub period*. By worsening the financial performance of the acquired company before the acquisition, management will find it much easier to report "improved" performance after the acquisition, thus demonstrating the positive effects of the business combination and providing an increase in reported earnings. This practice is often referred to as *spring-loading*. Generally, the practice involves accelerating the purchased company's payment of payables and other obligations, and writing down investments and other assets on the purchased company's books. These practices may not necessarily violate the letter of any GAAP standard.

.77 However, this sort of financial engineering may involve the deliberate inflation of reserves and allowances recorded on the acquired company's books. These inflated reserves are then reversed in the period following the acquisition providing a generous burst of earnings growth. Accounts that can be manipulated in this manner include:

- Reserves for merger costs
- Inventory obsolescence allowance
- Pension allowances
- Restructuring reserves
- Reserves for worker's compensation and medical insurance

You should be on the lookout for these kinds of accounting practices and determine that the appropriate accounting treatment in accordance with GAAP is being followed.

Compliance With the Sarbanes-Oxley Act

.78 Management of public companies may fail to consider the effect of Sarbanes-Oxley and related SEC regulations on the merger. For example, a company may encounter a serious challenge if it acquires a privately held company that has not had to comply with Sarbanes-Oxley. Necessary internal controls may not be in place at the acquired entity. Auditors of public companies need to pay special attention to the proper compliance with Sarbanes-Oxley at the acquired entity and should consider the guidance contained in 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).

Environmental Liabilities

.79 Certain auto dealerships may face problems with asbestos or other environmental liabilities. In March 2005, the FASB issued FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations—an interpretation of FASB Statement No. 143*. Although the Interpretation is not limited to environmental liabilities, it does address how to account for situations in which environmental liability can be projected.

.80 Under the requirements of the Interpretation, companies must account for the fair value of any future liabilities that attach to an asset, if a reasonable estimate of the fair value of that future liability can be projected. This estimate should include all assets, even if they are not currently scheduled for retirement; this includes assets that will have an environmental liability that will be triggered by a known future event. According to FASB Interpretation No. 47, financial statements are required to reflect any legally required obligations and expenses for environmental remediation, demolition, decommissioning, closure, disposal or recycling that will attach to the property in the future. A company must attempt to estimate the fair value of these future obligations, even if the conditional event in the future that triggers the environmental liability has not yet occurred. If a future event can be reasonably projected, and the costs reasonably estimated, then the liability must be recognized in the current financial statements. If such information is not available at the present time, then that fact and the supporting reasons shall be disclosed.

.81 If an auto dealership is faced with environmental issues, investigation may be required to determine whether the assets are subject to reporting under FASB Interpretation No. 47. Not only will a legal decision have to be made to confirm whether there is any obligation to estimate and report the liability, environmental managers and consultants may also need to estimate the probable costs and timing of the future remediation, closure, disposal or recycling obligations. The Interpretation is effective no later than the end of fiscal years ending after December 15, 2005 (December 31, 2005 for calendar-year companies).

Increasing Use of E-Commerce

.82 The Internet presence of U.S.-franchised new car and light truck dealers reached an all-time high in 2004, according to a survey from the NADA's Industry Analysis Division. NADA's annual survey of Internet utilization found that 94 percent of new car and light truck dealerships have Web sites—up from 93 percent in 2003 and 74 percent in 1999. Of these sites, 98 percent are interactive, with most allowing car shoppers to view stock and manufacturers' suggested retail prices, fill out finance forms, and schedule sales and service appointments. Many others provide customers the convenience of ordering on-line and linking directly to related financial, insurance, and auto sites.

.83 As dealerships venture into e-commerce, auditors need to consider how these ventures will affect the audit. The technological skills required to fully understand the operations of e-business and the manner in which business is transacted may be highly specialized. Therefore, you may need to engage information technology (IT) audit specialists to perform certain procedures. Qualified IT specialists are sometimes available from another part of the firm, such as the consulting division or the internal IT support staff. If not, you may have to go outside your own organization to obtain qualified specialists.

.84 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 AU section 336.06, specialized assistance is advisable for auditors who:

> …may encounter complex or subjective matters potentially material to the financial statements. Such matters may require special skill or knowledge and in the auditor's judgment require using the work of a specialist to obtain competent evidential matter.

.85 The use of an outside specialist[4] in an e-business context does not absolve the auditor from a certain level of understanding about computers. It is important to plan accordingly when a specialist's services are required, because of the lead time necessary to contract for a specialist's services and the time required for the auditor to obtain the minimum technological knowledge necessary to supervise the specialist. According to AU section 311.10:

---

[4] Note that AU section 336.06 does not apply to specialists who are employed by the firm and are part of the engagement team. AU section 336.06 indicates that the auditor uses the work of the specialist as evidential matter in performing substantive tests to evaluate material financial statement assertions. The specialist does not, however, perform the substantive tests or analytical procedures.

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.

Nonmonetary Exchanges

.86 On occasion, a dealership may exchange a vehicle for advertising services. Or, two dealerships may exchange vehicles to meet customer needs or to balance their inventory. These types of trades should be treated as an exchange, and should follow the guidance outlined in Accounting Principles Board (APB) Opinion No. 29, *Accounting for Nonmonetary Transactions*. The guidance in APB Opinion No. 29 is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. However, APB Opinion No. 29 provided an exception to the basic measurement principle (fair value) for exchanges of similar productive assets. That exception required that some nonmonetary exchanges, although commercially substantive, be recorded on a carryover basis. FASB Statement of Financial Accounting Standards No. 153, *Exchanges of Nonmonetary Assets—an amendment of APB Opinion No. 29,* issued in December 2004, amends APB Opinion No. 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance—that is, transactions that are not expected to result in significant changes in the cash flows of the reporting entity.

.87 In addition, EITF Issue No. 04-13, "Accounting for Purchases and Sales of Inventory with the Same Counterparty," addresses how to account for two-way exchanges of inventory by entities in the same line of business. EITF Issue No. 04-13 introduces an "in contemplation model," which determines whether acquired inventory that is subsequently sold represents one transaction or two. For example, two auto dealers who enter into simultaneous transactions to buy 10 cars from each other are deemed to be involved in one transaction, while the same dealers who happen to buy each other's cars at an auction are involved in two transactions. The auto dealers who swap cars would be required to record the exchange at the carrying amount of the inventory transferred. In contrast, the auction example would represent two separate transactions, and a gain or loss could be recognized on each sale.

.88 See www.fasb.org for further information on both EITF Issue No. 04-13 and FASB Statement No. 153.

The Use of Swaps

.89 Dealerships continue to use derivatives to manage their financing costs by mitigating their exposure to interest rate risk. As interest rates continue to rise, a growing number of dealers are locking in rates by swapping floating rates for fixed rates. Dealers typically use swaps to stabilize interest costs on real estate loans or floorplan financing. The AICPA Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (product no. 012520kk), defines a swap as follows:

> Swap—a forward-based contract in which two parties agree to swap streams of payments over a specified period of time.

.90 In effect, they exchange the investment performance of one underlying instrument for the investment performance of another instrument without exchanging the instruments themselves.

.91 The two main types of swaps are interest rate swaps and exchange rate swaps. An interest rate swap occurs if two parties agree to exchange interest payments on a set principal amount for a specified period of time. For example, if an entity pays a variable rate of interest under the swap and receives a fixed rate of interest under the swap, the entity actually pays or receives only the net amount under the swap. The most common form of an interest rate swap entails the exchange of streams of fixed rate and variable interest payments. Interest rate swaps are often used because they allow the borrower to borrow in a readily accessible market yet obtain the type of debt they need via the swap. Swaps are also used to hedge existing debt obligations.

.92 Other examples are basis swaps in which both rates are variable but are tied to different index rates, and fixed-rate currency swaps, whereby two counterparties exchange fixed-rate interest in one currency for fixed-rate interest in another currency.

.93 If your client is financing with swaps, you should become familiar with what a swap is and how to audit such financial instruments.

.94 Keep in mind that FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, applies when accounting for swaps. When auditing swaps, AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA *Professional Standards*, vol. 1), should be followed.

.95 The following are potential misstatements relating to swaps:

- Failure to identify the swap
- Failure to properly document the hedge and the expectation of hedge effectiveness
- Hedge not highly effective on an ongoing basis, so that hedge accounting is no longer appropriate
- Assessment of hedge effectiveness inconsistent with the risk management strategy documented for the particular hedging relationship
- Dealership not assessing hedge effectiveness for similar hedging strategies in a similar manner, and not documenting such differences
- Incorrectly determining the fair value of the swap and the bonds
- Incorrectly computing and recording interest and accrued interest on the bonds
- Inadequate financial statement presentation and disclosure

.96 The following are inherent risks related to swaps:

- The transaction requires no initial cash outlay, and, therefore, detection of the derivative may be difficult.
- Management may not have a valuation model capable of valuing the interest rate swap and may instead rely on the broker-dealer who arranged the transaction for the valuation of the swap.
- Credit risk related to the swap is moderate and is primarily related to the risk of nonperformance by the counterparty.

Vehicle Leasing

.97 Vehicle leasing began to make a modest comeback in 2004. Leasing peaked in 1999 with a 25-percent penetration of total sales of 17.4 million cars and trucks. The low point was 2003 when 13 percent of 16.9 million vehicle deliveries were leases. But the lease numbers are nudging up; about 2 million vehicles, or

14.2 percent, were leased in 2004. Leasing will increase to 16.5 percent in 2005 and hit 20 percent in a few years, according to Automotive Lease Guide.

.98 As interest rates rise and as residual values stabilize, leasing becomes more attractive. But the terrific lease terms of yesteryear will remain a memory. Back then, auto makers subsidized leasing to move the cars and build customer loyalty with low monthly leasing payments. The strategy was structured on overly optimistic forecasts that vehicle residual values would be higher than they actually turned out to be. That led to millions of dollars lost as predicted values collided with real values.

.99 Hefty sales incentives of the last four years also converted many lessees into buyers. Lease terms today are higher than before because they are built on a more realistic prediction of what a vehicle will be worth at the end of the lease. Manufacturers also do a better job of remarketing off-lease vehicles, especially through certified used-car programs that fetch higher prices for reconditioned three- and four-year-old vehicles with low mileage and warranties.

.100 In most cases, a dealer lease arrangement is treated as a typical sales transaction because the dealership does not maintain the lease but transfers it to a manufacturer's financing subsidiary. The dealership records a sale to the financing institution and the financing institution obtains a vehicle subject to a lease and the responsibility to account for the lease transaction.

.101 Dealerships may, however, retain vehicle leases and lease new vehicles under either a sales-type lease or an operating lease. If a long-term lease meets the criteria established by FASB Statement No. 13, *Accounting for Leases*, the leasing transaction is treated as a sale.

.102 Many leases establish a mileage charge in addition to the minimum lease payments. These are considered contingent payments under FASB Statement No. 13 and are not included in the minimum lease payments. Accordingly, they do not enter into the calculation of the sales price of a sales-type lease. Instead, they are recognized when they are determined to be receivable. FASB Statement No. 13 requires that the total contingent rentals included in income be disclosed in the financial statements. (See EITF Issue No. 98-9, "Accounting for Contingent Rent," for guidance on how lessors and lessees should account for contingent rental income that is based on future specified targets.)

.103 Dealerships may also enter into operating leases, some of which are long-term leases that do not meet the criteria established in FASB Statement No. 13 for sales-type leases. Others are short-term rentals to benefit customers whose vehicles need repair.[5] In these cases, rental revenue is recognized as it is earned. Many floorplan arrangements allow the dealer to pay off a portion of the debt every month for these vehicles.

.104 For operating leases, auditors should consider whether management has complied with the provisions and disclosures required by FASB Statement No. 13.

.105 Auditors may also wish to select a sample of the new leases and review selected lease agreements. Auditors may also wish to understand all relevant terms of the lease agreements, to ensure that management has properly accounted for the transactions, including the calculation of receivables and interest income for sales-type leases. Further, auditors may consider confirming the principal balance with the lessee for sales-type leases.

Showroom Lease Accounting

.106 Some auto dealers are heavily spending on new and refurbished showrooms to entice customers with upscale amenities. According to NADA, approximately one-third of one percent of U.S. dealers have

[5] The same accounting is usually used for loaners except that there is no rental revenue. Many dealerships include loaners under inventory in their financial statements.

made significant improvements to showrooms, service, and waiting areas in 2004 and 2005, with an emphasis on business centers for customers and showroom upgrades. Domestic automakers in particular have been pushing auto dealers to improve their facilities to help boost lagging sales.

.107 In January 2005, the SEC issued an interpretation clarifying its position on certain accounting issues and their application under GAAP relating to operating leases. Of specific concern was the appropriate accounting for (1) the amortization of leasehold improvements by a lessee in an operating lease with lease renewals, (2) the pattern of recognition of rent when the lease term in an operating lease contains a period where there are free or reduced rents (commonly referred to as *rent holidays*), and (3) incentives related to leasehold improvements provided by a landlord/lessor to a tenant/lessee in an operating lease.

.108 The staff's views on these issues were as follows:

- *Amortization of Leasehold Improvements.* The staff believes that leasehold improvements in an operating lease should be amortized by the lessee over the shorter of their economic lives or the lease term, as defined in paragraph 5(f) of FASB Statement No. 13, as amended. The staff believes amortizing leasehold improvements over a term that includes assumption of lease renewals is appropriate only when the renewals have been determined to be "reasonably assured," as that term is defined in FASB Statement No. 13.

- *Rent Holidays.* The staff believes that pursuant to the response in paragraph 2 of FASB Technical Bulletin 85-3, *Accounting for Operating Leases with Scheduled Rent Increases*, rent holidays in an operating lease should be recognized by the lessee on a straight-line basis over the lease term (including any rent holiday period) unless another systematic and rational allocation is more representative of the time pattern in which leased property is physically utilized.

- *Landlord/Tenant Incentives.* The staff believes that (1) leasehold improvements made by a lessee that are funded by landlord incentives or allowances under an operating lease should be recorded by the lessee as leasehold improvement assets and amortized over a term consistent with the guidance in the first bullet above; (2) the incentives should be recorded as deferred rent and amortized as reductions to lease expense over the lease term in accordance with paragraph 15 of FASB Statement No. 13 and the response to Question 2 of FASB Technical Bulletin 88-1, *Issues Relating to Accounting for Leases*, and therefore, the staff believes it is inappropriate to net the deferred rent against the leasehold improvements; and (3) a registrant's statement of cash flows should reflect cash received from the lessor that is accounted for as a lease incentive within operating activities and the acquisition of leasehold improvements for cash within investing activities.

.109 Although the SEC only directed its interpretation to public registrants, the accounting guidance outlined by the SEC also applies to privately held companies. To the extent that dealerships have deviated from the lease accounting standards and related interpretations set forth by the FASB, those dealerships, in consultation with their independent auditors, should assess the impact of the resulting errors on their financial statements to determine whether restatement is required. The SEC staff believes that the positions noted above are based upon existing accounting literature and dealerships who determine their prior accounting to be in error should state that the restatement results from the correction of errors or, if restatement was determined by management to be unnecessary, state that the errors were immaterial to prior periods.

.110 Registrants in particular should ensure that the disclosures regarding both operating and capital leases clearly and concisely address the material terms of and accounting for leases. Registrants should provide basic descriptive information about material leases, usual contract terms, and specific provisions in leases relating to rent increases, rent holidays, contingent rents, and leasehold incentives. The accounting for leases should be clearly described in the notes to the financial statements and in the discussion of critical accounting policies in management's discussion and analysis (MD&A) if appropriate. Known likely trends or uncertainties in future rent or amortization expense that could materially affect operating results or cash flows should be addressed in MD&A. The disclosures should address the following:

- *Material lease agreements or arrangements.* The essential provisions of material leases, including the original term, renewal periods, reasonably assured rent escalations, rent holidays, contingent rent, rent concessions, leasehold improvement incentives, and unusual provisions or conditions.
- The accounting policies for leases, including the treatment of each of the above components of lease agreements.
- The basis on which contingent rental payments are determined with specificity, not generality.
- The amortization period of material leasehold improvements made either at the inception of the lease or during the lease term, and how the amortization period relates to the initial lease term.

Lending

.111 The average new car loan term has jumped to nearly 62 months. With longer loans, negative equity becomes an issue. Also, new-car incentives, such as "employee pricing," have hurt used-car prices and trade-in values. When consumers look to purchase a new vehicle, their negative equity may get rolled into new loans.

.112 If the dealership provides the customer with financing and the note is sold to a financial institution, that institution generally pays a fee to the dealership. If a customer prepays or defaults on the note, the financial institution may charge back a portion of the fee to the dealership.

.113 In determining whether a dealership should recognize financing income, auditors should assess management's consideration of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

.114 Auditing Interpretation No. 1, "The Use of Legal Interpretations As Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Financial Accounting Standards Board Statement No. 140," of AU section 9336.01–.21, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), provides guidance regarding the use of a legal specialist's findings as audit evidence to support management's assertion that a transfer of financial assets meets the legal isolation criterion of paragraph 9(a) of FASB Statement No. 140. The Auditing Interpretation addresses when the use of a legal specialist's work may be appropriate; factors that should be considered in assessing the adequacy of the legal response; and the use, as audit evidence, of legal responses that are restricted to the client's use. The Interpretation includes the form of letter that adequately communicates permission for the auditor to use the legal specialist's opinion for the purpose of evaluating management's assertion as well as sample language that does not adequately communicate such permission.

.115 In December 2003, the AICPA issued SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*, which provides guidance on the proper accounting for loans acquired by purchase and in other transfers (including used automobile retail sales contracts) that show evidence of deteriorating credit quality since origination and for which it is probable, at acquisition, that the purchaser will be unable to collect all contractually required payments receivable. The guidance generally precludes accretion (or recognition) of purchase discount income when actual collections equal those that were expected when the loans were acquired. Additionally, a valuation allowance is required when actual collections are less than those expected at the time of acquisition. Only when actual cash flows exceed those that were expected at the time of acquisition, can the finance company recognize such differences into income subject to certain limitations. The ability to apply these rules is largely dependent on having reasonable expectations about the timing and amount of cash flows that can be expected to be collected at the time the loans are acquired. Therefore, finance companies will need to perform more extensive financial analysis prior to acquiring the loans and more accurately predict portfolio losses that will be expected over the remaining life of the portfolio.

.116 This accounting guidance applies when loans are acquired either by a related finance company (from its affiliated dealership) or from unrelated dealer operators. This SOP only affects reported financial results when the finance company reports separately from its related dealership, since transactions addressed by the SOP are eliminated when reporting the combined results of the finance company and the related dealership together. If applicable, this SOP must be applied prospectively in reporting financial results for years beginning after December 15, 2004.

Pension Plans

.117 Many companies in a variety of industries have underfunded defined-benefit plans whereby the obligations owed to retirees exceed the assets in the plans. These companies are faced with infusing large amounts of cash into these plans to maintain legal requirements; as a result, many companies have opted to terminate their pension plans. Management should continually monitor the key assumptions used in measuring pension benefit obligations, returns on plan assets, and periodic service cost. Principal actuarial assumptions include discount rates, participation rates, and factors affecting the amount and timing of future benefit payments. FASB Statements No. 87 and No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, indicate that each assumption shall reflect the best estimate with respect to that individual assumption on the applicable measurement date.

.118 When auditing accounting estimates, auditors should pay close attention to the underlying assumptions used by management. AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1), provides guidance on obtaining and evaluating sufficient evidential matter to support significant accounting estimates used in a client's financial statements. Practical guidance on auditing estimates is also available in the AICPA Audit and Accounting Practice Aid *Auditing Estimates and Other Soft Accounting Information* (product no. 010010kk).

.119 In addition, in December 2003, the FASB issued revised FASB Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits—an amendment of FASB Statements No. 87, 88, and 106*. This FASB Statement applies only to defined-benefit pension plans and other postretirement benefit plans, but does not apply to defined contribution or multiemployer plans. The FASB Statement requires additional disclosures about pension plans and other postretirement benefits. Auditors should understand the requirements of FASB Statement No. 132(R) to determine whether management has complied with those requirements.

Employee Stock Options

.120 Certain auto dealerships issue stock options to their employees as part of their compensation. Issuing equity instruments makes a lot of sense, partly because of the favorable accounting treatment and partly because the use of equity conserves cash and generates capital.

.121 In reaction to increased scrutiny from the press, Congress, regulators, and others, the FASB issued a revised standard, FASB Statement No. 123(R), in December 2004. The FASB Statement addresses the accounting for employee stock options, and accounting for transactions in which a company incurs liabilities that are based on the fair value of the company's equity instruments or that may be settled by issuing equity instruments in exchange for employee services. The FASB Statement only affects employee stock options and related liabilities; it does not affect the accounting for similar transactions involving parties other than employees. It also does not affect the accounting for employee stock ownership plans (ESOPs), which are subject to SOP 93-6, *Employers' Accounting for Employee Stock Ownership Plans.* Generally, the approach in the

FASB Statement is similar to the approach described in FASB Statement No. 123, *Accounting for Stock-Based Compensation*. However, the Statement requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values.

.122 The main purpose of this FASB Statement is to recognize the cost of employee services received in exchange for equity instruments and related liabilities in an entity's financial statements. Key provisions of the FASB Statement are as follows:

- For public entities, the cost of employee services received in exchange for equity instruments is measured using the fair value of those instruments on the grant date. The compensation cost is then recognized over the requisite service period (usually the vesting period). Generally, no cost is recognized if the equity instruments do not vest.

- For public entities, the cost of employee services received in exchange for liabilities is initially measured at the fair value of the liabilities, and then remeasured at each reporting date through the settlement date. The pro rata change in the fair value of the liability during the requisite service period is recognized over that period. After the requisite service period is complete, the change in fair value is recognized in the financial statements in the period of the change.

- On the grant date, the estimated fair value of employee stock options and similar instruments is determined using options pricing models (unless observable market prices are available).

- If an equity award is modified after the grant date, incremental compensation cost is recognized. This amount is the difference between the fair value of the modified award and the fair value of the original award immediately before the modification.

- If the terms of employee share purchase plans are no more favorable than those available to all holders of the same class of shares, and substantially all employees can participate on an equitable basis, those plans are not considered compensatory.

- Excess tax benefits, as defined by the FASB Statement, are treated as additional paid-in capital. Cash retained as a result of those benefits is reported in the statement of cash flows as cash from financial activities. The write-off of deferred tax assets as a result of unrealized tax benefits associated with recognized compensation is reported as income tax expense.

- The FASB Statement allows nonpublic companies to elect to use the intrinsic method to measure the cost of employee stock options and similar instruments, as well as liability instruments. Public companies may also use the intrinsic method if it is not reasonably possible to estimate grant-date fair value.

- The notes to the financial statements of all entities should include information that users need to understand the nature of employee stock options and similar instruments and the effect of those instruments on the financial statements.

.123 In April 2005, the SEC adopted a rule amending the compliance dates for FASB Statement No. 123(R). The new rule does not change the accounting that the FASB Statement requires, but it does allow companies more time to implement it. Originally, the deadline was the beginning of the first interim or annual period after June 15, 2005, or December 15, 2005, for small business issuers. The SEC now requires implementation no later than the beginning of the first fiscal year after those dates. For example, calendar year-end companies, excluding small business issuers, do not have to comply with FASB Statement No. 123(R) until the first quarter of 2006. However, companies with a June 30 year-end, excluding small business issuers, must comply with the Statement's requirements beginning July 1, 2005.

.124 The SEC also issued Staff Accounting Bulletin (SAB) No. 107, *Share-Based Payment*, in April 2005, to help public companies implement the provisions of FASB Statement No. 123(R). The SAB does not alter any conclusions in FASB Statement No. 123(R), but states that amounts represented in financial statements for stock option expenses are highly judgmental estimates. For example, because the grant-date fair value estimate required by FASB Statement No. 123(R) is not intended to predict the ultimate value realized by an option holder, the staff will not object to reasonable fair value estimates made in good faith, even if subsequent events indicate other estimates would have been more accurate. See the SEC Web site at www.sec.gov/interps/account/sab107.pdf for complete information.

.125 You should continue to follow the developments of this FASB Statement and discuss its implications with your auto dealership clients if they issue stock options. For information on this FASB Statement and other accounting standards issued subsequent to this Alert, please refer to 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*.

Disaster Recovery Resources

.126 In August 2005, Katrina 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 and auditing issues and provided a road map to relevant accounting literature for use by the nongovernmental entities that will assist preparers and practitioners. In addition, the AICPA issued three technical practice aids that relate to Katrina and other natural disasters:

- AICPA Technical Practice Aid 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"
- AICPA Technical Practice Aid 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"
- AICPA Technical Practice Aid 8345.02, "Considerations When Audit Documentation Has Been Destroyed by Fire, Flood, or Natural Disaster"

.127 In addition, the FASB noted that losses that resulted from the destruction of Hurricane Katrina are not extraordinary events; therefore, dealerships affected by the hurricane will not be able to exclude costs related to the hurricane when reporting their financial results. According to the FASB, "as tragic as hurricanes and other natural disasters are for everyone affected, unfortunately every year many businesses across the country are affected by these types of events and thus they do not represent an unusual and infrequent occurrence to businesses or to insurers." Additional disaster recovery resources are available at www.aicpa.org.

On the Horizon

.128 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 certain projects that are expected to result in final standards in the near future. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS.

.129 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 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
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
PCAOB	www.pcaobus.org

Help Desk—The AICPA's standard-setting committees publish exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To be added to the notification list for all AICPA exposure drafts, send your e-mail address to memsat@aicpa.org. Indicate "exposure draft e-mail list" in the subject header field to help process your submission more efficiently. Include your full name, mailing address and, if known, your membership and subscriber number in the message.

Auditing Pipeline—Nonpublic Companies

.130 The standards discussed in this section would not apply to the audits of public companies. 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.

Eight Statements on Auditing Standards Related to Audit Risk

.131 In October 2005, the AICPA's ASB voted to ballot eight new Statements on Auditing Standards (SASs) relating to the auditor's risk assessment process. One open item, dealing with materiality, is yet to be resolved. The ASB believes that the requirements and guidance provided in the SASs would result in a substantial change in audit practice and in more effective audits. The primary objective of the SASs is to enhance auditors' application of the audit risk model in practice by requiring:

- More in-depth understanding of the entity and its environment, including its internal control, to identify the risks of material misstatement in the financial statements and what the entity is doing to mitigate them.
- More rigorous assessment of the risks of material misstatement of the financial statements based on that understanding.
- Improved linkage between the assessed risks and the nature, timing, and extent of audit procedures performed in response to those risks.

.132 The eight SASs consist of:

- *Amendment to "Due Professional Care in the Performance of Work," of Statement on Auditing Standards No. 1*, Codification of Auditing Standards and Procedures
- *Amendment to Statement on Auditing Standards No. 95*, Generally Accepted Auditing Standards
- *Audit Evidence*

- *Audit Risk and Materiality in Conducting an Audit*
- *Planning and Supervision*
- *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
- *Amendment to Statement on Auditing Standards No. 39,* Audit Sampling

.133 The SASs establish standards and provide guidance concerning the auditor's assessment of the risks of material misstatement in a financial statement audit, and the design and performance of audit procedures whose nature, timing, and extent are responsive to the assessed risks. In addition, the SASs establish standards and provide guidance on planning and supervision, the nature of audit evidence, and evaluating whether the audit evidence obtained affords a reasonable basis for an opinion regarding the financial statements under audit.

Proposed SAS, Communication of Internal Control Related Matters Noted in an Audit

.134 This proposed SAS will supersede SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), and significantly strengthen the quality of auditor communications of such matters in audits of nonpublic companies. Readers should be alert for the issuance of a final standard in the first quarter of 2006.

SAS, Audit Documentation

.135 In October 2005, the ASB voted out this new SAS that will supersede SAS No. 96 of the same name (AICPA, *Professional Standards*, vol. 1, AU sec. 339), and establish standards and provide guidance to an auditor of a nonissuer on audit documentation for audits of financial statements or other financial information being reported on. In developing this SAS, the ASB considered the documentation requirements of PCAOB Auditing Standard No. 3, *Audit Documentation*; the International Auditing and Assurance Standards Board's exposure draft, ISA 230, *Audit Documentation*, issued in September 2004; suggestions received from the National Association of State Boards of Accountancy; and *Government Auditing Standards* (GAS, also referred to as the Yellow Book) issued by the Comptroller General of the United States.

.136 In addition to the SAS, the ASB voted out 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 the auditor's report not be dated earlier than the date on which the auditor has obtained sufficient competent audit evidence to support the opinion on the financial statements. The ASB also voted out an amendment to SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150.05). The amendment adds a requirement for the auditor to document his or her justification for a departure from the SASs in the working papers.

SAS, Defining Professional Requirements in Statements on Auditing Standards, *and Statement on Standards for Attestation Engagements*, Defining Professional Requirements in Statements on Standards for Attestation Engagements

.137 In October 2005, the ASB voted out a SAS entitled *Defining Professional Requirements in Statements on Auditing Standards* and a Statement on Standards for Attestation Engagements (SSAE) entitled *Defining Professional Requirements in Statements on Standards for Attestation Engagements*. The SAS and SSAE define the terminology the ASB will use to describe the degrees of responsibility that the requirements impose on the auditor or the practitioner.

Proposed SSAE, Reporting on an Entity's Internal Control Over Financial Reporting

.138 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

.139 Readers should be alert for the issuance of a final standard in the fourth quarter of 2005.

Amendment to SAS No. 69, The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles, for Nongovernmental Entities*

.140 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 moves responsibility for the GAAP hierarchy for nongovernmental entities from the auditing literature (SAS No. 69) 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 FASB proposed statement, which can be obtained at www.fasb.org.

Auditing Pipeline—Public Companies

PCAOB Auditing Standard No. 4, Reporting on Whether a Previously Reported Material Weakness Continues to Exist

.141 In July 2005, the PCAOB adopted a standard that applies when auditors report on the elimination of a material weakness in a company's internal control over financial reporting. The standard establishes a voluntary stand-alone engagement that would be performed at the company's request. This standard facilitates implementation of the requirements of Section 404 of the Act and provides for additional assurance regarding the reliability of public company financial reporting. The standard will not take effect unless approved by the SEC.

PCAOB Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees

.142 In July 2005, the PCAOB adopted certain ethics and independence rules addressing tax services, contingent fees, and certain related general ethics and independence standards. The rules further strengthen the auditor's responsibilities in connection with seeking audit committee pre-approval of tax services. The rules also treat registered public accounting firms as not independent of their audit clients if they (1) enter into contingent fee arrangements with those clients, (2) provide services related to marketing, planning, or opining in favor of a confidential transaction's tax treatment or a tax treatment on a transaction that is based on aggressive interpretation of tax laws, or (3) provide tax services to members of management who serve in financial reporting oversight roles at an audit client or to immediate family members of such person. The rules also include a general obligation requiring a registered public accounting firm to be independent of the firm's audit clients throughout the audit and professional engagement period. The rules will not take effect unless approved by the SEC.

Accounting Pipeline

Proposed FASB Statement, The Hierarchy of Generally Accepted Accounting Principles

.143 This proposed FASB 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 Statement on Auditing Standards 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 proposed FASB Statement would be effective for fiscal periods beginning after September 15, 2005. Readers should be alert for the issuance of a final FASB Statement, which is expected in the third quarter of 2005.

Proposed FASB Statements, Business Combinations, *and* Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries

.144 In these proposed FASB Statements, the Board plans to revise the existing guidance on the application of the purchase method. The following are among the main proposals:

1. That all acquisitions of businesses be measured at the fair value of the business acquired.
2. That substantially all of the assets acquired and liabilities assumed of the acquired business be recognized and measured at their fair values at the acquisition date.
3. That entities that follow U.S. GAAP and international standards apply substantially the same accounting requirements for their business combinations.

.145 Issuance of the exposure drafts on business combinations—purchase method procedures and noncontrolling interests are expected in mid-2005. The FASB's goal is to issue the two final Standards in the third quarter of 2006. The target effective date for the two proposed FASB Statements is for fiscal years beginning on or after December 15, 2006.

Proposed FASB Statements, Accounting for Transfers of Financial Assets, Accounting for Servicing of Financial Assets, and Accounting for Certain Hybrid Financial Instruments

.146 The exposure draft, *Accounting for Transfers of Financial Assets*, is a revision of a June 2003 exposure draft, *Qualifying Special-Purpose Entities and Isolation of Transferred Assets*, and would amend FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The proposed FASB Statement seeks to (1) clearly specify the circumstances that require the use of a qualifying special-purpose entity (SPE) in order to derecognize all or a portion of financial assets, (2) provide additional guidance on permitted activities of qualifying SPEs, (3) eliminate the prohibition on a qualifying SPE's ability to hold passive derivative financial instruments that pertain to beneficial interests held by a transferor, and (4) revise the initial measurement of interests related to transferred financial assets held by a transferor. The effective dates associated with this proposed FASB Statement vary; refer to the exposure draft for further information.

.147 The exposure draft, *Accounting for Servicing of Financial Assets*, would also amend FASB Statement No. 140. The proposed FASB Statement would (1) require all separately recognized servicing rights to be initially measured at fair value, if practicable, (2) permit an entity to choose between two measurement methods for each class of separately recognized servicing assets and liabilities, and (3) require additional disclosures for all separately recognized servicing rights. The proposed FASB Statement would be effective for transactions occurring in the earlier of the first fiscal year beginning after December 15, 2005, or fiscal years that begin during the fiscal quarter in which the FASB Statement is issued.

.148 The proposed FASB Statement, *Accounting for Certain Hybrid Financial Instruments*, would amend FASB Statement No. 140, and FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Specifically, the proposed FASB Statement would:

1. Permit fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation.
2. Clarify which interest-only strips and principal-only strips are not subject to the requirements of FASB Statement No. 133.
3. Establish a requirement to evaluate beneficial interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation.
4. Clarify that concentrations of credit risk in the form of subordination are not embedded derivatives.
5. Eliminate restrictions on a qualifying SPE's ability to hold passive derivative financial instruments that pertain to beneficial interests that are themselves or that contain a derivative financial instrument.

The proposed FASB Statement would be effective after the earlier of fiscal years beginning after December 15, 2005, or fiscal years that begin during the fiscal quarter in which the FASB Statement is issued.

.149 Readers should be alert for the issuance of final FASB Statements, which are expected in the first quarter of 2006. See the FASB Web site at www.fasb.org for complete information.

Proposed FASB Statement, Fair Value Measurements

.150 In June 2004, the FASB published an exposure draft of a proposed FASB Statement, *Fair Value Measurements*, which seeks to establish a framework for measuring fair value that would apply broadly to financial and nonfinancial assets and liabilities, improving the consistency, comparability, and reliability of the measurements. The fair value framework would clarify the fair value measurement objective and its application under authoritative pronouncements that require fair value measurements. The exposure draft would replace any current guidance for measuring fair value in those pronouncements and would expand current disclosures. Readers should be alert for the issuance of a final FASB Statement, which is expected in the first quarter of 2006. Refer to the FASB Web site at www.fasb.org for complete information.

Proposed FASB Statement, Earnings per Share—an amendment of FASB Statement No. 128

.151 This proposed FASB Statement would amend the computations guidance in FASB Statement No. 128, *Earnings per Share*, for calculating the number of incremental shares included in diluted shares when applying the Treasury stock method. Also, this proposed FASB Statement would eliminate the provisions of FASB Statement No. 128 that allow an entity to rebut the presumption that contracts with the option of settling in either cash or stock will be settled in stock. In addition, this proposed FASB Statement would require that shares that will be issued upon the mandatory conversion of a convertible security be included in the weighted-average number of ordinary shares outstanding used in computing basic earnings per share from the date when conversion becomes mandatory. Readers should be alert for the issuance of a final FASB Statement, which is expected to be released in the third quarter of 2005.

Proposed FASB Interpretation, Accounting for Uncertain Tax Positions

.152 In July 2005, the FASB published an exposure draft of a proposed FASB Interpretation, *Accounting for Uncertain Tax Positions*, which seeks to reduce the significant diversity in practice associated with recognition and measurement in the accounting for income taxes. It would apply to all tax positions accounted for in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. Specifically, the exposure draft requires that a tax position meet a *probable recognition threshold* for the benefit of the uncertain tax position to be recognized in the financial statements. This threshold is to be met assuming that the tax authorities will examine the uncertain tax position. The exposure draft also contains guidance with respect to the measurement of the benefit that is recognized for an uncertain tax position when that benefit should be derecognized and other matters. The effective date of the proposed FASB Interpretation would be as of the end of the first fiscal year ending after December 15, 2005. A final FASB Interpretation is expected to be released in the fourth quarter of 2005.

Proposed FASB EITF Issues

.153 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.

Proposed FASB Staff Positions

.154 A number of proposed FASB Staff Positions are in progress addressing issues related to FASB Statements No. 13, No. 123(R), and No. 140, and FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others.* Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/proposed_fsp.shtml for complete information.

AICPA Resource Central

.155 The following publications deliver valuable guidance and practical assistance as potent tools to be used on your auto dealership engagements (product numbers appear in parentheses).

- Audit Guide *Auditing Derivative Instruments, Hedging Activities and Investments in Securities* (012523kk)
- Audit Guide *Auditing Revenue in Certain Industries* (012515kk)
- Audit Guide *Audit Sampling* (012530kk)
- Audit Guide *Analytical Procedures* (012555kk)
- *Accounting Trends & Techniques—2005* (009897kk)
- Practice Aid *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* (006701kk)

Audit and Accounting Manual

.156 The *Audit and Accounting Manual* (product no. 005135kk) is a valuable nonauthoritative practice tool designed to provide assistance for audit, review, and compilation engagements. The Manual contains numerous practice aids, samples, and illustrations, including audit programs, auditors' reports, checklists, engagement letters, management representation letters, and confirmation letters.

AICPA reSOURCE: Online Accounting and Auditing Literature

.157 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 cpa2biz.com.

Educational Courses

.158 The AICPA has developed a number of continuing professional education (CPE) courses that are valuable to CPAs working in the auto dealership industry. Those courses include (product numbers are in parentheses):

- *AICPA's Annual Accounting and Auditing Update Workshop* (2005 edition) (736181kk, text; 187189kk, DVD; 187089kk, video). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.
- *Dealerships: Accounting, Auditing & Tax* (product no. 731204kk). This course is valuable to CPAs working in the automobile dealership industry.
- *The AICPA's Guide to Business Consolidations, Goodwill, and Other Consolidation Issues* (735129kk). Learn how FASB Statements No. 141 and No. 142 have changed the rules for business combinations and goodwill accounting.

Online CPE

.159 *AICPA InfoBytes*, offered exclusively through CPA2Biz.com, is AICPA's flagship online learning product. Selected as one of *Accounting Today*'s top 100 products for 2003, AICPA InfoBytes now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 ($369 nonmembers) for a new subscription and $119 ($319 nonmembers) for the annual renewal. Divided into one- and two-credit courses that are available 24/7, AICPA InfoBytes offers hundreds of hours of learning in a wide variety of topics. To register or learn more, visit www.cpa2biz.com/infobytes.

CPE CD-ROM

.160 *The Practitioner's Update* (product no. 738110kk) CD-ROM helps you keep on top of the latest standards. Issued twice a year, this cutting-edge course focuses primarily on new pronouncements that will become effective during the upcoming audit cycle.

Member Satisfaction Center

.161 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.

Technical Hotline and Ethics Hotline

.162 Do you have a complex technical question about GAAP; other comprehensive bases of accounting (OCBOA); accounting, auditing, or compilation engagements; review engagements; or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with their answer. You can reach the Technical Hotline at (888) 777-7077.

.163 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.

Conferences

.164 Each fall the AICPA sponsors a National Auto Dealership Conference that is specifically designed to update auditors and dealers on significant accounting, auditing, legal, financial, and tax developments affecting the auto dealership industry. Information on the conference may be obtained on the CPA2Biz Web site at www.cpa2biz.com.

Web Sites[6]

AICPA Online and CPA2Biz

.165 AICPA Online, at www.aicpa.org, informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, cpa2biz.com offers you all the latest AICPA products, including more than 15 Audit Risk Alerts, more than 20 Audit and Accounting Guides, the professional standards, and CPE courses.

.166 This Audit Risk Alert replaces *Auto Dealership Industry Developments—2003/04*. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Alert would also be appreciated. You may e-mail these comments to kglupe@aicpa.org or write to:

Karin Glupe
AICPA
Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881

[6] Additional helpful Web sites are presented in Appendix A.

.167

Appendix A—Helpful Web Sites

Here are some useful Web sites that may provide valuable information as you plan your client engagements. In addition to these Web sites, be sure to review those listed in the "On the Horizon" section of this Alert.

General Web Sites of Interest

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
AuditNet	Electronic communications among audit professionals	www.auditnet.org
CPAnet	Links to other Web sites of interest to CPAs	www.cpalinks.com/
Accountant's Home Page	Resources for accountants and financial and business professionals	www.computercpa.com/
Double Entries	A weekly newsletter on accounting and auditing around the world	www.accountingeducation.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
Governmental Accounting Standards Board	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org

(continued)

Name of Site	*Content*	*Internet Address*
National Automobile Dealers Association	The National Automobile Dealers Association (NADA) is a not-for-profit organization promoting the interests of franchised new car and truck dealers in the United States. The NADA publishes economic newsletters, a monthly magazine, used car valuation guides, and other information on various aspects of dealerships.	www.nada.org
American International Auto Dealers Association	The American International Auto Dealers Association (AIADA) is an organization promoting the interests of foreign franchises.	www.aiada.org

.168

Appendix B—Fraud Risk Factors

AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), provides fraud risk factor examples that have been written to apply to most enterprises. Remember that fraud risk factors are only one of several sources of information you consider when identifying and assessing risk of material misstatement due to fraud. Some examples of fraud risk factors that may exist in the auto dealership industry include the following:

- Fraudulent financial reporting, including:
  - — A high degree of competition or market saturation, accompanied by declining margins
  - — High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates
  - — Significant declines in customer demand and increasing business failures in either the industry or overall economy
  - — The vehicles produced by the manufacturer have been poorly received for the last few years
  - — Significant financial interests in the entity
  - — Personal guarantees of debts of the entity
  - — There is excessive pressure on management or operating personnel to meet financial targets set up by the board of directors or management, including sales or profitability incentive goals
  - — Domination of management by a single person or small group (in a nonowner-managed business) without compensating controls
  - — Nonfinancial management's excessive participation in or preoccupation with the selection of accounting principles or the determination of significant estimates
  - — An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons
- Misappropriation of assets, including:
  - — Large amounts of cash on hand or processed (often customers will pay for vehicles or parts with cash or other bearer instruments).
  - — Inventory items that are small in size, of high value, or in high demand (vehicles and parts have value in a secondary market).
  - — Inadequate segregation of duties or independent checks (used vehicle inventory count performed by the used vehicle manager).
  - — Inadequate physical safeguards over cash, investments, inventory, or fixed assets (infrequent counting of used vehicle inventory).

In identifying risks of material misstatement due to fraud, it is helpful to consider the information that has been gathered in accordance with the requirements of AU sections 316.19–.34. Your identification of fraud risks may be influenced by characteristics such as the size, complexity, and ownership attributes of the entity. In addition, you should evaluate whether identified risks of material misstatement due to fraud can be related to specific financial-statement account balances or classes of transactions and related assertions, or whether they relate more pervasively to the financial statements as a whole. Certain accounts, classes of transactions, and assertions that have high inherent risk because they involve a high degree of management judgment and subjectivity also may present risks of material misstatement due to fraud because they are susceptible to manipulation by management.

[*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*

Acknowledgments

The AICPA staff is grateful to the following individuals for their essential contributions in creating this publication.

L. Michael Howard	Randy Roberts
W. Michael Fritz	Donald L. Rahn
Brian Schebler	Mandy Nelson
Flo Ostrum	Tom Scheidegger

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

.161

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 8931.*]

AAM Section 8230

Manufacturing Industry Developments—2006/07

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

NOTICE TO READERS
MANUFACTURING INDUSTRY DEVELOPMENTS—2006/07

This Audit Risk Alert, prepared by the AICPA staff, is intended to help you identify the significant business risks that may result in the material misstatements of your manufacturing client's financial statements with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements you 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 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 Christopher Cole, CPA CFE
Technical Manager
Accounting and Auditing Publications

How This Alert Helps You

.01 This Audit Risk Alert is intended to help you plan and perform audits and other engagements of your manufacturing clients. The knowledge delivered by this Alert can assist 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 If you understand what is happening in the manufacturing industry, and if you can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert assists you in making considerable strides in gaining and understanding that industry knowledge.

.03 This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2006/07* (product no. 022336kk). 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.

.04 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.

Economic and Industry Developments

.05 AU section 311A, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1), among other matters, provides guidance for auditors regarding the specific procedures that should be considered in planning an audit in accordance with generally accepted auditing standards (GAAS). AU section 311A states that the auditor should obtain knowledge of matters that relate to the nature of the entity's business, organization, and operating characteristics, and consider matters affecting the industry in which the entity operates, including economic conditions as they relate to the specific audit.

Current Manufacturing Economic and Industry Developments

The U.S. Manufacturing Environment

.06 There are many competing and conflicting factors affecting the United States economy. The consensus is that the economy is still growing but not as quickly. That's good news for the Federal Reserve Board, which has increased the federal fund rate 75 basis points during the year to stabilize inflation and cool the economy. The U.S. Department of Commerce reported continued but smaller increases in real gross domestic product through third quarter of 2006.

.07 The Institute for Supply Management (ISM) cites data that shows October 2006 as the 41st consecutive month of growth in the manufacturing sector of the economy. At current levels, the National Association of Manufacturers' (NAM) president, John Engler, says, "U.S. manufacturing output has never been higher. Overall, manufacturing continues to grow but at a slower pace and with some level of decline in sectors related to the motor vehicle and home construction industries."

.08 According to a study conducted by Duke University, small business owners are concerned by slowing sales and rising labor and energy costs. As a result, many companies will be delaying capital spending and hiring plans. The NAM reported that labor, energy, and other structural costs are as much as 30 percent higher in the United States than those of foreign manufacturers, which serves to further squeeze profit margins.

.09 With a midterm election in 2006 many consumer-impact items have shown some price softening. Gas prices have declined by 25 percent this year, mortgage interest rates edged back to March 2006 levels, and price forecasts for heating fuels such as natural gas and propane are down from last winter. These trends should increase consumer and business confidence during the fourth quarter and boost spending by year end.

.10 Manufacturers face a variety of issues in this business environment. Some examples would include the shortage of skilled labor and the widening opportunities to outsource production design and processing. This in turn may give rise to concerns with supply chain security. New environmental regulations and enforcement efforts with regard to business practices may affect manufacturing throughout the world.

The Labor Pool and Why It Is Drying Up

.11 There is a drought coming. Over the next 10 years, the baby boomer generation will begin to receive their Social Security checks, cash in their 401k accounts, and roll over their lump sum pension distributions. Who is going to fill those empty workstations? Educational institutions in the United States have not been turning out enough engineers, information technology specialists, chemists, or machinists to offset these vacancies. According to the Bureau of Labor Statistics, the unemployment rate has remained essentially flat at 4.7 percent in August 2006, compared to 4.9 percent in the previous year. Of those who were unemployed, 22 percent were not actively seeking employment. There is a small pool of qualified applicants for skilled jobs and a general low level of unemployment with demand ready to skyrocket. Recruiting costs can be expected to increase along with wage and benefits expenses as competition drives the market rate for these applicants up. Recently there has been an increase in skilled labor outside the United States, which has allowed manufacturers to combat the rising domestic labor costs by outsourcing to nations with developing economies.

.12 The shrinking labor pool is also accompanied by an increase in the cost of providing employee benefits. According to a study released earlier this year by the U.S. Government Accountability Office (GAO), employee benefits costs have increased 18 percent while wages are up 10 percent from 1991 to 2005. The disparity in the increase between wages and benefits developed between 2002 and 2005. Prior to that time the growth rate was uniform. Since 2002, wages have shown no appreciable growth as a result of increased benefit costs.

.13 For the purpose of the GAO study, employee benefits expense contained three components; health insurance cost, paid leave, and retirement income. Paid leave has historically been the largest piece of the benefit dollar, but in 2005, health care costs were on par with it. This equality is a result of a 28 percent increase in health care costs versus a 5 percent increase in paid leave costs during the period of the study. Health insurance cost increases were greatest for medium-sized companies, at 45 percent, while large companies saw increased costs of 34 percent and small company costs remained flat.

.14 With global pricing competition causing shrinking profit margins, manufacturers have trended toward passing the cost of benefit increases through to employees in the forms of higher employee contributions to health insurance premiums, higher co-pay and deductible policies, and the shift from defined benefit pensions to defined contribution plans such as 401k or Simple IRA plans. For manufacturing clients with pension and postretirement benefits the Financial Accounting Standards Board (FASB) has recently issued Statement of Financial Accounting Standards No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)*.

Outsourcing to the Global Marketplace

.15 The outsourcing of U.S. manufacturing production is picking up pace. The availability of skilled and unskilled labor at a discount in China, Thailand, India, Viet Nam, and Mexico is very attractive to U.S. manufacturers under pressure to reduce costs. While the desire to reduce labor and product cost is universal, the final destination varies according to the needs or requirements of the manufacturer. Each of the recent slate of assembly countries has its own skill set and advantages for the U.S. manufacturer.

.16 China has the inexpensive labor to draw assembly business away from the United States and even other Asian countries. Now China is turning to creating competing products in the high tech, automotive, and value-added arenas based on the lessons learned. During 2006, China ousted the United States as the world's largest exporter. However, China does not have as much experience with U.S. quality and delivery standards, and the legal protection of a manufacturer's intellectual property is still a deep concern.

.17 Thailand has been in the marketplace for decades. Its manufacturers are more familiar with U.S. quality expectations and have a legal system that addresses product counterfeiting laws. As is to be expected with any nation that is developing an economic base, wages have risen, making Thailand less of a bargain to U.S. manufacturers.

.18 India has a cheap workforce and is comparable in size to that of China. India has taken a different tack with its economic development in that it is more focused on internal growth than imported jobs. The amount of paperwork required by foreign companies to operate in India could be described as daunting.

India has a healthy workforce number. Most are primarily employed in the service sector, and most of the remainder, employed in the manufacturing sector, are employees of India-based companies.

.19 Viet Nam is relatively new to this market and has wage rates similar to those in China. Similarly there is a lack of experience with U.S. manufacturers and a low level of legal protection for intellectual property. It may be possible that your client is the first foreign customer that a manufacturer has ever dealt with, which may lead to quality and U.S. import issues for your client.

.20 Mexico has drawn the interest of a different type of manufacturer. U.S. companies are beginning to rely more heavily on our southern neighbor in two areas: large product manufacturing and design engineering. The advantage to manufacturers of large items such as autos and appliances is proximity. Products can be easily transported by truck or train, and production line visits are less cumbersome for U.S. personnel. An increasingly well-trained pool of engineers has allowed companies to outsource design work and more complex production processes as well. This makes Mexico more attractive for high tech manufacturers. While still less expensive than the United States, Mexican wages are being pushed up by an increasing standard of living, as in Thailand. Mexico has positioned itself well with the focus on skilled labor to maintain an advantage.

.21 In general, the outsourcing trend continues as countries all over the world market the natural and human resources they have. Gaining an understanding of the risks and pitfalls of international commerce is as important as reaping the benefits.

Intellectual Property

.22 In the United States, manufacturers expect intellectual property rights (IPR) to be honored. For generations U.S. courts have enforced product and process patent rights, copyrights, and trademarks. The same may not be true with global trading partners. According to Congressman Donald Manzullo, 70 percent of all counterfeit goods are produced in China. Idea theft has been going on for centuries, only the products and processes have changed. The most counterfeited products in recent years have been music CDs and movie DVDs. Manzullo stated that there has been a growing market in bogus auto and aircraft parts, pharmaceuticals, and software.

.23 There are several types of theft, such as:

- An unauthorized sale of the genuine product.
- An unauthorized but functional copy of the product.
- An inferior copy of the product with the manufacturer's name or trademark affixed.

.24 Within the last category are the possibilities of harm to the public either through the use of harmless but ineffective components or through the use of ingredients that may actually cause harm.

.25 The concept of individual property is a fairly new one in China. Until recently, property, including IPR, belonged to the government. There are laws in place to protect IPR but they go largely unenforced, with the exception of domestically developed intellectual property.

.26 In the past, the same could be said for India. However, India has begun to realize that to become a modern nation with cutting edge, globally competitive products, you must have innovation. There will be little interest in investing time or money in innovation to have ideas stolen and then be driven out of the market by your own product. It is the national interest of every developed nation to respect and enforce IPR laws. Hopefully, China will eventually realize its own stake in enforcing the laws it agreed to when it joined the World Trade Organization. You may want to discuss with your clients the possibility of stolen IPR and their plans to address the issue.

.27 In the report produced by the National Intellectual Property Law Enforcement Coordination Council (NIPLECC), several government agencies in the commerce/trade and law enforcement areas outline actions to combat the theft of U.S. intellectual property. These measures include a Web site, www.stopfakes.gov, where companies can access information on protecting themselves when dealing with non-U.S. partners, with a special focus on China. The Department of Homeland Security and the Customs and Border Protection agency are working to intercept fake and counterfeit goods at the borders. Seizures of these goods have doubled since 2001.

Supply Chain Security

.28 A recent report indicated that 73 percent of U.S. companies with greater than $1 billion in sales had a disruption primarily related to raw materials, natural disasters, or supply chain partners in the past five years, and 36 percent of those surveyed took more than a month to recover. How is your client going to handle supply chain disruptions? Over the past few years there have been events that have brought production to a halt. It happened after 9/11, it happened after Hurricane Katrina, and it could happen again. With just-in-time production (JIT), inventory levels have dropped to record low amounts as manufacturers streamline processes to reduce holding costs. Under normal operating conditions this system is beneficial, but what happens when there are no airlines operating for seven days, or an entire region of the country is under water, or 40 percent of the workforce is affected by pandemic flu? Planning for the worst case scenario could prevent your client from becoming one of the 40 percent of small businesses that do not reopen after a major disaster, according to the American Red Cross. Companies should be prepared for risks such as fire, natural disasters such as hurricanes, pandemic illness, communications failure, civil disturbance, terrorist action, or hazardous materials incidents.

.29 A good plan may include:

- Maintaining a contact list of employees, suppliers, and customers.
- Establishing an emergency information number for employees.
- Storing a current back-up of computer data in a secure location off-site.
- A review of insurance coverage to establish appropriate coverage and address events that are excluded from coverage.

.30 The plan should be reviewed and updated periodically.

.31 Planning for major disasters will also address more localized or industry-specific disruptions, such as increases in fuel prices and raw materials, skilled labor shortages, changes in the competitive landscape, or the loss of a key supplier or customer. Use of multiple suppliers in a variety of geographic areas, identifying alternative raw materials, diversifying the customer base, and vertical integration of the supply chain are all solutions implemented by manufacturers.

.32 Further information on disaster recovery plans can be obtained at www.fema.gov, www.redcross.org, and www.sba.gov and from most insurance carriers.

Regulatory and Legislative Issues

Pension Protection Act of 2006

.33 On August 17, 2006, President Bush signed the Pension Protection Act. In addition to expanding and improving defined contribution plans such as IRAs and 401(k) plans, the purpose of the Act is to strengthen the federal pension insurance program. The provisions in the Act are effective for fiscal years beginning after December 31, 2007. The major provisions of this legislation that may affect manufacturers with pension plans are:

- Increased premiums and contributions required for underfunded plans and companies that terminate their plans.
- Requirements for accurate measurement and reporting of benefit obligation liabilities.
- A prohibition on promising additional benefits to employees until they are funded.
- Closure of loopholes that permitted companies to defer contributions to under-funded plans.

.34 Included in the Act were several trade provision changes, such as the suspension or modification of tariffs on certain categories of imported goods and modification of specific trade agreements and regulations. For technical explanations of the provisions of the Pension Protection Act, see www.house.gov/jct/x-38-06.pdf.

National Ambient Air Quality Standards

.35 The Environmental Protection Agency implemented new air quality standards that will require a nearly 50 percent reduction in particulate matter (PM) emissions. The National Ambient Air Quality Standards (NAAQS) announced on September 21, 2006, address fine and coarse particle pollution. Research has linked significant health issues ranging from respiratory problems to heart and lung disease to this type of pollution. These standards must be met by 2015. If your manufacturer has emission concerns, it may need to consider these standards in the future. For more information on NAAQS see www.epa.gov/pm/naaqsrev2006.html.

Foreign Corrupt Practices Act

.36 The past two years have been active for the Department of Justice (DOJ) and the Securities and Exchange Commission (SEC), which are the primary enforcement organizations for the Foreign Corrupt Practices Act (FCPA). Since 2004, the DOJ and SEC reached settlements totaling $64 million for improper payments made to foreign officials. The largest penalty ever assessed was recently imposed as a result of improper payments and an insufficient corporate FCPA compliance policy. Ethics are on the front burner for American companies at least in part because they are on the front page of America's newspapers. Stepped-up FCPA enforcement efforts by DOJ and SEC can result in crippling fines and forfeiture of profits for those who violate the Act.

.37 The FCPA was passed in 1977 in response to SEC investigations that determined that millions of dollars were being paid to foreign officials, politicians, and political parties. The purpose of this legislation is to help maintain the integrity of the American business system. The FCPA is written to acknowledge the fact that business practices and customs vary throughout the world. It is important to be aware of the provisions of this legislation in the age of the global economy.

.38 The FCPA prohibits the payment, offer, or promise of payment to induce the recipient to influence any act or decision of a foreign official in his or her official capacity, to violate his or her lawful duty, or induce a foreign official to exercise his or her influence in an improper manner. The prohibition extends to payments or offers made through third parties and the business sought does not need to be with a foreign governmental entity.

.39 Payments that are made to facilitate or expedite performance of a "routine governmental action" may be allowed. Examples provided by the U.S. DOJ include obtaining permits or licenses; processing visas; providing police protection, mail service, phone service, or utility service; and inspections associated with transit of goods.

.40 Each violation of the FCPA can result in fines for corporations of up to $2 million and fines up to $100,000 and five years imprisonment for officers, directors, stockholders, employees, and other agents of the corporation. In certain circumstances, the Racketeer Influenced and Corrupt Organizations Act provisions may apply as well. For more information about the FCPA or to utilize the DOJ's Foreign Corrupt Practices Act Opinion Procedure to predetermine compliance with the law see www.usdoj.gov.

An Update on European Hazardous Waste Regulations

.41 Last year's Alert discussed the Waste Electrical and Electronic Equipment (WEEE) and Restriction of the Use of Certain Hazardous Substances in Electrical and Electronic Equipment (RoHS) directives of the European Commission. The goals of these directives are the prevention of WEEE and to require environmentally friendly recovery and disposal of WEEE. The provisions of WEEE and RoHS are minimum standards required to be adopted by European Union (EU) members. Each member may impose more restrictive measures if it chooses. Fines and penalties for noncompliance will be established by individual nations. Regulations have been implemented in some nations with effective dates in 2006. Additional guidance in the form of questions and answers has been issued by the European Commission in an effort to clarify the application of these rules at http://ec.europa.eu/environment/waste/weee_index.htm. You may need to contact EU members to determine specific requirements for each nation.

.42 Many manufacturers may find it difficult to comply with RoHS requirements. The directive provides for the removal of lead, mercury, cadmium, hexavalent chromium, polybrominated biphenyl, and polybrominated dipheyl ether from their electronic products and file the appropriate compliance documents with the EU or face having their products stopped at the border. You may consider inquiring of your client if any of its products contain the regulated compounds. Compliance records include certification of all raw materials and component parts and must be maintained for four years from the time the product is first sold. If the EU is a large part of your client's market, the use of a specialist to verify compliance may be in order. See AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1).

Energy Efficiency Action Plan

.43 The European Commission has provided an overview of a plan to reduce energy consumption by EU members by 20 percent by 2020. During the next two years, the commission will be setting standards for minimum energy performance for appliances, equipment, buildings, and energy services. Some of the manufactured items that are specifically included in the plan are autos, refrigerators, water heaters, computers, televisions, heating and air conditioning systems, lighting, and washing machines. To be sold in the EU, these items will require special labeling that indicates that they meet the prescribed energy standards that are anticipated to be applied in 2009. The commission expects the plan to be fully implemented within six years. For more information see http://ec.europa.eu/index_en.htm.

U.S. Bureau of Customs and Border Protection

.44 Since September 11, 2001, the U.S. Bureau of Customs and Border Protection (CBP) has played an increasing role in policing imports to the United States. To ease the daily burden on an organization that processes nearly 70 thousand truck, rail, and sea containers each day, CBP implemented a voluntary program to improve supply chain security. The Customs-Trade Partnership Against Terrorism (C-TPAT) and its subsidiary Free and Secure Trade (FAST) program include annual corporate self-assessments of supply chain security procedures in relation to C-TPAT criteria, including all outsourced elements such as foreign facilities or warehousing. Once these criteria are met and validated by CBP, there are substantial benefits for participants, including a reduced number of inspections, Front of the Line processing for inspections, and assignment of a CBP Supply Chain Security Specialist to assist with the process. For more information on these or other CBP programs or requirements, see www.cbp.gov.

Transportation Worker Identification Credential Program

.45 Two Department of Homeland Security divisions are implementing a program that is part of the 2002 Maritime Transportation Security Act. The Transportation Worker Identification Credential (TWIC) program will require 850,000 port workers to prove legal citizenship and pass a background check to obtain an ID card. According to the Transportation Security Administration, the affected workers include 110,000 truck drivers and may include a substantial number of illegal immigrants. An article in the *Wall Street Journal* put the number between 20 percent and 50 percent of the truck drivers. The program is expected to begin by the end of 2006. There is a potential for major impact on the nation's goods flow from and to seaports. For more information, see www.tsa.gov.

Audit and Accounting Issues Arising From Current Risks

Related Party Transactions

.46 The existence of related party transactions has always presented a concern for the auditor. There is a current trend toward vertical integration of the supply chain, as discussed in the "Supply Chain Security" section of this Alert, which may affect your manufacturing clients. The client often fails to understand the question fully when asked about the existence of related parties. The definition, according to FASB Statement No. 57, *Related Party Disclosures*, is as follows:

> Affiliates of the enterprise; entities for which investments are accounted for by the equity method by the enterprise; trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management; principal owners of the enterprise; its management; members of the immediate families of principal owners of the enterprise and its management; and other parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

.47 One way that the existence of related parties can be established is through inquiry of management during the planning process. It is often helpful to provide the client with examples to help understand your query. Transactions that frequently occur between related parties could include:

- Borrowing or lending money at no or low interest
- Real estate transactions for amounts significantly different from appraised value
- Nonmonetary like-kind exchanges
- Loans made without repayment terms
- Related vendors or customers
- Use of company or personal property with or without payment
- Guarantees of indebtedness
- Other noncash activity with a related party

.48 Once known, the auditor can evaluate the company's policies and procedures for identifying, recording, and disclosing related activity.

.49 It is important to be alert for evidence of nondisclosed related parties throughout the audit. Some useful sources in a search for related parties are board of directors meeting minutes, conflict-of-interests disclosure forms, large unusual or nonrecurring accounting entries, legal invoices, bank confirmations, and vendors or customers that account for a large percentage of activity.

.50 The fact that there are dealings with related parties does not indicate that they are not valid business transactions. Identifying such items is merely the first step. Material transactions may be tested to ensure that they are reasonable, have an appropriate business purpose and, where possible, were reviewed and approved by disinterested parties at the appropriate level. Documentation of the items should include names and relationships of the parties involved, amounts, and a description of the transactions for possible disclosure in the financial statements. Be sure to refer to FASB Statement No. 57 for complete disclosure criteria and requirements.

Management Override of Controls

.51 As described in AU section 319, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), the design, implementation, and monitoring of internal control are the responsibility of the entity's management. One of the most difficult types of fraud to detect is management override of internal control. Auditors often spend a good deal of time considering, documenting, and testing a client's controls. Within minutes, a supervisor in the accounts payable department can bypass one or more controls and establish a bogus vendor without a trace. The clerk that "just went ahead" and entered the vendor without the prerequisite background check is on the supervisor's bowling team and was just "helping him out." Now the groundwork has been laid for payments on fictitious invoices that will either fund the supervisor's retirement or allow him to spend it in state prison. The likelihood is that the clerk won't think twice about helping out a friend (the supervisor) because he doesn't realize the implications of overriding controls such as obtaining a credit report or references for potential vendors. He may not even understand why the controls exist in the first place.

.52 How do you find out if it's likely that overrides are occurring? AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), has several things for you to think about:

- Brainstorming. Adopt the mindset of the potential fraudster. For example, if you were the accounts payable supervisor, how could you steal from the client? What if you were the accounts receivable supervisor, the purchasing manager, or even the CFO? Who has access to the accounting records? Use the required brainstorming session to get inside the organization's controls and look for holes and potential conflicts-of-interest. Which categories of accounts are most likely to have misstatements and which of those are lacking the controls to expose them in the normal course of business?
- Inquiring. Try to ask questions of the people that no one thinks to ask. You may be introduced to the department manager but also ask to interview one or two of the frontline employees. The people with their hands in the mix might just have the best vantage point. Be careful in the way you phrase your questions and try to put the employee at ease. The least you will get is a better understanding that the controls are working as designed.
- Flowcharting. Consider the use of flowcharts to record the flow of documents and the approval/review process. A flowchart is a good way to visually identify control system overlaps and gaps. Microsoft Excel can be a valuable tool in this arena.

.53 Once you have identified the potential problems, tailor your audit program to address those areas in your testing. In addition, AU section 316.57 provides guidance on procedures to address management override of controls. If you suspect management override of controls, you should document your findings and review them with the appropriate level of management.

.54 You should also refer to AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1), which addresses additional responsibilities of the auditor with regard to internal control issues discussed in the "Evaluating Control Deficiencies" section, which follows.

.55 The AICPA Auditing Standards Board (ASB) has issued Statements on Auditing Standards (SASs) No. 104 through No. 111, referred to as the Risk Assessment Standards. A discussion of these standards and how they affect your audit can be found in the "Recent Auditing and Attestation Pronouncements and Related Guidance" section of this Alert.

Evaluating Control Deficiencies

.56 In May 2006, the 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.

.57 The standard requires that auditors (1) evaluate identified control deficiencies and determine whether these deficiencies, individually or in combination, are significant deficiencies or material weaknesses and (2) 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.

.58 Some examples of potential control deficiencies that you might find in manufacturing companies are:

- Lack of segregation of duties in the cash management function due to a small number of administrative staff and without effective compensating controls
- Management override of controls by owners of privately held companies or by project managers in the invoice approval process
- Inadequate monitoring of the financial accounting process to detect deficiencies in internal control by management
- Inadequate controls that would prevent improper revenue recognition through recording change orders that have not been approved
- Ineffective perpetual inventory controls that do not detect a material misstatement of inventory
- Inadequate controls due to a lack of client expertise in preparing financial statements including the process for identification, consolidation, and disclosure of VIEs

.59 The AICPA has published the Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk) to assist in the implementation of this Standard.

Compliance With Laws and Regulations

.60 While it is not a requirement under generally accepted audit standards to design procedures to detect illegal acts by clients, exercising professional skepticism and due diligence may bring issues to light. AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1), discusses the responsibilities of the auditor when encountering questionable activity. Audit procedures that may highlight concerns could be reading of meeting minutes, obtaining a legal representation letter from the client's attorney, and substantive testing of transactions. As a step in understanding the client, AU section 317.08 recommends inquiry of management regarding the client's policies for the prevention of illegal acts to gain insight into the client's compliance with laws and regulations. Some examples provided of items that may warrant additional testing include:

- Unauthorized transactions, improperly recorded transactions, or transactions not recorded in a complete or timely manner in order to maintain accountability for assets
- Investigation by a governmental agency, an enforcement proceeding, or payment of unusual fines or penalties
- Large payments for unspecified services to consultants, affiliates, or employees
- Unusually large payments in cash, purchases of bank cashiers' checks in large amounts payable to bearer, transfers to numbered bank accounts, or similar transactions

.61 It is important to consider the impact that illegal acts would have on your audit engagement and your client's financial statements. It may be necessary to take one or more of the following steps:

- Consider whether management needs to record or disclose a contingent liability (FASB Statement No. 5, *Accounting for Contingencies*)
- Consider the impact on the entity as a whole, including its ability to continue as a going concern (AU sec. 341A, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,* AICPA, *Professional Standards,* vol. 1)
- Communicate with audit firm owners and legal counsel
- Communicate with the client's legal counsel
- Communicate with an appropriate level of management, the audit committee, or others of similar authority
- Express a qualified or adverse opinion (AU sec. 508, *Reports on Audited Financial Statements,* AICPA, *Professional Standards,* vol. 1)
- Withdraw from the engagement
- Document findings and steps taken to resolve the issues

Contingencies

.62 FASB Statement No. 5 defines a contingency as "an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability." The purpose of gaining an understanding of contingencies is to properly reflect the financial position of an entity at the end of the reporting period.

.63 The difficulty in recording or disclosing contingent events relates to the heavy reliance on estimates. When determining that a contingency should be accrued, the statement requires that as of the date of the financial statements, "it is probable that an asset has been impaired or a liability had been incurred." Further determinations are required regarding the reasonableness of the amount to be accrued and whether the loss will be substantiated by future events. The term *probable* is defined as "the future event or events are likely to occur." Events occurring subsequent to the financial statement date can provide a valuable resource in your search for contingent items. It is clear that a thorough reading of FASB Statement No. 5 is required to properly apply the rules. Appropriate documentation should be kept with regard to potential contingency accruals and disclosures.

.64 Examples of items that may require accrual or disclosure are:

- Pending or threatened litigation, claims, or assessments, including those related to counterfeit products

- Defense of intellectual property rights
- Threat of expropriation of assets
- Environmental remediation
- Self-insurance
- Tax assessments
- Product warranties
- Guarantees of indebtedness

.65 Sample disclosures for these events can be obtained in AICPA *Accounting Trends and Techniques*, 60th Edition (product no. 009898kk).

.66 Items that are generally not accrued and may not require disclosure could include:

- Gain contingencies
- General business risks
- Appropriated retained earnings

.67 The goal of accruing or disclosing contingencies is to provide users with financial statements that are not misleading.

Recent Auditing and Attestation Pronouncements and Related Guidance

.68 Presented below is a list of auditing and attestation pronouncements, Guides, and other 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/members/div/auditstd/technic.htm. The PCAOB sets auditing and attestation standards for audits of public companies. See the PCAOB Web site at www.pcaobus.org for information about its activities. 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.

SAS No. 102, *Defining Professional Requirements in Statements on Auditing Standards* SSAE No. 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (December 2005)	These standards established two categories of professional requirements that are identified by specific terms. The words *must* or *is required* are used to indicate an unconditional requirement. The word *should* is used to indicate a presumptively mandatory requirement. (The words *may*, *might*, *could*, and *should consider* represent actions that auditors have a professional obligation to consider.) The provisions of SAS No. 102 and SSAE No. 13 were effective upon issuance. The ASB intends to make conforming changes to AICPA literature over the next several years to remove any language that would imply a professional requirement where none exists.

SAS No. 103, *Audit Documentation* (December 2005)	SAS No. 103 supersedes AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), 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.
SASs No. 104 through No. 111, Risk Assessment Standards	See the "Spotlight" section in this Alert.
SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (May 2006)	The new standard supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, as amended. 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. Effective for periods ending on or after December 15, 2006.
PCAOB Auditing Standard No. 4 (February 2006) (Applicable to audits conducted in accordance with PCAOB standards only)	*Reporting on Whether a Previously Reported Material Weakness Continues to Exist* This standard applies if auditors report on the elimination of a material weakness in a company's internal control over financial reporting. The standard establishes a voluntary engagement that would be performed at the election of the company.
PCAOB Conforming Amendment to AT section 101.04*f*, *Attest Engagements* (February 2006) (Applicable to audits conducted in accordance with PCAOB standards only)	*Conforming Amendment to PCAOB Auditing and Related Professional Practice Standards Resulting from the Adoption of the Auditing Standard No. 4* This states that Auditing Standard No. 4 must be used for reporting on whether a material weakness continues to exist for any purpose other than a company's internal use.

Spotlight on the AICPA Risk Assessment Standards

.69 In March 2006, the ASB issued eight SASs that provide extensive guidance concerning the auditor's assessment of the risks of material misstatement in a financial statement audit, and the design and performance of audit procedures whose nature, timing, and extent are responsive to the assessed risks. Additionally, the SASs establish standards and provide guidance on planning and supervision, the nature of audit evidence, and evaluating whether the audit evidence obtained affords a reasonable basis for an opinion regarding the financial statements under audit. The following table lists the eight SASs and their effect 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")*	Amends SAS No. 1, *Due Professional Care in the Performance of Work* (AU section 230)
SAS No. 105, *Amendment to Statement on Auditing Standards No. 95*, Generally Accepted Auditing Standards	Amends SAS No. 95, *Generally Accepted Auditing Standards* (AU section 150)
SAS No. 106, *Audit Evidence*	Supersedes SAS No. 31, *Evidential Matter* (AU section 326A)
SAS No. 107, *Audit Risk and Materiality in Conducting an Audit*	Supersedes SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AU section 312A)
SAS No. 108, *Planning and Supervision*	Supersedes SAS No. 1, *Appointment of the Independent Auditor* (AU section 310); and supersedes SAS No. 22, *Planning and Supervision* (AU section 311A)
SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*	Supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AU section 319)
SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*	Supersedes SAS No. 45, *Substantive Tests Prior to the Balance-Sheet Date* (AU section 313); and together with SAS No. 109, supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AU section 319)
SAS No. 111, *Amendment to Statement on Auditing Standards No. 39*, Audit Sampling	Amends SAS No. 39, *Audit Sampling* (AU section 350)

Key Provisions of the New Standards

.70 The SASs emphasize the link between understanding the entity, assessing risks, and the design of further audit procedures. The SASs introduce the concept of risk assessment procedures, which are deemed necessary to provide a basis for assessing the risk of material misstatement. Risk assessment procedures, along with further audit procedures, which consist of tests of controls and substantive tests, provide the audit evidence to support the auditor's opinion of the financial statements. According to the SASs, the auditor should perform risk assessment procedures to gather information and gain an understanding of the entity and its environment, including its internal control. These procedures include inquiries, analytical procedures, and inspection and observation. Assessed risks and the basis for those assessments should be documented; therefore, auditors may no longer default to maximum control risk for an entity's risk assessment without documenting the basis for that assessment. The SASs also require auditors to consider and document how the risk assessment at the financial statement level affects individual financial statement assertions, so that auditors may tailor the nature, timing, and extent of their audit procedures to be responsive to their risk assessment. It is anticipated that generic audit programs will not be appropriate for all audit engagements, as risks vary between entities.

Effective Date and Implementation

.71 The SASs are effective for audits of financial statements for periods beginning on or after December 15, 2006; earlier application is permitted. In some cases, implementation of the SASs may result in an overall increased work effort by the audit team, particularly in the year of implementation. It also is anticipated that to implement the SASs appropriately, some firms will have to make significant revisions to their audit methodologies and train their personnel accordingly. Readers can obtain the SASs and the related AICPA Audit Risk Alert titled *Understanding the New Auditing Standards Related to Risk Assessments* (product no. 022526kk) at www.cpa2biz.com.

New Companion Audit Guide

.72 In December 2006, the AICPA published an Audit Guide titled *Assessing and Responding to Audit Risk in a Financial Statement Audit*. This guide will help practitioners 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.

SAS No. 103

.73 The ASB has issued SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), which supersedes SAS No. 96 of the same name 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. One key provision of this standard is the amendment of AU section 530.01 and .05, which 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." The footnote to this section 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 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.

Staff Accounting Bulletin No. 108

.74 On September 13, 2006, the 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.

.75 There have been two common approaches used to quantify such errors. Using 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 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.

.76 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.

.77 If, in correcting a prior year error in the current year, the amount 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 the SAB. 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.

Recent AICPA Independence and Ethics Pronouncements

.78 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.

.79 The AICPA general *Audit Risk Alert—2006/07* and other AICPA industry-specific Alerts contain summaries of recent pronouncements not included here. To obtain copies of AICPA standards and Guides, contact AICPA Service Center Operations at (888) 777-7077 or go online at www.cpa2biz.com.

Recent Accounting Pronouncements and Related Guidance

.80 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. 155	*Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*
FASB Statement No. 156	*Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140*
FASB Statement No. 157	*Fair Value Measurements*
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)*
FASB Interpretation No. 48	*Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*
FASB EITF Issues (Various dates)	Go to www.fasb.org/eitf/about_eitf.shtml for a complete list of EITF Issues.
FASB Staff Positions (Various dates)	Go to www.fasb.org/fasb_staff_positions/index.shtml for a complete list of FASB Staff Positions (FSP). Some of the recently issued FSPs address issues relating to FASB Statements No. 143 and No. 150, among others; and FASB Interpretation 46(R).

AICPA Technical Practice Aids 2130.09–.35 (December 2005) (Nonauthoritative)	Various topics on the application of Statement of Position (SOP) 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer* to Debt securities
AICPA Technical Practice Aids 5600.07–.17 (November 2005) (Nonauthoritative)	Various lease topics
AICPA Technical Practice Aid 6910.16–.20 (January 2006) (Nonauthoritative)	"Nonregistered Investment Partnerships"

On the Horizon

.81 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 manufacturing industry or that may result in very significant changes. Read the AICPA general *Audit Risk Alert—2006/07* for a more extensive list of ongoing auditing and accounting projects. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing generally accepted accounting principles (GAAP) or GAAS.

.82 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 beyond 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/
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.pcaobus.org or www.pcaob.com
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/members/div/ethics/index.htm
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 above.

Auditing Pipeline

Proposed Statement on Standards for Attestation Engagements, Reporting on an Entity's Internal Control Over Financial Reporting *(AT section 501)*

.83 In January 2006, the ASB issued a revised exposure draft of a proposed 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 would establish standards and provide 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). Additionally, the new definitions of *significant deficiency* and *material weakness* provided by SAS No. 112 have been incorporated into AT section 501. In May 2006, the PCAOB announced plans to amend certain aspects of PCAOB Auditing Standard No. 2 to improve its implementation. Because the forthcoming changes to the PCAOB Standard will be relevant to the revision of AT section 501, the ASB has decided to defer the issuance of final revised AT section 501 until the PCAOB issues its amendments and the ASB has time to consider them.

Proposed Amendment to SAS No. 69, The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles,* for Nongovernmental Entities

.84 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 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 FASB proposed statement, which can be obtained at www. fasb.org.

Proposed Statement on Auditing Standards, The Auditor's Communication With Those Charged With Governance

.85 This proposed SAS would replace AU section 380A, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1), and establish standards and provide guidance to an auditor on matters to be communicated with those charged with governance. Among other matters, the proposed SAS identifies specific matters to be communicated and also would amend AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1). Readers should be alert for the issuance of a final standard.

Accounting Pipeline

Proposed FASB Statement The Hierarchy of Generally Accepted Accounting Principles

.86 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 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 Statement Accounting for Transfers of Financial Assets

.87 The exposure draft *Accounting for Transfers of Financial Assets* (Transfers Project) is a revision of a June 2003 exposure draft, *Qualifying Special-Purpose Entities and Isolation of Transferred Assets,* and would amend FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The proposed Statement seeks to (1) clearly specify the permitted activities of a qualifying special-purpose entity (QSPE), (2) address practice issues related to which arrangements should be considered and how they should be considered in the legal isolation analysis, (3) eliminate the prohibition on a QSPE's ability to hold passive derivative financial instruments that pertain to beneficial interests held by a transferor, (4) revise the methodology used to initially measure at fair value interests related to transferred financial assets held by a transferor, and (5) clarify guidance related to when rollovers of beneficial interests are permitted within a QSPE. At its July 26, 2006, meeting, the FASB decided to combine the servicer discretion project (which addressed issues relating to the waiver of due-on-sale, collateral substitution, and foreclosed asset activities) into the Transfers Project. The FASB expects to issue a final Statement, which would amend FASB Statement No. 140, in the second quarter of 2007. See the FASB Web site at www.fasb.org for complete information.

Proposed FASB Statement The Fair Value Option for Financial Assets and Financial Liabilities—Including an Amendment of FASB Statement No. 115

.88 The fair value option project has two phases. This proposal represents Phase 1, which addresses the fair value option for certain financial assets and financial liabilities. Phase 2 will consider permitting the fair value option for certain nonfinancial assets and nonfinancial liabilities and some of the financial assets and financial liabilities excluded from the scope of Phase 1.

.89 The proposed FASB Statement would create a fair value option under which an entity may irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and financial liabilities on a contract-by-contract basis, with changes in fair value recognized in earnings as those changes occur. The proposed FASB Statement has specific financial presentation requirements to display fair values and those values that are measured using other measurement techniques. The proposed FASB Statement would amend FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* to require that securities reported at fair value in accordance with FASB Statement No. 115 satisfy the specific financial statement presentation requirements. Visit the FASB Website at www.fasb.org for additional information.

Proposed FASB Statements, Business Combinations *and* Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries

.90 In these proposed FASB Statements, the FASB plans to revise the existing guidance on the application of the purchase method. The following are among the main proposals:

1. That all acquisitions of businesses be measured at the fair value of the business acquired.

2. That substantially all the assets acquired and liabilities assumed of the acquired business be recognized and measured at their fair values at the acquisition date.

3. That entities that follow U.S. GAAP and international standards apply substantially the same accounting requirements for their business combinations.

.91 Exposure drafts on business combinations—purchase method procedures and noncontrolling interests—were issued on June 30, 2005. Visit the FASB Web site for further information.

FASB Project on Derivative Disclosures

.92 FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, has been criticized by certain analysts, auditors, investors, and others for lacking transparent disclosures, allowing a user of the financial statements to assess the overall risk of derivatives on a reporting entity from both a quantitative and qualitative perspective. An exposure draft on derivative disclosures is expected in the fourth quarter of 2006 or early 2007. The objective 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. Additionally, the project is expected to reconsider the existing disclosure requirements under FASB Statement No. 133 for relevance and applicability. It is also expected that derivative loan commitments will fall under the scope of this project and could have a significant impact on the financial statements of entities with derivative loan commitments.

Proposed FASB EITF Issues

.93 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.

Proposed FASB Staff Positions

.94 A number of proposed FASB Staff Positions are in progress addressing issues related to financial institutions. Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/proposed_fsp.shtml for complete information.

AICPA Resource Central

.95 Educational courses, publications, and other resources available to practitioners are listed here.

On the Bookshelf

.96 The following publications deliver valuable guidance and practical assistance as potent tools to be used on your engagements:

- Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (product no. 012776kk). This Audit Guide is designed to provide guidance to auditors reporting on a service organization's controls. This Guide also provides guidance to auditors of companies that use service organizations. In addition, it has been revised as of May 1, 2006, to reflect certain changes necessary because of the issuance of authoritative pronouncements.

- Audit Guide *Analytical Procedures* (product no. 012556kk). Receive guidance on the effective use of analytical procedures with an emphasis on analytical procedures as substantive tests.

- *Accounting Trends & Techniques*, 60th Edition (product no. 009898kk). This is the must-have resource for any CPA who frequently creates or uses financial reports. Filled with current reporting techniques and methods used by the nation's top organizations, this 650-page AICPA bestseller will provide guidance you need to improve your accounting preparation and procedures.

- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (product no. 012526kk). This Guide has been updated with conforming changes as of May 1, 2006. In it you'll find an overview of derivatives and securities, in addition to case studies to help you better understand auditing derivative instruments.

- Audit Guide *Auditing Revenue in Certain Industries* (product no. 012516kk). This publication, as of May 1, 2006, assists auditors in fulfilling their professional responsibilities with regard to auditing assertions about revenue.

- *Audit and Accounting Manual* (product no. 005136kk) is developed exclusively for small- and medium-size CPA practices. This unique manual explains and demonstrates useful techniques and procedures for conducting compilation, review, and audit engagements—from planning to internal control to accountants' reports.

AICPA reSOURCE: Online Accounting and Auditing Literature

.97 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's 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.

Educational Courses

.98 The AICPA has developed a number of continuing professional education (CPE) courses that are valuable to CPAs working in the manufacturing industry. Those courses include:

- *Auditing Inventory* (product no. 738340HSkk). This interactive CD-ROM course will teach you all you need to know to audit inventory effectively and efficiently. The course covers accounting principles, audit risks, performing an inventory observation, and reviewing the inventory amount. All this is taught with interactive exercises and a video inventory observation in which you participate.
- *Information Security: Critical Guidance for CPAs in Public Practice and Industry* (product no. 732451kk). This course informs participants about security for systems developed with new technology and what part the assessment of risk plays in developing controls to secure these systems.
- *SEC Reporting* (product no. 736773kk [text] and 186754kk [video]). 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. Learn to apply Regulations S-X, S-K, and other SEC guidance, prepare or review financial statements and their related disclosures, and more. This course benefits financial reporting managers of registrants or companies planning to go public as well as managers and partners in public practice with SEC registrants as clients.

.99 Accountants in the manufacturing industry, as well as in other industries, may also find the following courses helpful:

- *Accounting Update: A Review of Recent Activities* (2006 edition) (product no. 732762kk). This course keeps you current and shows you how to apply the most recent financial accounting and reporting standards. Highlights include FASB Statement No. 154 on accounting changes and error corrections, fair value concepts and measurements, and the revised FASB Statement No. 123 on share-based payment.
- *FASB Review for Industry* (2006-2007 edition) (product no. 730563kk). Comprehensive coverage of recent FASB, AcSEC, IASB, and EITF pronouncements is provided in this course geared to the specific interests of the CPA in corporate management.
- *AICPA's Annual Accounting and Auditing Update Workshop* (2006 edition) (product no. 736182kk, text; also available in video and DVD formats with a manual). 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.
- *Accounting for Income Taxes: Applying SFAS No. 109/FIN 48: A Whole New Ballgame!* (product no. 732792kk). No other area in accounting is as far reaching, and requires knowledge of a vast number

of topics in financial and tax accounting, as accounting for deferred taxes. This course addresses the application of this complex standard to many common differences between financial accounting and tax compliance. You will gain a sound knowledge of the theory of deferred taxes and how this theory can be applied to practical situations. Many practical examples are included to illustrate the theory, and the information is presented so you will be able to apply this theory to any other situation that you may encounter.

- *The AICPA's Guide to Business Consolidations, Goodwill and Other Consolidation Issues* (product no. 735134kk). Learn how FASB Statements No. 141 and No. 142 have changed the rules for business combinations and goodwill accounting. Develop standards for applying purchase accounting and how to allocate the acquired entity now that it's the only game in town under FASB Statement No. 141. Identify variable interest entities' impact under FASB Interpretation No. 46(R). Learn how FASB Statement No. 142 deals with goodwill from initial recognition to the annual impairment review requirements.

.100 For a listing of additional courses available, please download the *Fall/Winter 2006 AICPA CPE Catalog* at www.cpa2biz.com/CPE/default.htm.

Online CPE

.101 AICPA CPExpress (formerly 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 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. Some topics of special interest to construction company auditors are:

- *2006 Annual Update-A&A: Issues for Audits of Nonpublic Entities on the Horizon*
- *2006 Annual Update-A&A: Issues for Audits of Public Entities on the Horizon*
- *Just-in-Time Systems, Economic and Market-Value-Added*
- *Revenue Recognition: Income Statement Presentation and Disclosures*

.102 To register or learn more, visit www.cpa2biz.com.

Webcasts

.103 Stay plugged in to what's 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 on the discussion. If you can't make the live event, each webcast is archived and available on CD-ROM.

CFO Quarterly Roundtable Series

.104 The CFO 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

.105 The SEC Quarterly Update Webcast Series—brought to you each calendar quarter—showcases the profession's leading experts on what's "hot" at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and CorpFin activities, these hard-hitting sessions will keep you "plugged in" to what's important. A must for both 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.

Technical Hotline and Ethics Hotline

.106 Do you have a complex technical question about GAAP, other comprehensive bases of accounting (OCBOA), 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.

.107 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.

Service Center Operations

.108 To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Service Center Operations at (888) 777-7077.

.109 This Audit Risk Alert replaces the *Manufacturing Industry Developments—2005/06* Audit Risk Alert. The Alert is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Alert would also be appreciated. You may e-mail these comments to ccole@aicpa.org, or write to:

Christopher Cole, CPA CFE
AICPA
Palladian Corporate Center
220 Leigh Farm Road
Durham, NC 27707-8110

[*The next page is 8987.*]

AAM Section 8240

Independence and Ethics Alert—2006/07

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

Lori L. Pombo, CPA
Technical Manager
Accounting and Auditing Publications

Acknowledgments

We thank and acknowledge Lisa Snyder, CPA, Director, AICPA Professional Ethics Division, for her significant and valuable contributions to the development of this Alert.

How This Alert Helps You

.01 This Alert informs you of recent developments in the area of independence and ethics for accountants—an area 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 (the 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 back of this Alert so you can understand and apply them with greater confidence.

Independence Defined

.02 *Independence* is defined as:

1. *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; and
2. *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 has been compromised.

AICPA Independence and Ethics Developments

Two New Ethics Rulings on Gifts and Entertainment

.03 On October 26, 2005, the Professional Ethics Executive Committee (PEEC) adopted Ethics Ruling No. 113, "Acceptance or Offering of Gifts or Entertainment," under Rule 102, *Integrity and Objectivity* (AICPA, *Professional Standards*, vol. 2, ET sec. 191.226–.227), and Ethics Ruling No. 114, "Acceptance or Offering of Gifts and Entertainment to or From an Attest Client," under Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 191.228–.229). The new rulings 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. The PEEC also deleted Ethics Ruling No. 1, "Acceptance of a Gift," under Rule 101 (AICPA, *Professional Standards*, vol. 2, ET sec. 191.001–.002) because the substance of this ethics ruling was incorporated into Ethics Ruling No. 114.

Acceptance or Offering of Gifts or Entertainment

.04 Ethics Ruling No. 113 under Rule 102 is applicable to members in public practice with respect to all clients as well as to members in business and industry with respect to the customers and vendors of their employers, and provides that objectivity would not be considered to be impaired if a member offers or accepts gifts or entertainment to or from a client (including certain individuals associated with a client) or a customer or vendor of the member's employer (including representatives of the customer or vendor), provided the gift or entertainment is "reasonable in the circumstances."

.05 In determining whether gifts or entertainment are "reasonable in the circumstances," the ruling directs the member to exercise judgment. Relevant facts and circumstances include, but are not limited to:

- The nature of the gift or entertainment
- The occasion giving rise to the gift or entertainment
- The cost or value of the gift or entertainment
- The nature, frequency, and value of other gifts and entertainment offered or accepted
- Whether the entertainment was associated with the active conduct of business either directly before, during, or after the entertainment
- Whether other clients, customers, or vendors also participated in the entertainment
- The individuals from the client, customer, or vendor and the member's firm or employer who participated in the entertainment

.06 In addition, the ruling makes it clear that permitted gifts or entertainment should not violate a member, client, customer, or vendor's own policies governing gifts and entertainment, or applicable laws and regulations.

Acceptance or Offering of Gifts and Entertainment to or From an Attest Client

.07 Ethics Ruling No. 114 under Rule 101 incorporates the substance of the existing guidance contained in Ethics Ruling No. 1 and is applicable to members in public practice who are "covered members" with respect to an attest client of the member's firm. The ethics ruling provides that independence would be considered impaired if an individual on the attest engagement team or in a position to influence the attest engagement accepts a gift from an attest client unless the value is clearly insignificant to the member. In addition, since a member may also offer a gift to an attest client, the proposal also provides that as long as the gift offered was "reasonable in the circumstances," independence would not be considered impaired. With respect to entertainment, the proposal provides that covered members should be able to offer or accept entertainment to or from an attest client provided the entertainment is "reasonable in the circumstances."

Effective Date

.08 The ethics rulings became effective on January 21, 2006. Ethics Ruling No. 113 under Rule 102 can be found at www.aicpa.org/about/code/et_191.html#et_191_ruling_113 and Ethics Ruling No. 114 under Rule 101 can be found at www.aicpa.org/about/code/et_191.html#et_191_ruling_114.

Basis for Conclusions

.09 The PEEC also developed a basis for conclusion document which summarizes considerations that were deemed significant by the PEEC in the development of the new ethics rulings. It can be found at www.aicpa.org/download/ethics/Gifts_Basis_Document.pdf.

New Conceptual Framework for Independence Standards and Revision to "Other Considerations" of Interpretation No. 101-1

.10 In January 2006, the PEEC adopted a "Conceptual Framework for AICPA Independence Standards" (Conceptual Framework) (AICPA, *Professional Standards*, vol. 2, ET sec. 100.01), and a related revision to "Other Considerations" of Interpretation No. 101-1, "Interpretation of Rule 101" (AICPA, *Professional Standards*, vol. 2, ET sec. 101.02), under Rule 101.

.11 The revision to Interpretation No. 101-1 ("Other Considerations" section) requires members to use the Conceptual Framework when making independence decisions involving matters that are not specifically addressed in the independence interpretations and rulings in the Code. Interpretation No. 101-1 also states if the threats to independence are not at an acceptable level, safeguards should 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 should be documented.

.12 The provisions of the Conceptual Framework are discussed below.

Risk-Based Approach of the Conceptual Framework

.13 The Conceptual Framework provides a valuable tool to members in complying with the requirement in the "Other Considerations" section of Interpretation No. 101-1 to evaluate whether a specific circumstance that is not addressed in the Code would pose an unacceptable threat to a member's independence.[1] The Conceptual Framework, which is used by the PEEC when it develops independence standards, uses a risk-based approach to analyze independence matters.

.14 The risk-based approach entails evaluating the risk that the member would not be independent or would be perceived by a reasonable and informed third party having knowledge of all relevant information as not being independent. That risk must be reduced to an acceptable level to conclude that a member is independent under the concepts in this framework. Risk is at an acceptable level when threats are at an acceptable level, either because of the types of threats and their potential effect, or because safeguards have sufficiently mitigated or eliminated the threats. Threats are at an acceptable level when it is not reasonable to expect that the threat would compromise professional judgment.

.15 The risk-based approach involves the following steps:

a. Identifying and evaluating threats to independence.

b. Determining whether safeguards already eliminate or sufficiently mitigate identified threats and whether threats that have not yet been mitigated can be eliminated or sufficiently mitigated by safeguards.

---

[1] Members should note that under no circumstances should the Conceptual Framework be used to overcome specific prohibitions or requirements contained in the independence interpretations and rulings in the Code.

c. If no safeguards are available to eliminate an unacceptable threat or reduce it to an acceptable level, independence would be considered impaired.

These steps are discussed in more detail below.

Identifying and Evaluating Threats to Independence

.16 Threats should be identified and evaluated, both individually and in the aggregate, because threats can have a cumulative effect on a member's independence.

.17 Threats to independence are circumstances that could impair independence. Whether independence is impaired depends on the nature of the threat, whether it would be reasonable to expect that the threat would compromise the member's professional judgment and, if so, the specific safeguards applied to reduce or eliminate the threat, and the effectiveness of those safeguards.

.18 Many different circumstances (or combinations of circumstances) can create threats to independence. It is impossible to identify every situation that creates a threat. However, the following seven broad categories of threats should always be evaluated when threats to independence are being identified and assessed.

Categories of Threats to Be Evaluated

Threat	*Description*	*Example(s)*
Self-Review	Members reviewing as part of an attest engagement evidence that results from their own, or their firm's, nonattest work.	• Preparing source documents used to generate the client's financial statements.
Advocacy	Actions promoting an attest client's interests or position.	• Promoting the client's securities as part of an initial public offering. • Representing a client in U.S. tax court.
Adverse Interest	Actions or interests between the member and the client that are in opposition.	• Commencing, or the expressed intention to commence, litigation by either the client or the member against the other.
Familiarity	Members having a close or longstanding relationship with an attest client or knowing individuals or entities (including by reputation) who performed nonattest services for the client.	• A member of the attest engagement team whose spouse is in a key position at the client, such as the client's chief executive officer. • A partner of the firm who has provided the client with attest services for a prolonged period. • A member who performs insufficient audit procedures when reviewing the results of a nonattest service because the service was performed by the member's firm. • A member of the firm having recently been a director or officer of the client.

		• A member of the attest engagement team whose close friend is in a key position at the client.
Undue Influence	Attempts by an attest client's management or other interested parties to coerce the member or exercise excessive influence over the member.	• A threat to replace the member or the member's firm over a disagreement with client management on the application of an accounting principle. • Pressure from the client to reduce necessary audit procedures for the purpose of reducing audit fees. • A gift from the client to the member that is other than clearly insignificant to the member.
Financial Self-Interest	Potential benefit to a member from a financial interest in, or from some other financial relationship with, an attest client.	• Having a direct financial interest or material indirect financial interest in the client. • Having a loan from the client, from an officer or director of the client, or from an individual who owns 10 percent or more of the client's outstanding equity securities. • Excessive reliance on revenue from a single attest client. • Having a material joint venture or other material joint business arrangement with the client.
Management Participation	Taking on the role of client management or otherwise performing management functions on behalf of an attest client.	• Serving as an officer or director of the client. • Establishing and maintaining internal controls for the client. • Hiring, supervising, or terminating the client's employees.

.19 Where threats are identified but, due to the types of threats and their potential effects, such threats are considered to be at an acceptable level (that is, it is not reasonable to expect that the threats would compromise professional judgment), the consideration of safeguards is not required. If identified threats are not considered to be at an acceptable level, safeguards should be considered as described below.

Determining Whether Safeguards Mitigate or Eliminate Threats

.20 Safeguards are controls that mitigate or eliminate threats to independence. Safeguards range from partial to complete prohibitions of the threatening circumstance to procedures that counteract the potential influence of a threat. The nature and extent of the safeguards to be applied depend on many factors, including the size of the firm and whether the client is a public interest entity.[2] To be effective, safeguards should eliminate the threat or reduce to an acceptable level the threat's potential to impair independence.

[2] Refer to footnote 5 of the Conceptual Framework (AICPA, *Professional Standards*, vol. 2, ET sec. 100.01.20), for the definition of a *public interest entity* as used in the Conceptual Framework.

.21 To determine whether safeguards already eliminate or sufficiently mitigate identified threats and whether threats that have not yet been mitigated can be eliminated or sufficiently mitigated by safeguards, the effectiveness of the safeguards should be considered. The effectiveness of safeguards depends on many factors, including those listed here:

a. The facts and circumstances specific to a particular situation

b. The proper identification of threats

c. Whether the safeguard is suitably designed to meet its objectives

d. The party or parties that will be subject to the safeguard

e. How the safeguard is applied

f. The consistency with which the safeguard is applied

g. Who applies the safeguard

.22 Different safeguards can mitigate or eliminate different types of threats, and one safeguard can mitigate or eliminate several types of threats simultaneously. When threats are sufficiently mitigated by safeguards, the threats' potential to compromise professional judgment is reduced to an acceptable level. A threat has been sufficiently mitigated by safeguards if, after application of the safeguards, it is not reasonable to expect that the threat would compromise professional judgment.

.23 Per revised Interpretation No. 101-1 (as previously discussed), in cases where a threat to independence is not at an acceptable level before the application of safeguards, members are required to document that threat and the safeguards applied to eliminate it or reduce it to an acceptable level. This is a new requirement that is consistent with the International Federation of Accountants Code of Ethics for Professional Accountants. A failure to prepare the documentation would be considered a violation of Rule 202, *Compliance With Standards* (AICPA, *Professional Standards,* vol. 2, ET sec. 202.01), but would not result in an independence impairment, provided the member can demonstrate that he or she did apply safeguards to eliminate the unacceptable threat or reduce it to an acceptable level.

.24 Refer to the Conceptual Framework for numerous examples of the various types of safeguards.

Determining When Independence Is Impaired

.25 If no safeguards are available to eliminate an unacceptable threat or reduce it to an acceptable level, independence would be considered impaired.

Effective Date

.26 The provisions of the Conceptual Framework and the related revision to "Other Considerations" of Interpretation No. 101-1 are effective for all independence decisions made after April 30, 2007. Earlier application is encouraged. The Conceptual Framework can be found at www.aicpa.org/about/code/et_100.html and the revised "Other Considerations" section in Interpretation No. 101-1 can be found at www.aicpa.org/about/code/et_101.html#et_101.02.

Revised Ethics Interpretation on Requests for Client Records

.27 In January 2006, the PEEC adopted revisions to Ethics Interpretation No. 501-1, "Response to Requests by Clients and Former Clients for Records," under Rule 501, *Acts Discreditable* (AICPA, *Professional Standards*, vol. 2, ET sec. 501.02), and Ethics Ruling No. 189, "Requests for Records Pursuant to Interpretation 501-1," of ET section 591, *Ethics Rulings on Other Responsibilities and Practices* (AICPA, *Professional Standards*, vol. 2, ET sec. 591.377–.378), 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 four categories of documents and provides guidance when each is required to be made available to clients, as presented in the table below:

Document Type	*Description*	*Member's Requirement Upon Request From Client*
Client-provided records	Accounting or other records belonging to the client that were provided to the member by or on behalf of the client.	When in the member's custody or control, client-provided records should be returned to the client.
Client records prepared by the member	Accounting or other records (for example, tax returns, general ledgers, subsidiary journals, and supporting schedules such as detailed employee payroll records and depreciation schedules) that the member was engaged to prepare for the client.	Should be provided to the client, except that client records prepared by the member may be withheld if the preparation of such records is not complete or there are fees due the member for the engagement to prepare those records.
Supporting records	Information not reflected in the client's books and records that are otherwise not available to the client, with the result that the client's financial information is incomplete. For example, supporting records include adjusting, closing, combining, or consolidating journal entries (including computations supporting such entries) that are produced by the member during an engagement (for example, an audit).	When relating to a completed and issued work product, supporting records should be provided to the client, except that such supporting records may be withheld if there are fees due to the member for the specific work product.
Member's working papers	Include, but are not limited to, audit programs, analytical review schedules, and statistical sampling results, analyses, and schedules prepared by the client at the request of the member.	Member's working papers are the member's property and need not be provided to the client under provisions of this interpretation; however, such requirements may be imposed by state and federal statutes and regulations, and contractual agreements.

.28 Once the member has complied with the requirements above for client-provided records, client records prepared by the member, or supporting records, he or she is under no ethical obligation to comply with any subsequent requests to again provide such records or copies of such records. However, if subsequent to complying with a request, a client experiences a loss of records due to a natural disaster or an act of war, the member should comply with an additional request to provide such records.

.29 In connection with any request for client-provided records, client records prepared by the member, or supporting records, the member may:

- Charge the client a reasonable fee for the time and expense incurred to retrieve and copy such records and require that such fee be paid prior to the time such records are provided to the client;
- Provide the requested records in any format usable by the client;[3] and

[3] The member is not required to convert records that are not in electronic format to electronic format. However if the client requests records in a specific format and the member was engaged to prepare the records in that format, the client's request should be honored.

- Make and retain copies of any records returned or provided to the client.

.30 The revised interpretation also states that the member should comply with the client's request as soon as practicable but, absent extenuating circumstances, no later than 45 days after the request is made. The fact that the statutes of the state in which the member practices grants the member a lien on certain records in his or her custody or control does not relieve the member of his or her obligation to comply with this interpretation. In addition, certain states have laws and regulations that impose obligations on the member greater than the provisions of this interpretation and should be complied with.

.31 In addition, the committee has deleted Ethics Ruling No. 182, "Termination of Engagement Prior to Completion," of ET section 591 (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.

Effective Date

.32 Revised Interpretation No. 501-1 became effective April 30, 2006 and can be found at www.aicpa.org/about/code/et_500.html#et_501.02.

New PCAOB Independence and Ethics Rules

.33 (Please refer to "PCAOB Rules Regarding Independence and Ethics" in the section in this Alert entitled "Compliance Reminder Regarding Other Authoritative Bodies" for additional information regarding the Public Company Accounting Oversight Board's (PCAOB) independence and ethics rules.)

.34 On July 26, 2005 the PCAOB adopted seven independence and ethics rules pertaining to independence, tax services, and contingent fees. Pursuant to section 107(b) of the Sarbanes-Oxley Act, these rules were approved by the Securities Exchange Commission (SEC) on April 19, 2006.

.35 The ethics and independence rules cover three primary areas:

1. Fundamental ethics and independence requirements,
2. Contingent fees, and
3. Prohibited tax services that impair auditor independence and audit committee preapproval of certain tax services.

Each of these areas is described in further detail below.

Fundamental Ethics and Independence Requirements

.36 Rule 3502, *Responsibility Not to Knowingly or Recklessly Contribute to Violations*, codifies, in an ethics rule, the principle that persons associated with a registered public accounting firm should not take or omit to take an action knowing, or recklessly not knowing, that the act or omission would directly and substantially contribute to a violation by that registered public accounting firm of relevant laws, rules, and professional standards. Rule 3502 became effective April 29, 2006.

.37 Rule 3520, *Auditor Independence*, establishes a general obligation requiring registered public accounting firms and persons associated with them to be independent of the firm's audit clients throughout the audit and professional engagement period. Rule 3520 became effective April 29, 2006.

Contingent Fees

.38 Rule 3521, *Contingent Fees*, states that a registered accounting firm is not independent if it provides any service or product to the audit client for a contingent fee or a commission, or receives from the audit client, directly or indirectly, a contingent fee or commission. 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.

Prohibited Tax Services and Audit Committee Preapproval

.39 Rule 3522, *Tax Transactions*, states that a registered accounting firm is not independent if it provides any nonaudit service to the audit client related to marketing, planning, or opining in favor of the tax treatment of a transaction that is confidential or that was initially recommended, directly or indirectly, by the registered public accounting firm and a significant purpose of which is tax avoidance, unless the proposed tax treatment is at least more likely than not to be allowable under applicable tax laws. Rule 3522 does not apply to tax services that were completed by a registered public accounting firm no later than June 18, 2006.

.40 Rule 3523, *Tax Services for Persons in Financial Reporting Oversight Roles*, states that a registered accounting firm is not independent if it provides tax services to a person in a financial reporting oversight role at the audit client, or an immediate family member of such person. Certain exceptions exist for persons who are in a financial reporting oversight role as a result of service on the audit client's board of directors; employed by certain affiliates of the audit client; or hired, promoted, or other change in employment event, provided the tax service was (1) in process before the employment event and (2) completed within 180 days after the event. Rule 3523 does not apply to tax services being provided pursuant to an engagement in process on April 19, 2006, provided that such services are completed before October 31, 2006.

.41 Rule 3524, *Audit Committee Pre-approval of Certain Tax Services*, discusses what a registered accounting firm should do when seeking audit committee preapproval to perform for an audit client any permissible tax service. Specifically, the rules require a registered public accounting firm seeking preapproval to (1) describe proposed tax service 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. Rule 3524 does not apply to any tax service preapproved on an engagement-by-engagement basis before June 18, 2006. For tax services provided to audit clients whose audit committees preapproved tax services pursuant to policies and procedures, this rule will not apply to any such tax service that is begun by April 20, 2007.

Additional Information

.42 Rule 3501, *Definition of Terms*, defines the terms used in the rules. Rule 3501 became effective April 29, 2006.

.43 More detailed information regarding these rules can be found on the PCAOB Web site at www.pcaobus.org/Rules/Rules_of_the_Board/tax_t.aspx.

Compliance Reminder Regarding Other Authoritative Bodies

.44 The independence and ethics rules under the AICPA Code of Professional Conduct apply to all members of the AICPA. However, other rule-making and standard-setting bodies such as the SEC, the 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/or ethics rules that members must comply with, if applicable, in addition to the AICPA rules. The rules of the SEC, PCAOB, and GAO are discussed briefly below. You should refer to the original text of each organization's rules for full guidance.

SEC Rules Regarding Auditor Independence

.45 Of continuing importance to auditors are the SEC rules entitled "Strengthening the Commission's Requirements Regarding Auditor Independence." These rules were adopted in January 2003 to fulfill the mandate of Title II of the Sarbanes-Oxley Act of 2002, strengthen auditor independence, and require additional disclosures to investors about the services provided to issuers by the independent accountant. These rules address nonaudit services, employment of audit engagement team members by issuers, partner rotation and compensation rules, audit committee reporting requirements, auditor fee and service disclosure requirements to investors, and audit committee reporting requirements.

.46 Auditors should be familiar with these rules as they apply to the audits of domestic issuers, foreign subsidiaries, and affiliates of U.S. issuers, as well as foreign private issuers, by U.S. and foreign accounting firms. More detailed information regarding these rules can be found in the original SEC release at www.sec.gov/rules/final/33-8183.htm.

.47 In response to questions about the implementation and interpretation of the SEC rules discussed above, the SEC staff issued a document to assist practitioners entitled *Application of the January 2003 Rules on Auditor Independence—Frequently Asked Questions*. In December 2004, the SEC expanded and updated the January 2003 FAQs and consolidated all previous auditor independence FAQs into a single release, which will be updated and maintained in one place for easier access. The consolidated and updated FAQs are titled *Application of the Commission's Rules on Auditor Independence—Frequently Asked Questions* (December 13, 2004) and can be found at www.sec.gov/info/accountants/ocafaqaudind121304.htm. The updated FAQs primarily relate to partner rotation and fee disclosures.

PCAOB Rules Regarding Independence and Ethics

.48 The PCAOB has the authority to establish ethics and independence standards in accordance with sections 103(a) and 103(b), respectively, of the Sarbanes-Oxley Act. 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 the Sarbanes-Oxley Act.

.49 As mentioned earlier, on April 19, 2006, the SEC approved seven PCAOB independence and ethics rules pertaining to independence, tax services, and contingent fees. See the section entitled, "New PCAOB Independence and Ethics Rules" for further discussion.

.50 In addition to the above-mentioned rules, the PCAOB rules pertaining to independence and ethics also include Rule 3100, *Compliance with Auditing and Related Professional Practice Standards*; Rule 3500T, *Interim Ethics Standards*; and Rule 3600T, *Interim Independence Standards*. Given the continuing importance of these rules, they are summarized below.

Compliance With Auditing and Related Professional Practice Standards

.51 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 their 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, Rule 3100, by its own terms, does not apply to that engagement or activity.

Interim Ethics Standards

.52 Rule 3500T designates the provisions of the AICPA Code of Professional Conduct 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 the AICPA Code of Professional Conduct 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 (AICPA, *Professional Standards*, vol. 2, ET sec. 191), to the extent not superseded or amended by the PCAOB.

Interim Independence Standards

.53 Rule 3600T designates the provisions of the AICPA Code of Professional Conduct 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:

1. The AICPA Code of Professional Conduct Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.01), and interpretations and rulings thereunder, as in existence on April 16, 2003 (AICPA, *Professional Standards*, vol. 2, ET sec. 191)
2. 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*; and 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*, of the ISB

.54 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.

.55 The PCAOB rules referenced above can be found at www.pcaobus.org/Standards/Standards_and_Related_Rules/index.aspx.

GAO Independence Standard

.56 CPAs, non-CPAs, government financial auditors, and performance auditors who are auditing 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 Amendment No. 3, *Independence*, of the GAO's *Government Auditing Standards* (GAGAS, also referred to as the Yellow Book). The GAO independence rules, which are in some cases very similar to the AICPA independence rules and in other cases more restrictive, address three types of independence impairments, namely, personal, external, and organizational. But it is particularly important that practitioners comprehend the standard's most important provision, which involves personal independence impairments.

.57 The GAO's Independence Standard can be found at www.gao.gov/govaud/yb/2003/html/chap33.html#1034803. The GAO also has a Q&A book, *Answers to Independence Standard Questions*, which can be found at www.gao.gov/govaud/d02870g.pdf. Additional information is available at AICPA Online at www.aicpa.org/members/div/ethics/index.htm.

On the Horizon

Omnibus Proposal of AICPA Ethics Interpretations and Rulings

.58 On September 8, 2006, the PEEC issued an omnibus exposure draft that proposes one new and one revised interpretation under Rule 101, *Independence*. Based on comments received on the PEEC's September 15, 2005, omnibus exposure draft containing proposed guidance regarding independence and the use of indemnification and limitation of liability provisions and the performance of forensic accounting services, the PEEC agreed to revise and re-expose such guidance, which is included in the September 8, 2006, exposure draft. The exposure draft also includes new guidance regarding independence and the performance of tax compliance services.

Proposed Interpretation No. 101-16

.59 Proposed Interpretation No. 101-16, "Indemnification, Limitation of Liability, and ADR Clauses in Engagement Letters," would provide guidance to members on the impact that certain indemnification and limitation of liability provisions may have on a member's independence when included in engagement letters or other agreements entered into with a client.

.60 Under the proposal, certain types of indemnification and limitation of liability provisions in connection with an attest engagement are considered to pose an unacceptable threat to a member's independence because they may result in a member's performance of insufficient attest procedures in reliance on the belief that the member is protected through the indemnification or limitation of liability provision. However, this threat could be sufficiently mitigated, provided the limitation of liability or indemnification agreement was contingent on the member's attest services being performed in compliance with professional standards. Accordingly, the PEEC is proposing ethics guidance that adopts an underlying principle whereby independence would be considered to be impaired if a member entered into an agreement with a client that included an indemnification or limitation of liability provision regarding a member's exposure to actual damages unless such provision was contingent on the member's attest services being performed in compliance with professional standards, in all material respects. The indemnification and limitation of liability provisions in attest services engagements and the related effect on a member's independence, as proposed, is summarized as follows:

Indemnification or Limitation of Liability Provision in an Attest Services Engagement	*Effect on Member's Independence*
One that limits or eliminates a member's liability for actual damages arising from the member's failure to perform the attest services in accordance with professional standards, in all material respects	Would impair independence
One that limits or eliminates a member's liability for punitive damages in an attest services engagement	Would not impair independence
One that requires the client to reimburse the member for litigation costs and expenses, including amounts paid in settlement of actual damage claims, incurred in connection with the member's defense of claims for damages arising from the member's performance of attest services —provided that such provision is contingent upon the member having performed such services in accordance with professional standards, in all material respects	Would not impair independence

.61 The proposed interpretation also provides guidance on arrangements whereby a member and client agree to use arbitration, mediation, or other alternative dispute resolution (ADR) methods to resolve a dispute between them, or an agreement to waive a jury trial. The proposed interpretation states that an agreement between a member and client to use arbitration, mediation, or another ADR technique or proceeding to resolve a dispute between them would not impair the member's independence, provided the ADR technique or proceeding does not incorporate a provision, procedure, or rule that would impair independence under the preceding guidance. However, a provision in an arbitration agreement that prohibits discovery, or unreasonably limits the extent or nature of discovery, would impair independence unless the agreement permits the arbitrator(s) to override such provision as they determine necessary for the conduct of a fair and cost-effective proceeding. An agreement between a member and client to waive a jury trial would not impair independence.

.62 In addition, the proposed interpretation states that the following would *not* impair independence:

- An indemnification and limitation of liability provision related to nonattest services performed for an attest client
- An agreement whereby the member and the client agree that the unsuccessful party in a lawsuit or ADR proceeding between them will pay the legal fees and expenses of the successful party
- A limitation of the time period during which the client would otherwise be legally entitled to file a claim, provided the time period is reasonable in the circumstances
- A limitation on the clients legal right to assign or transfer a claim or potential claim

Proposed Revisions to Interpretation No. 101-3

.63 The proposed revisions to Ethics Interpretation No. 101-3, "Performance of Nonattest Services," under Rule 101 (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05) would incorporate guidance on how the provision of forensic accounting services and tax compliance services would affect a member's independence.

.64 Under the proposal, forensic accounting services consist of (1) litigation services and (2) investigative services. Litigation services recognize the role of the member as an expert or consultant and consist of providing assistance for actual or potential legal or regulatory proceedings before a trier of fact in connection with the resolution of disputes between parties. Litigation services are further categorized as expert witness services, litigation consulting services, and other services. The effect of each of these services on a member's independence is summarized as follows:

- Expert witness services create the appearance that a member is advocating or promoting a client's position. Accordingly, if a member conditionally or unconditionally agrees to provide expert witness testimony for a client, independence would be considered to be impaired.
- The performance of litigation consulting services would not impair independence, provided the member complies with the general requirements set forth under Interpretation No. 101-3. However, if the member subsequently agrees to serve as an expert witness, independence would be considered to be impaired.
- Other services, such as serving as a court-appointed expert, special master, trier of fact, or arbitrator, create the appearance that the member is not independent. Accordingly, if a member serves in such a role, independence would be considered to be impaired.

.65 Investigative services include all forensic services not involving actual or threatened litigation such as performing analyses or investigations that may require the same skills as used in litigation services. Investigative services would not impair independence, provided the member complies with the general requirements set forth under Interpretation No. 101-3.

.66 The proposed interpretation also provides guidance on the provision of fact witness testimony. As a fact witness, the member's role is to provide factual testimony to the trier of fact. While testifying as a fact witness, the trier of fact or counsel may request that the member testify as to his or her opinions pertaining to matters within the member's area of expertise. In such circumstances, independence would not be considered to be impaired.

.67 With regard to tax compliance services, the services included under the proposal are (1) preparation of a tax return; (2) transmittal of a tax return, and transmittal of the related tax payment to the taxing authority; (3) signing and filing of a tax return; and (4) authorized representation of clients before a taxing authority. The proposal states that preparing a tax return and transmitting the tax return and related tax payment to a taxing authority, in paper or electronic form, would not impair a member's independence, provided the member does not have custody or control over the client's funds and the individual designated by the client to oversee the tax services approves and signs the tax return prior to the member transmitting the return to the taxing authority. However, signing and filing a tax return on behalf of client management would impair independence, unless certain criteria are met. Authorized representation of a client in administrative proceedings before a taxing authority would not impair a member's independence, provided the member does not commit a client to a specific arrangement with the taxing authority without first obtaining client approval. Filing a petition or otherwise representing a client in a court to resolve a tax dispute would impair a member's independence.

.68 The omnibus exposure draft can be obtained at www.aicpa.org/download/ethics/Final_ED_September_2006.pdf.

.69 The PEEC is expected to consider all comments and adopt final guidance at a public meeting scheduled for November 30, 2006, in Durham, NC.

Other AICPA Projects

Potential Guidance on Contingent Fees

.70 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." Amongst 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."

International Ethics Convergence and Monitoring

.71 The AICPA is a member body of the International Federation of Accountants (IFAC). IFAC is the global organization for the profession and consists of approximately 163 member bodies including most of the major accounting associations around the world. IFAC's Ethics Standards Board, which includes AICPA representation, develops ethical standards and guidance for professional accountants for use around the world which is published in its Code of Ethics for Professional Accountants. The PEEC has formed a task force to monitor the activities of the IFAC Ethics Standards Board and consider how the AICPA Code differs from that of IFAC. Where appropriate, the task force will recommend changes to the AICPA Code to harmonize it with the IFAC guidance. For example, the IFAC Code is drafted primarily in a threats and safeguards framework approach. The AICPA Conceptual Framework for Independence Standards is consistent with the independence framework used in the IFAC Code. Consistent with IFAC, the PEEC is currently considering expanding the conceptual framework approach to all rules of conduct of the AICPA Code. Other projects include developing a definition of a "network firm" which was recently adopted by IFAC and incorporated into its independence standard.

Three-Year Project Agenda

.72 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.

GAO Exposure Draft on Proposed Changes to Government Auditing Standards

.73 In June 2006, the GAO issued an exposure draft requesting comments on proposed changes to Government Auditing Standards. These changes propose revisions throughout the entire set of standards, including the "General Standards," which incorporate the independence standards. Specifically, the Independence section was reorganized and the guidance on nonaudit services was clarified to facilitate implementing the standard. The standard on nonaudit services was not changed. In particular, the discussion of nonaudit services was moved from "personal" to "organizational" impairments because it is often the audit organization's independence that is impaired rather than that of the individual auditor and reorganized into three categories of nonaudit services. In addition, examples that had previously been interspersed throughout the independence section have been consolidated and streamlined.

.74 The three distinct categories of nonaudit services are:

1. Nonaudit services that do not impair auditor independence and, therefore, do not require compliance with the supplemental safeguards.
2. Nonaudit services that would not impair independence if supplemental safeguards are implemented.
3. Nonaudit services that impair independence.

.75 Additional guidance in the appendix was included to deal with nonaudit services that are frequently conducted by government audit organizations.

.76 The GAO's exposure draft can be found at www.gao.gov/govaud/ybk01.htm.

DOL Request for Comments on Independence Rules Pertaining to Employee Benefit Plan Audits

.77 On September 11, 2006, the Department of Labor (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. Comments on the RFI must be submitted to the DOL by December 11, 2006.

.78 The DOL's RFI can be found at ebpaqc.aicpa.org/Resources/Independence/.

Digest of the AICPA Independence Rules

.79 Presented below is a plain-English description of the AICPA independence rules. The purpose of the section is to help you to understand your independence requirements under the AICPA Code of Professional Conduct 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 broadly use the term *rules* to also mean standards, interpretations, rulings, laws, regulations, opinions, policies, or positions. This guide discusses the independence requirements of the principal rule-making bodies in the United States in plain English so you can understand and apply them with greater confidence and ease.

.80 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 them. Nonetheless, this guide should help you to 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

.81 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 U.S. Securities and Exchange Commission (SEC) and Public Company Accounting Oversight Board (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 has a rule that differs in some manner or is presented somewhat differently than the corresponding AICPA rule.

.82 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 resolutions of AICPA Council) that is engaged in the practice of public accounting

What Is Independence?

.83 Independence is defined in the "Conceptual Framework for AICPA Independence Standards" (AICPA, *Professional Standards*, vol. 2, ET sec. 100.01), 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.

.84 This definition reflects 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.

What Should I Do If No Specific Guidance Exists on My Particular Independence Issue?

.85 The "Other Considerations" section of Interpretation No. 101-1, "Interpretation of Rule 101" (AICPA, *Professional Standards*, vol. 2, ET sec. 101.02), recognizes that it is impossible for the AICPA Code of Professional Conduct (the Code) to identify all circumstances in which the appearance of independence might be questioned. In January 2006, the AICPA adopted the Conceptual Framework and a related revision to "Other Considerations" of Interpretation No. 101-1 of the Code.

.86 The revision to 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.

.87 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 are effective for all independence decisions made after April 30, 2007, with earlier application encouraged.

When Is Independence Required, and Who Sets the Rules?

.88 AICPA professional standards require your firm, including the firm's partners and professional employees, to be independent in accordance with Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.01), 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)

.89 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."[4]

.90 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) 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?

.91 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 (also known as Yellow Book requirements). For these clients (and others, such as those subject to regulation by the SEC or DOL), you and your firm also must comply with the independence rules established by those agencies.

.92 The SEC regulates public companies[5] and establishes the qualifications of independent auditors. This section refers to these independence rules as *SEC rules*.

.93 The PCAOB, a private standards-setting body whose activities are overseen by the SEC, is authorized to set, among other things, auditing, 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 AICPA's Code of Professional Conduct, Rule 102, *Integrity and Objectivity* (AICPA, *Professional Standards*, vol. 2, ET sec. 102.01), and Rule 101, *Independence*, and interpretations and rulings under those rules, as of April 16, 2003. It also adopted Independence Standards Board (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.

---

[4] See Statements on Standards for Accounting and Review Services (SSARS) No. 1, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR sec. 100.19).

[5] This includes companies that are registered with or are otherwise regulated by the Securities and Exchange Commission (SEC) or that file audited financial statements with the SEC, including foreign filers.

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 adopt several new independence rules adopted by the PCAOB:

- General independence standard
- Accountability for independence violations
- Contingent fees
- Tax services provided to persons in financial reporting oversight roles
- The accountant's involvement in potentially abusive tax transactions
- Preapproval requirements for nonprohibited tax services

.94 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

.95 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.

.96 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?

.97 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:

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[6] by any of the individuals or entities described in items 1 through 5 or by two or more such individuals or entities if they act together.

> The SEC uses the term *covered person*[7] 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?

.98 Yes; there are two 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) of the client, promoter, underwriter, voting trustee, or trustee of any of the client's employee benefit plans
- Ownership of more than 5 percent of an attest client's outstanding equity securities (or other ownership interests)

.99 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?

.100 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 2005, you would be prohibited from serving on the client's audit engagement for the fiscal year 2005 financial statements. You also could not serve in a position that would allow you to influence the fiscal 2005 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).[8]

---

[6] As defined by generally accepted accounting principles (GAAP) for consolidation purposes.

[7] 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)].

[8] 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.

- Dispose of all financial interests[9] in the client.
- Collect and repay all loans to or from the client (except those specifically permitted or grandfathered).[10]
- Cease active participation in the client's employee benefits 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?

.101 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?

.102 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 that the substance, and not only the position title, determines whether a position is "key" or not.

.103 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.

.104 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
- Your position and status with the client
- The amount of time that has passed since you left the firm

.105 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.

---

[9] See the "When Do My Financial Interests—or My Family's—Impair Independence?" section.

[10] 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).

- If you will interact significantly with the engagement team, reconsider the successor engagement team to ensure it has sufficient stature and experience to deal effectively with you in your new position.
- 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.[11]

> 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 less than 10 hours of services 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?

.106 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.

.107 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:
   - 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

.108 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.

---

[11] An objective professional with the appropriate stature and expertise should perform this review and the firm should take any recommended action(s) that result from the review.

> 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?

.109 The close relatives (siblings, parents, and nondependent children) of covered members (with the exception of covered members who provide only nonattest services to a client) are subject to some employment and financial restrictions. Your close relative's employment by a client *in a key position* impairs independence.

.110 Rules pertaining to your close relatives' financial interests differ depending on whether you participate on the client's attest engagement as follows:

- If you participate on the client's attest engagement team, your independence would be considered to be impaired if you are aware that your close relative has a financial interest in the client that either:
  - Was material to your relative's net worth, *or*
  - Enables the relative to exercise significant influence over the client.
- If you are able to influence the client's attest engagement or are a partner in the office in which the lead attest engagement partner practices in connection with the engagement, your independence will be impaired if you are aware that your close relative has a financial interest in the client that:
- Is material to your relative's net worth, *and*
- Enables your relative to exercise significant influence over the client.

> Under SEC rules, your close family members include your spouse (or equivalent) and dependents and your 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 5 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?

.111 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*).

.112 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 AICPA Code of Professional Conduct 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.

.113 In addition, if you commit to acquire a 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.

.114 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.

.115 Direct financial interests are financial interests that are:

1. Owned by you directly, or
2. Under your control, or
3. Beneficially owned[12] 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.

.116 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.

.117 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

.118 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.

.119 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.

.120 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.

---

[12] 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.

Note: Interpretation No. 101-15, "Financial Relationships" (AICPA, *Professional Standards*, vol. 2, ET sec. 101.17), of the Code (effective December 31, 2005) 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 Are the Rules That Apply to My Mutual Fund Investments—and Those of My Family—If My Firm Audits Those Mutual Funds?

.121 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?

.122 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.

.123 If a mutual fund is diversified, and you and/or your immediate family own 5 percent or less 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.

.124 If the fund is *not* diversified, or you and/or your family own more than 5 percent of the fund's equity, you should treat the fund's holdings as indirect financial interests. Here is an illustration.

.125 Suppose ABC 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 2 percent of its assets invested in XYZ.
- Your indirect financial interest in XYZ is $1,000 ($50,000 x .02).

If $1,000 is material to your net worth, independence would be considered to be impaired.

May I Have a Joint Closely Held Investment With a Client?

.126 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?

.127 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)

.128 Investments in a client's bonds are considered a prohibited loan to that client.

.129 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

.130 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

.131 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 bank became a client.
3. The client acquired the loan.

.132 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?

.133 The AICPA rules indicate that in order for independence to be maintained, a covered member whose assets are held by a broker/dealer client must not receive any preferential treatment or terms and any assets that are subject to risk of loss must be immaterial to the covered member's net worth. In addition, margin accounts are subject to the loan rules.[13]

> 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?

.134 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.[14]

> 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.[15]

May I Have an Insurance Policy With a Client?

.135 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.

---

[13] See the preceding question, "May My Family or I Borrow Money From or Lend Money to a Client?"

[14] 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.

[15] The SEC treats money market *funds* (as opposed to money market *accounts*) as mutual funds for purposes of their rules. Also see Rule 2-01(c)(1)(B).

May I Give or Accept Gifts or Entertainment From a Client?

.136 A new ethics ruling[16] 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 10 percent or more stockholders of the client).

.137 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."

.138 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.

.139 Another new ethics ruling[17] 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).[18]

.140 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?

.141 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
- General counsel (or equivalent)
- Trustee for a client's pension or profit-sharing trust

.142 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.

.143 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.

.144 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:

---

[16] See Ethics Ruling No. 114 under Rule 101 (ET section 191.228–.229).

[17] See Ethics Ruling No. 113 under Rule 101 (ET section 191.226–.227).

[18] See www.aicpa.org/download/ethics/Gifts_Basis_Document.pdf.

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 or 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.

> The SEC prohibits direct or material indirect business relationships with a client (or persons associated with 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 and these goods or services will be consumed by the firm). Examples of prohibited business relationships include 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?

.145 The term *nonattest services* includes accounting and consulting services that are not part of an attest engagement.[19] Nonattest services specifically addressed in the rules are:

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

[19] 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.

In addition to considering the general standard and four guiding principals, the SEC rules generally prohibit a CPA 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

.146 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 tasks will be limited by the rules. Further, certain services will be prohibited (for example, serving as a client's general counsel).

.147 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 Interpretation No. 101-3, "Performance of Nonattest Services," under Rule 101, *Independence*, and SEC Rule 2-01(c)(4), "Non-audit services."

.148 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 the DOL.

> ***Note:*** On September 8, 2006, the AICPA issued an omnibus exposure draft that includes proposed revisions to Interpretation No. 101-3, "Performance of Nonattest Services," which would incorporate guidance on how the provision of forensic accounting services and tax compliance services would affect a member's independence.

The SEC rules require independence of the client and various affiliated entities.[20]

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.

AICPA General Requirements

.149 *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.

[20] See Rule 2-01(f)(4) and (6).

.150 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

.151 *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 to 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/or 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.
5. Establish and maintain internal controls, including monitoring ongoing activities.

.152 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 re-perform 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.

.153 *General Requirement 3.* Before performing nonattest services, the firm should establish and document its understanding with the client regarding the following:

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

.154 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 member-client relationship are exempt from the second and third general requirements.

What Are the Rules on Performing Bookkeeping Services for a Client?

.155 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).
- Establish and maintain internal controls over the member's bookkeeping activities.

  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, provided the client reviews these entries and understands the impact on its financial statements and records 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.

May My Firm Provide Internal Audit Assistance to a Client?

.156 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:

- Have custody of the client's assets.
- Make decisions on the client's behalf.
- Report to the client's governing body.

.157 To maintain independence, the client must:

- Designate an individual or individuals who possess suitable skill, knowledge, and/or 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?

.158 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.

.159 For instance, your firm may not perform a valuation in connection with a business merger 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).

.160 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 since these services are not considered to entail a significant subjectivity (that is, 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[21] 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?

.161 Here are examples of what you and your firm may do under the AICPA rules:

- Make recommendations to a client about the allocation of funds to various asset classes.
- Analyze investment performance.

.162 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?

.163 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.

.164 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.

.165 Your firm is not precluded from designing, implementing, integrating, or installing an information system that is unrelated to the client's financial reporting process.[22]

---

[21] 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.

[22] FAQs 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.

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:

- Evaluate internal controls of a financial information system as it is being designed, implemented, or operated for the client by another service provider, or
- Make recommendations on internal control matters to management in connection with a system design and implementation project being performed by another service provider.

Fee Issues

What Types of Fee Arrangements Between My Firm and a Client Are Prohibited?

.166 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.

.167 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:

- 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.

.168 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

.169 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.

.170 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.

.171 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

- Compiled 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

.172 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.

> On April 19, 2006, the SEC approved PCAOB Rule 3521, *Contingent Fees*, which 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 eliminates 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. 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.

.173 The AICPA rule provides an exception for *referral fees* for recommending or referring a CPA's services to another person or entity. That is, you may (1) receive a fee for referring a CPA's services to any person or entity or (2) if you are a CPA, you may pay a fee to obtain a client. You must inform the client if you receive or pay a referral fee.

Is Independence Affected When a Client Owes the Firm Fees for Professional Services the Firm Has Already Provided?

.174 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.[23]

Does Being Compensated for Selling Certain Services to Clients Affect My Independence?

.175 The AICPA rules do not specifically address this issue.

[23] 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.

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.[24]

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?

.176 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*, and *Article IV—Objectivity and Independence*, of the Principles of Professional Conduct (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.

.177 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
   - 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

[24] Accounting firms with ten or fewer partners and five or fewer audit clients that are *issuers*, as defined by the SEC, are exempt from this rule.

- Subjecting significant client attest engagements to internal firm monitoring procedures
- Subjecting significant client attest engagements to pre- or post-issuance reviews or to the firm's external peer review process

.178 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, that is, 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

.179 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,[25] 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 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
- 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

.180 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, or practice unit), or partner, may be useful but will likely be different for various levels within the firm.

---

[25] 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).

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 Questions?

.181 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.

.182 In addition, readers should refer to the Conceptual Framework for AICPA Independence Standards in evaluating whether a specific circumstance that is not addressed in the Code would pose an unacceptable threat to independence.

Resource Central

Independence and Ethics Contact List

.183 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

.184

- The Web site address for information about the AICPA's ethics standard-setting activities is www.aicpa.org/members/div/ethics/standard.htm
- For resources related to understanding and applying nonattest services rules, see www.aicpa.org/members/div/ethics/intr_101-3.htm
- The AICPA Code of Professional Conduct 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.

Securities and Exchange Commission

.185

- 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/ocaaccount.htm.
- U.S. Securities & Exchange Commission, Office of the Chief Accountant, 100 F Street, NE, Washington, DC 20549; 202-551-5300 (phone); 202-772-9252 (fax).

Public Company Accounting Oversight Board

.186 The PCAOB has established a Web site at www.pcaobus.org, which provides information about its activities. The standards and rules of the PCAOB, including those on independence, can be found at www.pcaobus.org/Standards/Standards_and_Related_Rules/index.aspx.

Government Accountability Office

.187

- GAO Yellow Book requirements (see www.gao.gov/aac.html)
- Yellow Book Independence Standard (see www.gao.gov/govaud/agagas3.pdf)
- 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.

> ***Note:*** In June 2006, the GAO issued an exposure draft requesting comments on proposed changes to Government Auditing Standards, including the "General Standards" which incorporate the independence standards. Specifically, the Independence section was reorganized and the guidance on nonaudit services was clarified to facilitate implementing the standard. The exposure draft may be found at www.gao.gov/govaud/ybk01.htm.

Department of Labor

.188 See DOL Regulation 2509.75-9, *Interpretive Bulletin Relating to Guidelines on Independence of Accountant Retained by Employee Benefit Plan*. Direct inquiries to the Department of Labor at (866) 4-USA-DOL.

> ***Note:*** 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).

Federal Deposit Insurance Corporation

.189 Obtain FDIC regulations (12 CFR Part 363), *Annual Independent Audits and Reporting Requirements*, at www.fdic.gov/regulations/laws/rules/2000-8500.html#2000part363.

.190 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.

Educational Courses

.191 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. 739175kk)
- *Selected Topics in Professional Ethics* (product no. 738380kk)
- *Professional Ethics: The AICPA's Comprehensive Course* (product no. 738328kk)
- *Real World Business Ethics: How Would You React?* (product no. 731683kk)
- *Ethics: Non-Attest Services, Integrity, and Objectivity* (product no. 739400kk)

Additional information can be found at www.cpa2biz.com.

.192 This Audit Risk Alert replaces *Independence and Ethics Alert—2005/06*.

.193 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 lpombo@aicpa.org or write to:

Lori L. Pombo
AICPA
Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881

[*The next page is 9000-51*.]

AAM Section 8250

Internal Control Reporting—Implementing Sarbanes-Oxley Act Section 404

NOTICE TO READERS
INTERNAL CONTROL REPORTING—IMPLEMENTING SARBANES-OXLEY ACT SECTION 404 (REVISED EDITION)

This Financial Reporting Alert was developed by an independent consultant and the staff of the AICPA. Its content represents the opinions of the author. This Financial Reporting Alert has not been approved, disapproved, or otherwise acted upon by any senior technical committee of the AICPA and has no official or authoritative status.

AICPA Staff

Written by
Michael J. Ramos, CPA

Edited by
Karin Glupe, CPA
Technical Manager
Accounting and Auditing Publications

Introduction

.01 In July 2002, the Sarbanes-Oxley Act of 2002 (the Act) was signed into law, bringing with it sweeping changes to many aspects of the financial reporting, corporate governance, and regulatory landscape for public companies. Section 404 of the Act requires public companies to include with their annual report to the Securities and Exchange Commission (SEC) a separate report on the assessment of the effectiveness of the entity's internal control. Additionally, the entity's external auditors must attest to and report on the assessment made by management.

.02 A company that is an "accelerated filer" must begin to comply with the internal control reporting and attestation requirements associated with the Act for its fiscal year ending on or after November 15, 2004. According to the SEC, a company is an accelerated filer if its common public equity float was $75 million or more as of the last business day of its most recently completed second fiscal quarter; the company has been subject to the reporting requirements of the Securities Exchange Act of 1934 for at least 12 calendar months; the company has filed at least one annual report; and the company is not a small-business issuer (that is, it is not eligible to use Forms 10-KSB or 10-QSB). By contrast, a nonaccelerated filer does not meet these requirements, and is not required to file its annual and quarterly reports on an accelerated basis. A nonaccelerated filer, or a foreign private issuer that files its annual reports on Form 20-F or Form 40-F, must begin to comply with the internal control reporting and attestation requirements for its first fiscal year ending on or after July 15, 2006.

.03 Since the passage of the Act, many issues have arisen regarding the implementation of the internal control assessment and reporting process. The purpose of this Alert is to articulate significant technical issues that have surfaced and to provide direction for those responsible for managing or participating in the implementation of section 404, including:

- The entity's CEO and CFO, who have the overall responsibility for assessing and reporting on internal control
- Internal auditors
- Third parties who might be engaged by the entity to assist with the assessment process

Summary of Relevant Rules and Other Authoritative Literature

.04 Management's assessment and reporting on internal control is shaped by several key rules and standards, including:

- *SEC rules.* The Sarbanes-Oxley Act directed the SEC to adopt detailed rules to implement the requirements of the Act relating to internal control. These rules define for issuers the requirements for assessing and reporting on internal control. To read the SEC rules, go to the SEC Web site at www.sec.gov/rules/final/33-8238.htm.
- *External auditor standards.* These standards describe the approach, required tests, and other guidance that the entity's external auditors are expected to follow when reporting on management's assertion about the effectiveness of internal control. These standards do not affect the issuer directly, but they do have a significant *indirect* effect on the procedures performed by management.
- *The Committee of Sponsoring Organizations of the Treadway Commission (COSO) Internal Control Integrated Framework.* Management's report on internal control effectiveness is required to disclose the criteria against which management assesses effectiveness. The COSO framework is one example set of criteria and it is anticipated that most U.S. entities will use COSO in their evaluation. To obtain the COSO framework, call the AICPA at (888) 777-7077 or visit www.cpa2biz.com and order *Internal Control—Integrated Framework* (product no. 990012kk).

The SEC Rules

.05 The SEC issued its final rule on management's report on internal control in May 2003, and the rule became effective on August 14, 2003. It is the entity's annual report to the SEC (Form 10-K) that contains management's report on internal control, and therefore it is the SEC rules regarding those reports that management must follow in planning and performing its assessment of control effectiveness.

Definition of Internal Control

.06 The SEC rules clarify that management's assessment and report are limited to *internal control over financial reporting*. Management is not required to consider other aspects of control, such as controls pertaining to operating efficiency. The SEC's definition of *internal control* encompasses the COSO definition (described later in this Alert in the section titled "The COSO Internal Control Integrated Framework"), but the SEC does not mandate that the entity use COSO as its criteria for judging effectiveness.

Annual Reporting Requirements

.07 Under the SEC rules, the company's annual 10-K must include:

1. *Management's Annual Report on Internal Control Over Financial Reporting.* This report on the company's internal control over financial reporting should contain:
   a. A statement of management's responsibilities for establishing and maintaining adequate internal control over financial reporting.
   b. A statement identifying the framework used by management to evaluate the effectiveness of the company's internal control over financial reporting.

c. Management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the most recent fiscal year, including a statement as to whether or not internal control over financial reporting is effective. This discussion must include disclosure of any material weakness in the company's internal control over financial reporting identified by management. Management is not permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the company's internal control over financial reporting.

d. A statement that the registered public accounting firm that audited the financial statements included in the annual report has issued an attestation report on management's assessment of the registrant's internal control over financial reporting.

2. *Attestation Report of the Registered Public Accounting Firm.* This is the registered public accounting firm's attestation report on management's assessment of the company's internal control over financial reporting.

3. *Changes in Internal Control Over Financial Reporting.* This report must disclose any change in the company's internal control over financial reporting that has materially affected or is reasonably likely to materially affect the company's internal control over financial reporting.

.08 Key provisions of these reporting requirements that merit management's consideration include the following.

- *"As of" reporting.* Management assesses the effectiveness of internal control as of the end of the fiscal year, rather than throughout the reporting period. This reporting requirement has significant implications for the reporting of material weaknesses that were identified and corrected during the period. It also affects the timing of management's tests of the design and operating effectiveness of controls.
- *Material weakness in internal control.* Management is required to disclose any material weakness[1] in the company's internal control. Further, the existence of one or more material weaknesses precludes management from concluding that its internal control is effective.

Both of these considerations are discussed in more detail in the section titled "Reporting" in this Alert.

Quarterly Reporting Requirements

.09 The SEC rules also require management to evaluate any change in the entity's internal control that occurred during a fiscal quarter and that has materially affected, or is reasonably likely to materially affect, the entity's internal control over financial reporting.

.10 Additionally, management is required to evaluate the effectiveness of the entity's "disclosure controls and procedures" and issue a report as to their effectiveness on a quarterly basis. With these rules, the SEC introduced a new term, *disclosure controls and procedures*, which differs from *internal controls over financial reporting* and is much broader.

.11 As defined, disclosure controls and procedures encompass the controls over all material financial *and nonfinancial information* in Exchange Act reports. Information that would fall under this definition that would *not* be part of an entity's internal control over financial reporting might include the signing of a significant contract, changes in a strategic relationship, management compensation, or legal proceedings.

.12 This Alert does not discuss the evaluation of disclosure controls and procedures but is limited to a discussion of the annual and quarterly evaluation and reporting of internal control over financial reporting.

[1] For a definition of *material weakness*, see the "Reporting" section of this Alert.

External Auditor Standards

.13 The entity's external auditors are required to audit management's internal control report in accordance with certain professional standards. These standards *directly* affect *only* the work of the external auditor. The work performed by the entity to assess the effectiveness of its internal controls need only comply with the requirements of the SEC rules. However, the auditing standards related to internal control reporting will have a *significant indirect* effect on the way in which management plans and performs its internal control testwork. For example, the standards may require the external auditors to include certain divisions, categories of controls, or control procedures within the scope of their work. If that is the case, management would need to ensure that the scope of their assessment process is congruent with the requirements of external auditors.

Public Company Accounting Oversight Board Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Conducted in Conjunction With an Audit of Financial Statements

.14 In June 2004, the SEC approved Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 2. This standard is effective for audits of internal control over financial reporting required by section 404 of the Sarbanes-Oxley Act of 2002 and addresses several important areas that affect financial statement issuers. A brief discussion of these follows.

.15 ***The Audit Process.*** The overall objective of the external auditor's engagement is to form an opinion about management's assessment of the effectiveness of internal control. To form his or her opinion, the auditor:

- Evaluates the reliability of the process used by management to assess the entity's internal control and assesses the adequacy of the company's documentation of internal control. Lack of adequate documentation is considered a control deficiency that may preclude an unqualified opinion on internal control or may result in a scope limitation on the auditor's engagement.
- Confirms his or her understanding of the entity's internal control by performing walk-throughs of the company's significant processes. A walkthrough is a procedure in which a transaction is traced from its origination through the information processing system, to the transaction's reporting in the financial statements.
- Reviews and relies on the results of *some* of the tests performed by management, internal auditors, and others during their assessment process.
- Performs his or her own tests.

.16 This framework of the auditor's process poses several important questions for management, including:

- What are the qualities of management's process for assessing internal control that the external auditors deem necessary to make the process "reliable"?
- Which of management's tests can the external auditor rely on and which are subject to retesting by the auditor?

.17 ***Required Elements of Management's Process.*** The standard provides guidance on the *required* elements of management's process for assessing the effectiveness of internal control. The absence of one or more of those required elements may result in a modification to the standard audit report. For this reason, it is critical that management's process comply with all requirements established by the new standard.

.18 The auditing standard states that the auditor should determine whether management's assessment process has addressed the following elements.

- Determining which controls should be tested, including controls over relevant assertions related to all significant accounts and disclosures in the financial statements. Generally, such controls include:
  - — Controls over initiating, authorizing, recording, processing, and reporting significant accounts and disclosures and related assertions embodied in the financial statements.
  - — Controls over the selection and application of accounting policies that are in conformity with generally accepted accounting principles.
  - — Antifraud programs and controls.
  - — Controls, including information technology general controls, on which other controls are dependent.
  - — Controls over significant nonroutine and nonsystematic transactions, such as accounts involving judgments and estimates.
  - — Company-level controls, including the control environment.
  - — Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; to initiate, authorize, record, and process journal entries in the general ledger; and to record recurring and nonrecurring adjustments to the financial statements (for example, consolidating adjustments, report combinations, and reclassifications).
- Evaluating the likelihood that failure of the control could result in a misstatement, the magnitude of such a misstatement, and the degree to which other controls, if effective, achieve the same control objectives.
- Determining the locations or business units to include in the evaluation for a company with multiple locations or business units.
- Evaluating the design effectiveness of controls.
- Evaluating the operating effectiveness of controls based on procedures sufficient to assess their operating effectiveness. To evaluate the effectiveness of the company's internal control over financial reporting, management must have evaluated controls over all relevant assertions related to all significant accounts and disclosures.
- Determining the deficiencies in internal control over financial reporting that are of such a magnitude and likelihood of occurrence that they constitute significant deficiencies or material weaknesses.
- Communicating findings to the auditor and to others, if applicable.
- Evaluating whether findings are reasonable and support management's assessment.

.19 ***Documentation of Testwork to Support Management's Assertion.*** The standard provides additional guidance on the nature and extent of the documentation required by the entity to support management's assessment of internal control. The form and extent of documentation should vary depending on the size, nature, and complexity of the company. The standard also states that inadequate documentation is a control deficiency that may rise to the level of a material weakness.

.20 The standard also addresses other situations that are likely to occur in practice, including:

- *Extent of testing of multiple locations, business segments, or subsidiaries.* To determine the locations or business units that should be tested, management should evaluate their relative financial significance and the risk of material misstatement arising from them. Management should also determine the other locations or business units that, when aggregated, represent a group with a level of financial significance that could create a material misstatement in the financial statements.

- *Required tests when the entity uses a service organization to process transactions.* Management should obtain an understanding of the controls at the service organization that are relevant to the entity's internal control and the controls at the user organization over the activities of the service organization. Management should also obtain evidence that the controls that are relevant to management's assessment are operating effectively.

- *Updated testwork required when the original testing was performed at an interim date in advance of the year-end reporting date.* Generally, as the risk associated with the control being tested decreases, the testing may be performed farther from the as-of date; on the other hand, as the risk associated with the control increases, the testing should be performed closer to the as-of date.

Appendix B of Auditing Standard No. 2 provides further information regarding these situations.

.21 ***Using the Work of Internal Auditors and Others.*** Many entities are using the work of their own internal audit staff and others within the organization to perform tests of the effectiveness of internal control. At issue is the extent to which the external auditors can rely on those tests to reach their own conclusion.

.22 Paragraphs 108 through 126 of the standard provide extensive guidance on the degree to which the company's work on internal control can be used by the external auditors. The standard indicates that the work of "others" includes the relevant work performed by internal auditors, other company personnel, and third parties working under the direction of management or the audit committee. However, the external auditor "must perform enough of the testing himself or herself so that the [*external*] auditor's own work provides the principal evidence for the [*external*] auditor's opinion."

.23 There are two areas where the external auditors are prohibited from using the company's work in their audit.

- *Control environment.* The external auditors are prohibited from using the work of company management and others to reduce the amount of work they perform on controls in the control environment. However, the external auditor should still "consider the results of work performed in this area by others because it might indicate the need for the [*external*] auditor to increase his or her [*own*] work."

- *Walkthroughs.* External auditors are required to perform at least one walkthrough for each major class of transactions.

.24 For all areas other than the control environment and the walkthroughs, the external auditors may use the company's tests on internal control during their audit. To determine the extent to which the external auditor may use the company's work, the external auditor is required to:

- Evaluate the nature of the controls subjected to the work of others;

- Evaluate the competence and objectivity of the individuals who performed the work; and

- Test some of the work performed by others to evaluate the quality and effectiveness of their work.

.25 The auditor should evaluate the following factors when evaluating the nature of the controls subjected to the work of others. As these factors increase or decrease in significance, the need for the auditor to perform his or her own work on those controls increases or decreases, respectively.

- The materiality of the accounts and disclosures that the control addresses and the risk of material misstatement.

- The degree of judgment required to evaluate the operating effectiveness of the control.

- The pervasiveness of the control.
- The level of judgment or estimation required in the account or disclosure.
- The potential for management override of the control.

.26 The extent to which the external auditors can use the company's work depends on the degree of competence and objectivity of the individuals performing the work. The more objective and competent the individuals who performed the work, the more the external auditors can rely on such work. Factors concerning the competence of the individuals performing the tests of controls include their educational level and professional experience, their professional certification and continuing education, practices regarding the assignment of individuals to work areas, supervision and review of their activities, the quality of the documentation of their work, and the level of supervision and review of their activities. Factors concerning the objectivity of the individuals performing the tests of controls include the following: if the individuals responsible for the work of others (testing authority) in testing controls reports to an officer of sufficient status to ensure sufficient testing coverage and appropriate action on findings and recommendations of the individuals performing the testing; if the testing authority reports regularly to the board of directors or audit committee; and if there are policies prohibiting individuals from testing controls in areas to which they were recently assigned, or areas in which relatives are employed.

.27 The auditing standard notes that the work of internal auditors may be used "to a greater extent than the work of other company personnel." This is particularly true for internal auditors who follow the *International Standards for the Professional Practice of Internal Auditing*, issued by the Institute of Internal Auditors. According to the standard, "if internal auditors have performed an extensive amount of relevant work and the auditor determines they possess a high degree of competence and objectivity, the auditor could use their work to the greatest extent an auditor could use the work of others."

.28 ***Documentation of Internal Control.*** The external auditors evaluate the adequacy of management's documentation of internal control. Paragraph 42 of the auditing standard states that when determining whether management's documentation provides reasonable support for its assessment, the auditor should evaluate whether such documentation includes the following:

- The design of controls over all relevant assertions related to all significant accounts and disclosures in the financial statements. The documentation should include the five components of internal control over financial reporting, including the control environment and company-level controls.
- Information about how significant transactions are initiated, authorized, recorded, processed, and reported.
- Sufficient information about the flow of transactions to identify the points at which material misstatements due to error or fraud could occur.
- Controls designed to prevent or detect fraud, including who performs the controls and the related segregation of duties.
- Controls over the period-end financial reporting process.
- Controls over safeguarding of assets.
- The results of management's testing and evaluation.

.29 As management documents internal control, they should be aware of what elements their auditors will be looking for and ensure that those elements are present.

.30 ***Seeking Help From External Auditors—Independence Issues.*** The auditing standard incorporates four basic principles in its guidance on independence when performing an audit of internal control. These basic principles state that independence would be impaired if the auditor's services to the company create a mutual or conflicting interest between the firm and the client, place the firm in a position where it subsequently audits its own work, result in the firm acting as an employee of the client, or result in the firm acting as an advocate for the client.

.31 Maintaining independence is primarily the responsibility of the external auditors. However, note that several of the independence requirements impose certain responsibilities on management and the audit committee.

- *Preapproval by the audit committee.* Any internal control-related service to be provided by the external auditor must be preapproved by the audit committee. There is no grandfathering for ongoing internal control-related engagements that were preapproved before the effective date of Auditing Standard No. 2 in a manner that would not satisfy the requirements in the standard.
- *Active involvement of management.* Management must be "actively involved" in a "substantive and extensive" way in all internal control services the external auditor provides. Management cannot delegate these responsibilities, nor can it merely accept responsibility for documentation and testing performed by the auditors.
- *Independence in fact and appearance.* According to the standard, the test for independence in fact is whether "the activities would impede the ability of anyone on the engagement team or in a position to influence the engagement team from exercising objective judgment in the audits of the financial statements or internal control over financial reporting." The test for independence in appearance, according to the standard, is "whether a reasonable investor … would perceive an auditor as having interests which could jeopardize the exercise of objective and impartial judgments on all issues … within the auditor's engagement."

.32 ***Additional Guidance.*** Subsequent to the approval of the standard, both the PCAOB and the SEC released documents of answers to frequently asked questions (see the Appendix of this Alert for the SEC questions and answers). These documents set forth the PCAOB and SEC staff's opinions and views on certain matters. Although the PCAOB and the SEC point out that these opinions and views do not represent official "rules," any departure from the answers to questions discussed in these documents should be justified. In addition, the auditing standard can be downloaded directly from the PCAOB Web site at www.pcaobus.org/Standards/index.aspx.

The COSO Internal Control Integrated Framework

.33 In 1985, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) was formed to sponsor the National Commission on Fraudulent Financial Reporting, whose charge was to study and report on the factors that can lead to fraudulent financial reporting. Since this initial undertaking, COSO has expanded its mission to improving the quality of financial reporting. A significant part of this mission is aimed at developing guidance on internal control. In 1992, COSO published *Internal Control—Integrated Framework*, which established a framework for internal control and provided evaluation tools that business and other entities could use to evaluate their control systems. This COSO report can be obtained through the AICPA by calling (888) 777-7077 or by going online at www.cpa2biz.com (product no. 990012kk).

The COSO Internal Control Components

.34 The COSO framework describes five interrelated components of internal control.

- *Control environment.* Senior management must set an appropriate "tone at the top" that positively influences the control consciousness of entity personnel. The control environment is the foundation for all other components of internal control and provides discipline and structure.

- *Risk assessment.* The entity must be aware of and deal with the risks it faces. It must set objectives, integrated throughout all value chain activities, so the organization is operating in concert. Once these objectives are set, the entity must then identify the risks to achieving those objectives, analyze those risks, and develop ways to manage them.

- *Control activities.* Control policies and procedures must be established and executed to help ensure the actions identified by management as necessary to address risks are effectively carried out.

- *Information and communications.* Surrounding the control activities are information and communication systems, including the accounting system. These systems enable the entity's people to capture and exchange the information needed to conduct, manage, and control its operations.

- *Monitoring.* The entire control process must be monitored, and modifications made as necessary. In this way, the system can react dynamically, changing as conditions warrant.

.35 The COSO report describes these individual components as being tightly integrated with each other. Each component has a relationship with and can influence the functioning of every other component. When evaluating the effectiveness of internal control, management should consider it as an integrated whole. Weak controls in one area can be offset by stronger controls in another area.

Key Characteristics of the COSO Framework

Flexible, Adaptable, No "One Size Fits All" Approach

.36 The COSO framework is not a rigid, prescriptive approach to internal controls. It recognizes that different entities make different choices about how to control their businesses. Internal control is not a "one size fits all" proposition. Consequently, internal control cannot be evaluated against a detailed set of fixed, required procedures. Management has to exercise a great deal of judgment, driven by the particular needs of the entity, to determine the nature of the controls in place and whether they are functioning effectively.

Effectiveness Determined by Achievement of Objectives

.37 Management should judge the effectiveness of internal control by how well the controls enable the entity to achieve stated objectives. Controls have value only to the degree to which they allow the entity to achieve its objectives. Thus, the COSO framework adopts a business objectives-driven approach to defining internal control. Under that approach, the entity:

1. Establishes business objectives. The SEC rules describe those objectives as relating to the preparation of reliable financial statements.

2. Identifies the risks to achieving those objectives.

3. Determines how to manage the identified risks. The establishment of internal controls is just one of several options.

4. Where appropriate, establishes control objectives as a way to manage certain risks. Individual controls are then designed and implemented to meet the stated control objectives.

Significant Control Objectives

.38 The COSO framework focuses on the achievement of control *objectives* (rather than the existence of predetermined control procedures), and it is expected that management will rely on some control procedures more than others to achieve these objectives. For example, management may decide to rely more on detective controls rather than preventive controls to identify and correct unauthorized transactions. At the entity level, some control objectives or activity-level processing streams may be more significant to the entity's financial statements or financial reporting process than others.

.39 When assessing the effectiveness of internal control *as a whole*, management should be sure to identify the controls it relies on most to produce reliable financial statements, and to include the testing of these controls in the scope of its work.

The Importance of the Control Environment

.40 Managers typically think of internal control only in terms of the policies and procedures related to the processing of transactions. For example, the matching of a vendor invoice to a master file of approved vendors, the recalculation of that invoice, or the reconciliation of the accounts payable subsidiary ledger to the general ledger account are all examples of controls over the processing of purchases.

.41 The COSO framework does not limit itself to these types of business activity-level procedures. The framework acknowledges that the *environment* in which those procedures operate has a direct effect on their effectiveness. In fact, this environment is described as the foundation of all other control components. The control environment encompasses the following:

- Integrity and ethical values
- Commitment to competence
- Board of directors or audit committee
- Management's philosophy and operating style
- Organizational structure
- Assignment of authority and responsibility
- Human resource policies and practices

.42 When evaluating the effectiveness of internal control, management must be sure to perform tests that allow it to assess the effectiveness of the control environment. The section of this Alert titled "Testing of Internal Control" discusses this matter in more detail.

.43 ***Antifraud Programs and Controls.*** Management is responsible for designing and implementing systems and procedures for the prevention and detection of fraud and, along with the board of directors, for ensuring a culture and environment that promote honesty and ethical behavior. Broadly stated, three fundamental elements are essential when implementing a system to prevent, deter, and detect fraud. They are: (*a*) create and maintain a culture of honesty and high ethics; (*b*) evaluate the risks of fraud and implement the processes, procedures, and controls needed to mitigate the risks and reduce the opportunities for fraud; and (*c*) develop an appropriate oversight process. The AICPA Antifraud & Corporate Responsibility Resource Center provides extensive guidance for developing antifraud programs and controls.

Reasonable Assurance

.44 No matter how well designed or operated, internal control can provide only reasonable assurance that objectives will be met. Reasonable assurance is a high threshold, but it stops short of absolute assurance. The presence of an internal control failure does not, in and of itself, mean that a system is ineffective. The COSO report states that "even an effective internal control system can experience failure."

Information Technology Considerations

.45 The COSO framework groups information technology (IT)-related controls into two types: general computer controls and application-specific controls.

- *General controls* include controls over:
  - Data center operations (for example, job scheduling, backup, and recovery procedures)
  - Systems software controls (for example, the acquisition and implementation of operating systems)
  - Access security
  - Application system development and maintenance controls (for example, the acquisition and implementation of individual computer software applications)
- *Application controls* are designed to control information processing and help ensure the completeness and accuracy of transaction processing, authorization, and validity. Application controls also encompass the way in which different applications interface with each other and exchange data.

.46 The COSO report does not mandate this approach to assessing the effectiveness of internal controls but states that this is one set of groupings of IT-related control activities that can be used.

.47 Many entities will find the COSO guidance on IT-related controls to be insubstantial and may look for additional guidance. The Control Objectives for Information and Related Technology (COBIT) framework is a good source for such guidance.

The COBIT Framework

.48 Since the release of COSO, the Information Systems Audit and Control Association and Foundation (ISACA) has developed its COBIT framework, which provides a generally applicable and accepted standard for IT security and control practices. Among IT audit professionals, COBIT is widely accepted.

.49 The COBIT framework is similar to COSO in that it puts controls within the context of an entity's need to achieve certain business objectives and the risks it faces toward achievement. In defining the goals of IT governance and control, COBIT takes a rather broad brush and does not limit itself to the financial reporting process. For the purpose of complying with the SEC internal control reporting requirements, management should limit its consideration of IT controls to those that affect the reliability of financial reporting, either directly (for example, application controls) or indirectly (for example, general controls).

.50 COBIT groups the IT processes into four categories, each of which is critical in delivering information that meets certain stated criteria.

- *Planning and organization.* These processes cover strategy and tactics and concern the identification of the way IT can best contribute to the achievement of stated business objectives, both now and in the future.
- *Acquisition and implementation.* To realize the IT strategy, IT solutions need to be identified, developed, or acquired, as well as implemented and integrated into business processes.
- *Delivery and support.* These processes include the actual processing of data by application systems.
- *Monitoring.* All IT processes need to be regularly assessed over time for their quality and compliance with control requirements.

.51 The delivery and support category of processes is analogous to the COSO category of application controls. The other categories identified by COBIT approximate the general controls described by COSO but are somewhat broader in scope.

AICPA Trust Services, Including SysTrust[SM] and WebTrust[SM]

.52 SysTrust and WebTrust are professional services that address areas such as security, privacy, processing integrity, availability, and confidentiality through the use of the AICPA/CICA Trust Services Principles and Criteria. Management can benefit from using these suitable criteria in several ways when implementing Sarbanes-Oxley section 404 requirements. They can use the AICPA/CICA Trust Services Principles and Criteria as:

1. A guideline to setting up appropriate controls and systems that will instill confidence and trust.
2. A method of evaluating a system to determine whether it meets specific criteria and employs best practices.
3. An internal method of assurance and self-assessment that management, the board, and others can rely upon.

For more information about Trust Services, visit AICPA Online at www.aicpa.org/trustservices.

Project Planning Considerations

.53 To reach a reliable conclusion about the effectiveness of the entity's internal control, management will need to plan a logical, structured approach to its testing and evaluation, for example:

1. Ensure adequate documentation of existing controls. If controls are found to be missing or to contain design deficiencies, new or redesigned controls need to be documented and implemented.
2. Perform tests of the design and operating effectiveness of all significant controls.
3. Evaluate the test results and form a conclusion about the effectiveness of internal control. If the tests reveal significant deficiencies or material weaknesses in internal control, corrective action should be taken immediately.
4. Prepare management's report on internal control.

General Planning Considerations

.54 During the course of the project to assess internal control effectiveness, management will be required to make important judgments regarding:

- The focus of testing and areas of risk requiring increased scrutiny
- The nature of the testwork and other procedures necessary to achieve the project's objectives
- The scope of the work to be performed, for example, the locations or business units to be included in testing

.55 Planning involves gathering information to help make broad, preliminary judgments on these matters. The knowledge gained from gathering this information also provides the requisite knowledge to make informed decisions as the engagement proceeds. In that sense, planning is an ongoing process. Preliminary judgments made at the onset of the project are revisited continuously as the project progresses and more information becomes available.

Information Sources

.56 Sources of information that are useful for planning an assessment of internal control include the following:

- Published sources such as:
  - Form 10K and other SEC filings
  - Annual report
  - Information available in the Investor Relations section of the entity's Web site
  - Analyst reports
  - Inquiries of key individuals with knowledge of the entity's most significant business processes and financial reporting processes and how these processes are monitored and controlled.

Areas of Focus

.57 The tests of control effectiveness should be focused on the entity's most significant control objectives. Determining these control objectives is largely a matter of judgment that requires management to consider the most significant risks of producing reliable financial statements and the controls that mitigate these risks. The use of a percentage or other quantitative threshold may provide a reasonable basis for evaluating the significance of an account or process; however, judgment, including a review of qualitative factors, should be used to determine if amounts above or below the quantitative threshold must be evaluated. Factors that management should consider include the following:

- The entity's most significant business process activities
- Significant risks facing the entity and the industry
- Significant accounts, classes of transactions, and disclosures in the entity's financial statements
- Areas that pose a high risk of material misstatement to the financial statements, including those that:
  — Have a known or suspected control weakness
  — Possess a high risk for material misstatement irrespective of any controls

.58 Management should be careful not to make the assessment a "check-the-box" exercise. An assessment of internal control that is too formulaic or too detailed may not fulfill the underlying requirements. The desired approach should be to focus resources on the areas with the greatest risk, and avoid giving all significant accounts and related controls equal attention without regard to risk.

.59 For future years' assessments of internal controls, management's knowledge of the prior year's assessment results affect its current year risk-based analysis of the significant accounts and the related required documentation and testing. Management may determine that certain controls require more extensive testing, while other controls require little testing. Management may also find it appropriate to adjust the nature, timing, and extent of testing from year to year, by performing extensive tests in selected internal control areas some years, while performing less extensive testing in other areas, and changing that focus from year to year.

Management Override of Controls

.60 Assessing internal control effectiveness may necessitate addressing the key area of management override of controls, a characteristic of many fraudulent financial reporting schemes. The audit committee plays an important role in helping the board of directors fulfill its oversight responsibilities with respect to the entity's financial reporting process and the system of internal control. In exercising this oversight responsibility, the audit committee should consider the potential for management override of controls or other inappropriate influence over the financial reporting process.

Structuring the Project Team

.61 Performing an assessment of internal control is a complex process. Management should assemble a project team that includes individuals with a wide variety of technical expertise, including the following:

- Financial reporting requirements and processes
- Operations management
- Auditing concepts, techniques, and tools
- Information technology
- Securities law and SEC reporting requirements

.62 Members of the project team should have sufficient authority and stature within the organization to allow them access to information and resources. The team should report directly to the CEO and CFO, who ultimately bear the responsibility for establishing and maintaining internal control and reporting on its effectiveness.

Engaging Third Parties for Assistance

.63 Entities that lack sufficient resources or expertise may look to third parties for assistance. Completely outsourcing the entire project to a third party normally would be inappropriate for management to do—ultimately, management should remain responsible for evaluating and reporting on the effectiveness of the entity's internal control. However, third parties may be engaged to participate as part of the project team or to provide other services such as training.

.64 When engaging third parties for help on the project, management should clarify with the third party:

- *Qualifications.* This includes the nature of their expertise and their experience in performing the work you will ask of them.
- *Scope of work.* Management should be sure to define, as unambiguously as possible, the scope of the third party's work. For example, if the entity engages a third party to assist "in the documentation of internal control," what does that entail? Is that limited to the preparation of documentation for controls already in existence? What if, during this process, management discovers that some necessary controls do not exist or the ones that do are inadequately designed? Is the design or redesign of controls within the original scope of work?
- *Work product.* The work performed by a third party may result in evidence used by management to support its assessment of internal control effectiveness. As such, the external auditors also may rely on some or all of the work to reach their conclusion about management's assertion. When engaging third parties, management should obtain a clear understanding about the form and content of the work product to ensure that it is suitable for their purposes and, if necessary, acceptable for use by the external auditors.

Working With the External Auditors

.65 Management's relationship with its external auditor will play a role in determining effectiveness, efficiency, and cost of the project. Particularly in the first year of implementation, the entity's efforts to assess internal control effectiveness should be closely coordinated with the needs of the external auditor. A lack of coordination with the auditors could result in a variety of negative, unforeseen consequences, including:

- Duplication of effort
- Reperformance of certain tests
- Performance of additional tests or unanticipated expansion of the scope of the engagement
- Misunderstandings relating to the definition or reporting of material weaknesses.

Issues to Consider With the External Auditors

.66 The communication between management and the external auditors should take place early and continue throughout the project. Many issues arise during the course of the project. For some of these issues, the input of the external auditors is important if management is to reach a suitable resolution. Issues that management should consider discussing with its external auditors include the following.

Project Planning

- The overall process and approach management will take to evaluate internal control effectiveness
- The scope of the project
- The degree to which the external auditors will rely on the results of management's test work to reach their conclusion
- The list of controls determined to be significant and, therefore, the primary focus of the project
- The use of service centers and reliance on service center reports

Documentation

- Documentation of internal control policies and procedures, including the form of the documentation and what the documentation will contain
- The nature and extent of the documentation of tests of controls
- How to determine whether documentation of controls and tests of controls is sufficient

Tests of Internal Control

- The nature and extent of the planned tests of controls and whether the evidence expected to be obtained in those tests is sufficient to allow management to draw a reliable conclusion about the design and operating effectiveness of internal control
- The general type of deviations or conditions that might be considered significant deficiencies or material weaknesses[2] and therefore should be considered when designing tests of controls; the planned timing of management's tests of controls and whether this timing will allow management to draw conclusions about the design and operating effectiveness of internal control "as of" year end
- The nature and extent of procedures that may be required to update management's conclusions about effectiveness from the time the procedures were performed until year end
- The results of management's tests of controls and the conclusions reached regarding the effectiveness of internal control

Reporting

- Contents of management's report on internal control, including:

---

[2] See definitions of *significant deficiencies* and *material weaknesses* in the "Reporting" section of this Alert.

— Completeness of the report and whether the contents satisfy the SEC reporting requirements

— Possible deletion of material that is not required

- Disclosure of material weaknesses that exist at the reporting date
- The nonreporting of material weaknesses that existed and were reported at an interim period but subsequently have been remediated
- Disclosure of significant control changes that occurred after year end

Auditor Independence

.67 To perform an audit of an entity's financial statements, the external auditor must be independent of the entity. The SEC has developed a detailed body of rules that define auditor independence. Underlying these detailed rules are fundamental concepts of independence, including:

- Auditors should not act in the capacity of management.
- Auditors should not audit their own work.

.68 The audit committee should proceed carefully when engaging the entity's external auditors to assist in management's internal control assessment process. The nature of the relationship and scope of work should be defined in a way that the auditor's independence both in appearance and in fact remains uncompromised. The audit committee or board of directors should be involved in all discussions and have the final authority for determining whether and how the external auditors will be engaged to assist in any internal control related matters. The consequences of violating the SEC's auditor independence rules may be severe, and in some cases, the SEC may even require the entity to have its financial statements reaudited.

Documentation of Internal Control and Tests of Controls

.69 Within the context of assessing internal control to comply with the SEC reporting requirements, there are two separate sets of documentation:

- Documentation of the entity's internal control policies and procedures
- Documentation of management's tests to support its conclusion about the design and operating effectiveness of those controls

Documentation of Internal Control Policies and Procedures

.70 The adequate documentation of internal control is important for the following reasons.

- *To improve reliability of internal control.* The documentation of an entity's internal control policies and procedures improves the effectiveness and reliability of the system. Without adequate documentation, the performance of the system depends exclusively on the skills and competence of the individual responsible for performing the procedure. As such, performance can vary greatly between individuals or over time. Adequate documentation reduces this variability by facilitating the consistent dissemination of critical information. Additionally, by clearly stating the parameters within which control procedures should be performed, it becomes easier to identify deviations from the policy or procedure—that is, material weaknesses can be identified.
- *To enable effective monitoring.* Management is required to report material changes in internal control on a quarterly basis. As a result, one of the most important features of the monitoring component of

the entity's internal control system is its ability to identify changes. Documentation facilitates this monitoring element.

.71 In addition to enhancing the overall effectiveness of internal control, documentation of control policies and procedures also will facilitate management's assessment of effectiveness by providing a basis for:

- Evaluating design effectiveness
- Planning tests of operating effectiveness

.72 Management should be careful to distinguish between the documentation of internal control and internal control itself. Creating a document that describes the control policies and procedures that should be followed is *not* internal control. Internal control is the *process* used by the *people* to carry out those documented policies and procedures.

.73 The mere documentation of a control policy or procedure provides *no evidence* to support the operating effectiveness of the control. To support a conclusion about effectiveness, management needs to gather evidence by performing tests of controls.

Assessing the Adequacy of Existing Documentation

.74 Many entities currently are involved in projects to assess the adequacy of their existing documentation of internal control. In assessing the adequacy of documentation, management should determine whether:

- *All significant controls objectives have been considered.* As described previously, some control objectives, policies, and procedures are more significant to the entity's overall internal control structure than others. When considering the adequacy of an entity's documentation of internal control, individual policies and procedures should be documented for all significant control objectives. If control policies have not been documented for certain significant control objectives, management must determine whether:
  - — Controls do not exist to achieve the stated control objective, in which case the entity must design, implement, and document new control procedures, or
  - — Controls exist to achieve the control objective; however, they are informal, communicated verbally, or otherwise not documented. In this case, suitable documentation must be developed to facilitate an evaluation of the effectiveness of the design of the control.
- *Documentation is sufficient.* To be sufficient, the documentation should allow management and the external auditor to:
  - — Determine whether the policy or procedure is adequately designed
  - — Design and perform procedures to test the operating effectiveness of the controls

Documenting the Control Environment

.75 The documentation of the entity's control environment should encompass all the control environment elements described in COSO and summarized in "The Importance of the Control Environment" in the "Key Characteristics of the COSO Framework" section of this Alert. Those elements usually are described in documents such as:

- Board of directors' charter
- Audit committee documents and charter
- Company code of conduct

- Disclosure committee[3] charter
- Human resource policies and personnel handbook

Documentation can also encompass the elements essential in management's antifraud programs and controls.

Documenting Activity Level Control Policies and Procedures

.76 The documentation of controls related to transaction processing streams should contain the following elements.

- A link between the control objective and the control policy or procedure
- A description of the control policy or procedure that achieves the control objective
- A description of:
  - — How the control procedure is to be applied
  - — Who is responsible for performing the procedure
  - — How frequently the procedure is performed

.77 There are no requirements for the form of the documentation. There are many different acceptable ways to document control policies and procedures, including narratives, "walk through" descriptions of key documents, and flowcharts. Computerized documentation tools may be used to facilitate this process.

Documentation of Tests of Controls

.78 The entity should document the tests performed and evidence obtained to evaluate both the design and operating effectiveness of internal control. This documentation serves two purposes.

- It provides the CEO and CFO with the information needed to make and support their assessment of the effectiveness of internal control.
- It may be used, at least in part, by the external auditors to reach their conclusion about management's assertion.[4]

.79 No definitive guidance on the form or content of the entity's documentation of its tests of controls currently exists. However, one might expect such guidance to address matters such as the following:

- The objective of the tests performed
- A description of the test performance, including:
  - — The scope of the procedures, for example, the number of transactions tested or business segments reviewed
  - — When the tests were performed or the period covered by the tests
  - — Who performed the tests

---

[3] As described in the section of this Alert titled "The SEC Rules," management is required to report on the effectiveness of the entity's disclosure controls and procedures on a quarterly basis. The SEC has recommended that entities form a disclosure committee to comply with this requirement.

[4] The degree to which the external auditors may rely on tests performed by the entity to evaluate the effectiveness of internal control is a matter that is addressed in Public Company Accounting Oversight Board Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Conducted in Conjunction With an Audit of Financial Statements*, as discussed in the section of this Alert titled "External Auditor Standards."

- The results of the tests
- The conclusion reached as a result of the tests performed

Automated Documentation Tools

.80 Since the passage of the Sarbanes-Oxley Act, many companies have developed computer software products that aid in complying with the internal control provisions of the Act. These software tools typically center on helping companies automate the documentation of internal control policies and procedures, although some products perform additional functions such as automating the testing and reporting on internal controls, business process activities (for example, the approval and payment of vendor invoices), or both.

.81 The first function of an automated tool typically is to serve as a repository for all the documentation relating to the design of internal control. In those instances where the documentation of the control or the control itself either does not exist or otherwise is deficient, the software may allow the company to efficiently (*a*) document existing policies or (*b*) design and document new ones.

Documentation Process

.82 Automated internal control documentation tools typically use a combination of the following methods for creating and accumulating internal control documentation.

- *Reference existing documentation.* In many instances, the documentation of a policy or procedure already exists, for example, human resource policies or personnel manuals. When that is the case, the automated tool will allow this existing documentation to be accessed and reviewed by the user. To allow for this sharing of existing information, the automated tool may have to:
  - — Interface with existing systems
  - — Import existing data
- *Menu-driven responses.* To create documentation for a new or existing control procedure, the automated tool may provide users with choices from a pull-down menu. For example, to describe a control objective, the user may be presented with a choice of "ensure proper authorization of transactions," "verify accuracy," "ensure the capture of all valid transactions," and so on.
- *Free responses.* Instead of choosing from a predetermined list of possibilities, users may enter their own response into a text box.

.83 Regardless of the method used to document new or existing controls, the goal remains the same—to accurately describe the entity's control policies and procedures as they currently exist. Whether that goal is achieved depends primarily on the user's qualifications, knowledge, and training. To effectively document the entity's control policies and procedures, the user should have an in-depth understanding of all of the following:

- The entity's operations and existing control policies and procedures
- Internal control concepts, as described in the COSO framework (or other framework, if the entity does not use COSO)
- The financial reporting process
- The assertions that are represented in the financial statements[5]

[5] Financial statement assertions are described in the auditing literature as the assertions that are embodied in an entity's financial statements. For example, implicit in the financial statements is the assertion that the statements present *all* transactions and that only bona fide, authorized transactions are included. The five financial statement assertions are completeness, existence or occurrence, valuation, rights or ownership, and presentation and disclosure. A working knowledge of these assertions will help users understand risks and related controls. For example, there is a risk that the entity will fail to capture and process all valid transactions (completeness assertion). Therefore, a control objective of the entity's system should be to ensure completeness.

Maintaining Information Integrity

.84 To be effective, management must be able to rely on the accuracy of the documentation maintained. To achieve this integrity, the automated tool should have the following features:

- *Logical access controls.* The ability to modify documentation should be tightly controlled in the same way that access to all of an entity's sensitive information and computer applications is controlled. Individual users should be granted access privileges only to those areas of documentation that pertain to their assigned responsibilities. These access privileges should be administered carefully.
- *Standardized updating procedures.* As with any database, changes to data—in this case, the documentation of internal control—should be monitored and controlled. Modifications to the documentation should be done in an orderly fashion that ensures that all required changes are made. Once the changes have been made, they should be reviewed.

Monitoring Documentation Changes

.85 Once the documentation warehouse becomes established as an accurate reflection of internal control, and standardized updating procedures are in place, any changes to the documentation should represent actual changes to internal control. Management is required to report material changes in internal control. Identifying and capturing changes to the internal control documentation will enable this requirement to be met.

.86 The automated documentation tool should have a means for identifying changes since the last reporting date. To help reviewers evaluate their significance, these changes should be able to be grouped in a variety of ways, including business process, control objective, and financial statement account grouping.

Testing of Internal Control

.87 Management's tests of internal control should be:

- *Complete.* If the COSO criteria are used to measure internal control effectiveness, all five components of internal control, including the control environment, should be tested.
- *Sufficient.* The scope and extent of the tests should be sufficient for management to draw a reliable conclusion about the overall effectiveness of internal control taken as a whole.
- *Timely.* The timing of the tests, or the time period covered by the tests, should allow management to draw a reliable conclusion about the effectiveness of controls as of the reporting date, that is, fiscal year end.

.88 Additionally, the entity should address both the design and the operating effectiveness of the control.

- *Design effectiveness.* A control policy or procedure should be designed in a way that material misstatements to the financial statements will be prevented or detected in a timely manner.
- *Operating effectiveness.* Tests to evaluate operating effectiveness should allow management to evaluate how the control procedure was applied, the consistency with which it was applied, and by whom it was applied.

.89 To be effective, the tests should have:

- Clearly stated objectives
- A design that is appropriate to achieve those objectives

- A scope and extent that is comprehensive enough to draw a reliable conclusion

Testing the Control Environment

.90 The control environment has a significant influence on the operating effectiveness of the other components of the COSO integrated framework. The control environment is different from the other components in that it:

- Has an *indirect* effect on the amounts and disclosures reported in the financial statement, and
- Is *not* transaction-oriented. As such, it does not lend itself to transaction-oriented testing.

.91 Testing the operating effectiveness of the control environment may pose a challenge for management. Documenting the control policies that make up the control environment is not sufficient to draw a conclusion about operating effectiveness. For example, the mere existence of a company code of conduct and its dissemination are not sufficient to allow management to conclude on the effectiveness of the related elements of the entity's control environment. Following the guidance provided here, tests must be performed to allow management to determine:

- How management, the board of directors, the audit committee, and the company employees applied the policies described in the code of conduct to their work
- The consistency with which individuals followed the guidelines contained in the code
- Who followed the code and who did not

.92 In general, two approaches have begun to emerge for testing the control environment.

1. *Indirect.* Under this approach, management focuses its primary testing on activity-level controls. The results of those tests are evaluated carefully, and any deficiencies are investigated thoroughly to understand their root causes. Based on the information gained from these tests of activity-level controls, management is able to infer the relative effectiveness of the control environment.
2. *Direct.* Under this approach, management plans and performs tests to gather evidence directly about the operating effectiveness of the control environment. Such tests might include employee surveys, interviews with selected individuals, and the performance of a computer general controls review. Management uses the results of these tests of the control environment to design the activity-level tests.

.93 The definitive guidance on internal control reporting does not express a preference for either approach. In the opinion of the author, directly testing the control environment will lead to more reliable conclusions about its operating effectiveness. Designing and performing these types of tests may be outside the realm of tests normally performed by audit or financial professionals; however, credentialed specialists in organizational development and other disciplines have developed tools and methodologies in this area that may be appropriate for management wishing to gain a direct understanding of an entity's control environment effectiveness.

Testing Activity-Level Controls

Assessing the Effectiveness of Design

.94 Activity-level controls are effective when they can provide reasonable assurance that material financial statement errors will be prevented or detected in a timely fashion. To assess design effectiveness, management should consider:

- The general types of errors that could occur
- The points in the processing stream where errors may be introduced

.95 After gaining an understanding of what could go wrong and where, management will then determine whether the system, as designed, adequately addresses these potential errors and error points.

Assessing Operating Effectiveness

.96 ***Nature.*** Management will need to decide about the kinds of tests it will perform. For example, will the entity conduct inquiries, observe controls being performed, or reperform certain control procedures? The nature of the tests performed depends on the kind of control procedure being tested and whether its performance is documented.

.97 Typically, management will perform a combination of one or more controls to gather evidence about their effective operations. It would be unlikely that one test will provide all the evidence needed to support a conclusion. An opinion about control effectiveness most likely will be formed by the congruence and consistency of the evidence gathered from several sources and kinds of tests.

.98 Typical tests that management may choose from include:

- Tests of transactions
- Reperformance of control procedures
- Tests of computer application controls
- Inquiries
- Direct observation

.99 ***Timing.*** The Sarbanes-Oxley Act requires management to report on the effectiveness of internal control as of a point in time, namely, year end. As a practical matter, many tests will be performed in advance of the reporting date. In those situations, management will need to consider the need to perform additional tests to establish the effectiveness of the control procedure from the time the tests were performed until the reporting date. For example, if the entity tests the effectiveness of bank reconciliations as of June 30 and the reporting date is December 31, management will need to consider performing tests to cover the period from July 1 through December 31. These tests may *not* require a repeat of the detailed tests performed at June 30 for the subsequent six-month period. Once management establishes the effectiveness of the control procedure at June 30, it may be able to support the effectiveness of the control at the reporting date indirectly through the consideration of entity-level controls and other procedures such as:

- The effectiveness of personnel-related controls such as the training and supervision of personnel who perform control procedures.
- The effectiveness of risk identification and management controls, including change management.
- The effectiveness of the monitoring component of the entity's internal control.
- Inquiries of personnel to determine what changes, if any, occurred during the period that would affect the performance of controls.
- Repeating the procedures performed earlier in the year, focusing primarily on elements of the control procedure that have changed during the period.

Reporting

.100 The section of this Alert titled "The SEC Rules" describes what management's report on internal control must contain. However, the SEC has not mandated a prescribed form for management's report. Of the items required to be included in management's report, the one that calls for the most judgment is the following:

> Management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the most recent fiscal year, including a statement as to whether or not internal control over financial reporting is effective. This discussion must include disclosure of any material weakness in the company's internal control over financial reporting identified by management. Management is not permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the company's internal control over financial reporting.

.101 In its commentary to the final rules, the SEC requires management to state whether internal control is functioning effectively or not. "Negative assurance"—in which management states that "nothing came to its attention that would lead it to believe that internal control was not functioning effectively"—is not acceptable.

Material Weaknesses and Significant Deficiencies

.102 Management is required to disclose any "material weakness" in the company's internal control. Further, the existence of one or more material weaknesses precludes management from concluding that its internal control is effective.

.103 The SEC has stated that the meaning of the terms *material weaknesses* and *significant deficiencies* should be determined by reference to the auditing literature. Paragraphs 9 and 10 of the auditing standard provide the following definitions:

> 9. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected.
>
> Note: The term "remote likelihood" as used in the definitions of *significant deficiency* and *material weakness* (paragraph 10) has the same meaning as the term "remote" as used in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies* ("FAS No. 5"). Paragraph 3 of FAS 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 events or events occurring is slight. Therefore, the likelihood of an event is "more than reasonably possible or probable."
>
> Note: 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 could not reach such a conclusion regarding a particular misstatement, that misstatement is more than inconsequential.
>
> 10. 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 annual or interim financial statements will not be prevented or detected.

Note: In evaluating whether a control deficiency exists and whether control deficiencies, either individually or in combination with other control deficiencies, are significant deficiencies or material weaknesses, the auditor should consider the definitions in paragraphs 8, 9 and 10 [*of the auditing standard*], and the directions in paragraphs 130 through 137 [*of the auditing standard*]. As explained in paragraph 23 [*of the auditing standard*], the evaluation of the materiality of the control deficiency should include both quantitative and qualitative considerations. Qualitative factors that might be important in this evaluation include the nature of the financial statement accounts and assertions involved and the reasonably possible future consequences of the deficiency. Furthermore, in determining whether a control deficiency or combination of deficiencies is a significant deficiency or a material weakness, the auditor should evaluate the effect of compensating controls and whether such compensating controls are effective.

Making Judgments About the Severity of Internal Control Deficiencies

.104 Determining whether an internal control deficiency rises to the level of a material weakness will require management to consider:

- *Likelihood*, that is, the chance that the deficiency could result in a financial statement misstatement. When assessing likelihood, consider:
  - The relative importance of the control and whether the overall control objective is achieved by other control activities or a combination of control activities.
  - If the deficiency is an operating deficiency, the frequency of the operating failure rate. For example, numerous or repeated failures in the operation of a control would be more likely to be considered a significant deficiency than failures that are considered isolated occurrences.
  - Whether the control is automated and therefore could be expected to perform consistently over time.
- *Significance*, that is, the magnitude of potential misstatements resulting from the deficiency. When assessing significance, consider:
  - The nature of the account balance or classes of transactions affected by the deficiency and the financial statement assertions involved.
  - Whether the deficiency relates to an entity-level or activity-level control. Because entity-level controls can affect many account balances, classes of transactions, or financial statement assertions, weaknesses in entity-level controls that seem relatively insignificant by themselves could result in material financial statement misstatements.

Disclosures About Material Weaknesses

.105 When a company identifies a material weakness, and such material weakness has not been remediated before its fiscal year end, it must conclude that its internal control over financial reporting is ineffective. The SEC staff believes that in such a case, companies should consider including the following in their disclosures:

- The nature of any material weakness
- Its impact on financial reporting and the control environment
- Management's current plans, if any, for remediating the weakness

Annual Reporting of Material Weaknesses That Have Been Corrected

.106 Management is required to report on the effectiveness of internal control over financial reporting as of year end. In some cases, management may have identified and corrected a material weakness in internal control during an interim period. At issue is whether that corrected weakness is required to be reported in the entity's annual report on internal control.

.107 To make that determination, management should consider whether the corrected deficiency has been operational for a period of time that is sufficient to draw a reliable conclusion about its operating effectiveness as of year end. Testing the corrected deficiency for design and operational effectiveness would be required to support management's conclusion. Before making its final decision regarding the reporting of a corrected deficiency, management should consult with its SEC legal counsel and the external auditors.

.108 In addition, in July 2005, the PCAOB adopted Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*; this standard established a stand-alone engagement that is completely voluntary, performed at the company's request. Although the auditor's evaluation of the design and operating effectiveness of the identified controls generally follows the requirements of PCAOB Auditing Standard No. 2, this engagement is designed to be significantly narrower in scope because the auditor's testing is limited to the controls specifically identified by management as addressing the material weakness. Also, unlike an auditor's report on internal control over financial reporting, in which the assessment is required to be as of the date of the annual financial statements, an auditor's report on whether a material weakness continues to exist may be as of any date set by management. The PCAOB believes that in deciding whether to engage their auditors to report on whether a material weakness continues to exist, most companies will do so only when the benefits, such as renewed investor confidence, would outweigh the costs of such an audit. Auditing Standard No. 4 will become effective when ratified by the SEC.

Resource Central

On the Bookshelf

.109 The following publications deliver valuable guidance and practical assistance related to internal control.

- *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.

AICPA's reSOURCE Online Accounting and Auditing Literature

.110 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

.111 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.

Educational Courses and Training

.112 The AICPA offers the following continuing professional education (CPE) courses related to internal control:

- *Internal Control Reporting for Public Companies*, a self-study course on CD (product no. 737132kk).
- *Internal Control and Design*, a CPE course, and *Internal Controls: Design and Documentation*, a CPE self-study course (product no. 731850kk), that provide information on regulatory requirements and techniques for meeting them. These courses explain why internal controls matter to management, auditors, and regulators; what makes up a good system; how internal controls can be both cost- effective and efficient; and how to create usable, affordable documentation.
- *Internal Control Reporting: Standards for Compliance*, a video CPE course.
- *Internal Control Reporting for Public Companies*, a July 17, 2003, Webcast that described what the SEC's final rules require of companies and who is affected. Available on CD-ROM (product no. 737132kk).

Online CPE

.113 The AICPA offers an online learning tool, *AICPA InfoBytes*. An annual fee will offer unlimited access to over 1,000 credits of online CPE in one- and two-hour segments. Register today at www.cpa2biz.com.

AICPA's Antifraud & Corporate Responsibility Resource Center

.114 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

.115 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/CPA2Biz Service Center

.116 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

.117 The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

.118 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

Sarbanes-Oxley Act/PCAOB Implementation Central

.119 Visit Sarbanes-Oxley Act/PCAOB Implementation Central at www.aicpa.org/Sarbanes/index.asp. This AICPA Web site provides extensive, up-to-date compliance information for CPAs.

AICPA Online and CPA2Biz

.120 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.

.121

Appendix

Frequently Asked Questions (From the U.S. Securities and Exchange Commission)

November 8, 2002 (Revised November 14, 2002)

The answers to these frequently asked questions represent the views of the Division of Corporation Finance. They are not rules, regulations nor statements of the Securities and Exchange Commission. Further, the Commission has neither approved nor disapproved them.

Q1: Section 2(a)(7) of the Sarbanes-Oxley Act of 2002 (the "Act") defines an "issuer" as an "issuer (as defined in Section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78(c)), 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)…." A company has offered and sold debt securities pursuant to a registration statement filed under the Securities Act of 1933, thus subjecting it to the reporting requirements of Section 15(d). The company did not register the debt securities under Section 12 of the Exchange Act of 1934. Subsequently, the company's reporting obligations have been statutorily suspended under Section 15(d) because it had fewer than 300 security holders of record at the beginning of its fiscal year. The company has not filed a Form 15 and has continued to file reports pursuant to its indenture. Is the company considered an "issuer" under the Act?

A1: No. Because the issuer had fewer than 300 security holders of record at the beginning of its fiscal year, the suspension is granted by statute and is not contingent on filing a Form 15. The definition of issuer applies only to issuers required to file reports. However, see Question 9 regarding these kinds of filers under Section 302 of the Act.

Q2: Will the rules relating to Section 301 apply to issuers whose securities are traded on the over-the-counter bulletin board market?

A2: No. Securities traded on the over-the-counter bulletin board market currently are not considered listed securities.

Q3: An issuer is filing a Form 10-K report after August 29, 2002, the date Rules 13a-14, 13a-15, 15d-14 and 15d-15 became effective, for a period ending prior to the effective date. Section V of Release No. 33-8124 provides that the certification required to be included with the report need contain only the statements set forth in paragraphs (b)(1), (2) and (3) of Exchange Act Rules 13a-14 and 15d-14. However, the instructions to Forms 10-Q, 10-QSB, 10-K, 10-KSB, 20-F and 40-F indicate that the required certification must be in the exact form set forth in the report. Must a certification filed during the transition period for a period ended before August 29th include the statements set forth in paragraphs (b)(4), (5) and (6) of Rules 13a-14 and 15d-14?

A3: No. Paragraphs (b)(4), (5) and (6) of Rules 13a-14 and 15d-14 need only be included for quarterly and annual reports, including transition reports, filed for periods ending after August 29, 2002.

Q4: Does an amended quarterly or annual report filed after August 29, 2002, the effective date of Rules 13a-14 and 15d-14, that amends a report filed prior to August 29, 2002 have to be certified?

A4: Yes. See note 48 of Release 33-8124. The certification need not include paragraphs (b)(4), (5) and (6) of Rules 13a-14 and 15d-14.

Q5: A company is filing a Form 10-Q/A for a period ending prior to the effective date of Rules 13a-14 and 15d-14. The amendment will neither contain nor amend financial statements. May the principal executive officer and principal financial officer omit paragraph 3 from the certifications?

A5: Yes. Since there will be no financial statements in the Form 10-Q/A, paragraph 3 may be omitted.

Q6: If an issuer has filed a Form 10-Q before the effective date of Rules 13a-14 and 15d-14, but needs to file an amended Form 10-Q after August 29, does the issuer need to provide the disclosure required by Item 307 of Regulation S-K?

A6: No.

Q7: Does the new Item 15 of Form 20-F apply to periods ending prior to August 29, 2002?

A7: Issuers must comply with Item 15(b) but not Item 15(a).

Q8: Does Section 302 apply to Forms 8-K filed by asset-backed issuers?

A8: No. Asset-Backed Issuers, as defined in Rules 13a-14(g) and 15d-14(g), do not need to file a certification with each Form 8-K. However, the certification that is filed with the Asset-Backed Issuer's Form 10-K will relate to certain Forms 8-K filed by the issuer in the preceding year. Please refer to Statement by the Staff of the Division of Corporation Finance of the Securities and Exchange Commission Regarding Compliance by Asset-Backed Issuers with Exchange Act Rules 13a-14 and 15d-14, dated August 27, 2002.

Q9: Is an issuer that is filing or submitting reports exclusively under Section 15(d) of the Exchange Act on a "voluntary" basis (for example, pursuant to a covenant in an indenture or similar document), due to a statutory suspension of the Section 15(d) filing obligation, subject to Rules 15d-14 and 15d-15 and the disclosure required by Item 307 of Regulations S-B and S-K?

A9: Yes. All companies filing or submitting reports under Section 13(a) or 15(d) must comply with those provisions whether or not a Form 15 has been filed pursuant to Rule 15d-6.

Q10: If only one other officer is certifying to the issuer's reports, is it permissible to revise paragraph 4 of the certification to make "other certifying officers" singular?

A10: Yes.

Q11: If an officer signs the certification without altering the wording to indicate he or she is providing the certification as principal financial officer, how will readers know whether the signatory is the principal executive officer or the principal financial officer?

A11: The officer should include his or her title under the signature.

Q12: If the same individual is both the principal executive officer and principal financial officer, must he or she sign two certifications?

A12: The individual may provide one certification and provide both titles underneath the signature.

Q13: A CEO resigned after the end of the quarter but before the filing of the upcoming Form 10-Q. The company appointed a new CEO prior to the filing. Who signs the certification?

A13: The new CEO because he or she is the principal executive officer at the time of the filing.

Q14: A company has a CEO who is resigning at the end of the year and is no longer performing the function of CEO although he is still employed with the company. In the interim, the company has another individual that is performing the functions of CEO. Can that other individual sign the certification despite the fact that the company still has another person with the CEO title?

A14: The person performing the function of CEO at the time of the filing should provide the certification. If it is not the person with the title of CEO, the company should disclose in the filing that the other individual is performing that function.

Q15: An issuer currently does not have a CEO/CFO. Who must execute the certifications required by Rules 13a-14 and 15d-14?

A15: As set forth in paragraph (a) of Rules 13a-14 and 15d-14, where an issuer does not have a CEO/CFO, the person or persons performing similar functions must execute the required certification.

Q16: Must co-principal executive officers (or co-principal financial officers) execute separate certifications or may both execute the same certification?

A16: Co-principal executive officers (or co-principal financial officers) should each execute separate certifications.

Q17: If Section 302 certifications are not included in, for example, a Form 10-K or 10-Q filing, and an amendment will be filed to include the certifications, must the entire document be re-filed or can the amendment include only the signature pages?

A17: Because the certification relates to the entire Form 10-K or 10-Q filing, the amendment should include the entire filing, not just the signature pages.

Q18: Using the same facts in Question 17 above, if the amendment is not filed within the time period required for the periodic report, is the report deemed to be untimely?

A18: Yes. The periodic report will not be deemed timely for purposes of form eligibility and the issuer will not be deemed current until the amended periodic report containing the certification is filed.

Q19: A Canadian issuer is filing a Form F-10. Are certifications required because the Form F-10 incorporates prior Exchange Act filings?

A19: No.

Q20: What definition is the Commission currently using for internal controls and internal controls and procedures for financial reporting?

A20: In the release adopting the rules pursuant to Section 302 of the Act, the Commission noted the pre-existing concept of "internal controls" contained in Codification of Statements on Auditing Standards Section 319 ("AU Section 319"). See Release 33-8124 fn. 59 and accompanying text. In Release No. 33-8138, the Commission proposed defining "internal controls and procedures for financial reporting" by reference to AU Section 319, subject to any future modifications by the Public Company Accounting Oversight Board. Pending completion of rulemaking, the staff interprets both "internal controls and procedures for financial reporting" and "internal controls" for purposes of Exchange Act Rules 13a-14(b)(5) and (6) and 15d-14(b)(5) and (6) and Item 307 of Regulations S-B and S-K by reference to existing literature regarding generally accepted auditing standards, which would also be by reference to AU Section 319.

Q21: Are paragraphs (b)(5) and (b)(6) of Rules 13a-14 and 15d-14 currently operative given that there is no current requirement for evaluation of internal controls?

A21: Yes, these paragraphs are currently operative as to any filing relating to a period ending after August 29, 2002. See also Question 22.

Q22: New Exchange Act Rules 13a-14(b)(5) and (6) and 15d-14(b)(5) and (6) require an issuer's CEO and CFO to certify that:

> He or she and the other certifying officers have disclosed, based on their most recent evaluation, to the issuer's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function):
>
> - All significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and
> - Any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and
> - He or she and the other certifying officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

In addition, paragraph (b) of Item 307 of Regulations S-B and S-K requires an issuer to disclose whether or not there were significant changes in the issuer's internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses. Is a quarterly evaluation of internal controls or internal controls and procedures for financial reporting required at this time, and if so, what are the particular standards? How should the issuer respond to Item 307(b) of Regulations S-B and S-K? How should the issuer's CEO and CFO address this situation in their certification statements?

A22: Although proposed amendments to Exchange Act Rules 13a-15 and 15d-15 would impose a requirement on an issuer's management to conduct an evaluation, with the participation of the issuer's CEO and CFO, of the effectiveness of the issuer's internal controls and procedures for financial reporting (See Release No. 33-8138), the Commission's rules currently do not specifically require an issuer's CEO or CFO, or the issuer itself, to conduct periodic evaluations of the issuer's internal controls or the issuer's internal controls and procedures for financial reporting. Some elements of internal controls are included in the definition of disclosure controls and procedures. There is a current evaluation requirement involving the CEO and the CFO of that portion of internal controls that is included within disclosure controls and procedures as part of the required evaluation of disclosure controls and procedures. We expect that issuers generally also would engage in an evaluation of internal controls. We believe that issuers generally currently evaluate internal controls, for example, in connection with reviewing compliance with Section 13(b) of the Exchange Act or in connection with the preparation or audit of financial statements.

In the case of Item 307(b) of Regulations S-K and S-B, to the extent that an issuer has conducted an evaluation of its internal controls as of the end of the period covered by the report, including under the circumstances described in the preceding paragraph, the issuer should disclose any significant changes to the internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses. If the issuer has made any significant changes to internal controls or in other factors that could significantly affect these controls, such changes would presumably follow some evaluation, in which case the required disclosure must be made. If the issuer has made no significant changes, then no disclosure is required. This response is also applicable to Item 15(b) of Form 20-F and Item 6(c) of Form 40-F.

Regarding the certifications under Exchange Act Rules 13a-14(b)(5) and (6) and 15d-14(b)(5) and (6), the disclosures under Item 307 of Regulations S-B and S-K described above following any evaluations of internal controls, including in the circumstances described above in which the CEO or the CFO participates, would satisfy the requirements of paragraph (6). Paragraph (5) would currently require that disclosure be made by the CEO and the CFO to the issuer's auditors and the audit committee of its board of directors of any events enumerated in paragraph (5) that have occurred of which the CEO or CFO become aware based on the most recent evaluation of internal controls, including in the circumstances described above, in which the CEO or CFO participates.

Q23: For purposes of Rules 13a-14(b)(5) and (6) and 15d-14(b)(5) and (6), what do the terms "significant deficiencies" and "material weaknesses" mean?

A23: For purposes of Rules 13a-14(b)(5) and (6) and 15d-14(b)(5) and (6), the meaning of the terms "significant deficiencies" and "material weaknesses" should be determined by reference to generally accepted auditing standards. See generally, AU Section 325.

Q24: Where the registrant is a limited partnership that does not have an audit committee, who should be considered the persons performing the equivalent function as referenced in new Exchange Act Rules 13a-14(b)(5) and 15d-14(b)(5)?

A24: Many limited partnerships do not have audit committees. Many general partners of limited partnerships are themselves limited partnerships. In this case, look through each general partner of the limited partnerships acting as general partner until a corporate general partner or an individual general partner is reached. With respect to a corporate general partner, the registrant should look to the audit committee of the corporate general partner or to the full board of directors as fulfilling the role of the audit committee. With respect to an individual general partner, the registrant should look to the individual as fulfilling the role of the audit committee.

Q25: If a company otherwise maintains a dividend reinvestment plan that satisfies the exemptive conditions of Rule 16a-11, are automatic dividend reinvestments under a non-qualified deferred compensation plan also eligible for the Rule 16a-11 exemption, so that those reinvestment transactions would not be required to be reported, thus reducing the number of Forms 4 due?

A25: Non-qualified deferred compensation plans are not Excess Benefit Plans, as defined by Rule 16b-3(b)(2) under the Exchange Act, in which transactions are exempted by Rule 16b-3(c). See Interpretive Letter to American Bar Association (Feb. 10, 1999, Q. 2(c)). Under Rule 16a-3(g)(1), as amended in Release 34-46421 (Aug. 27, 2002), each transaction in a non-qualified deferred compensation plan must be reported on a Form 4 not later than the end of the second business day following the day on which the transaction was executed. However, if a company maintains a dividend reinvestment plan that satisfies the exemptive conditions of Rule 16a-11, automatic dividend reinvestments under a non-qualified deferred compensation plan are also eligible for the Rule 16a-11 exemption. See Interpretive letter to American Home Products (Dec. 15, 1992).

Q26: In order to reduce the number of Forms 4 due annually, an insider makes the following choices: In connection with the annual year-end election to defer some of the following year's salary into a non-qualified deferred compensation plan, the insider elects to have payroll deductions invested in the plan's interest-only account. The insider also elects for the deferred salary so invested to be "swept" on a quarterly basis into the plan's stock fund account. How should these "sweep" transactions be reported?

A26: Each "sweep" transaction would be reportable separately on Form 4. If the "sweep" election satisfies the Rule 16b-3(f) exemptive conditions for Discretionary Transactions (as defined in Rule 16b-3(b)(1)), the "sweep" transactions would be reported using Code I. Further, if the reporting person does not select the date of execution for a "sweep" that is a Discretionary Transaction, Rules 16a-3(g)(3) and (4) would apply to determine the deemed execution date.

Q27: For purposes of satisfying the affirmative defense conditions of Rule 10b5-1(c), an insider adopts a written plan for the purchase or sale of issuer equity securities. In the plan, which was drafted by a broker-dealer, the broker-dealer specified the dates on which plan transactions will be executed. Can the insider rely on Rule 16a-3(g)(2) to compute the Form 4 due date for plan transactions based on a deemed execution date?

A27: No. By adopting a written plan that specifies the dates on which plan transactions will be executed, the insider will have selected the date of execution for plan transactions. Consequently, the insider will not be able to rely on Rule 16a-3(g)(2) to compute the Form 4 due date for plan transactions based on a deemed execution date.

Q28: When reporting more than one transaction on the same Form 4, what date should be stated in Box 4?

A28: The transaction date (not the deemed execution date) of the earliest transaction reported should be stated in Box 4.

(Revised October 6, 2004)[1]

The answers to these frequently asked questions 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 Securities and Exchange Commission. Further, the Commission has neither approved nor disapproved them.

Q1: Financial Accounting Standards Board (FASB) Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities—An interpretation of ARB No. 51*, requires that registrants apply that guidance and, if applicable, consolidate entities based on characteristics other than voting control no later than the period ending March 15, 2004, or December 15, 2004 for small business issuers. In instances where the registrant lacks the ability to dictate or modify the internal controls of an entity consolidated pursuant to Interpretation No. 46, it may not have legal or contractual rights or authority to assess the internal controls of the consolidated entity even though that entity's financial information is included in the registrant's financial statements. Similarly, for entities accounted for via proportionate consolidation in accordance with Emerging Issues Task Force Issue No. 00-1 (EITF 00-1), management may not have the ability to assess the internal controls. How should management's report on internal control over financial reporting address these situations?

A1: We would typically expect management's report on internal control over financial reporting to include controls at all consolidated entities, irrespective of the basis for consolidation. However, in a situation where the entity was in existence prior to December 15, 2003 and is consolidated by virtue of Interpretation No. 46 (i.e., would not have been consolidated in the absence of application of that guidance) and where the registrant does not have the right or authority to assess the internal controls of the consolidated entity and also lacks the ability, in practice, to make that assessment, we believe management's report on internal control over financial reporting should provide disclosure in the body of its Form 10-K or 10-KSB regarding such entities. For example, a registrant could refer readers to a discussion of the scope of management's report on internal control over financial reporting in a section of the annual report entitled "Scope of Management's Report on Internal Control Over Financial Reporting." The registrant should disclose in the body of the Form 10-K or 10-KSB that it has not evaluated the internal controls of the entity and should also note that the registrant's conclusion regarding the effectiveness of its internal control over financial reporting does not extend to the internal controls of the entity. The registrant should also disclose any key sub-totals, such as total and net assets, revenues and net income that result from consolidation of entities whose internal controls have not been assessed. The disclosure should note that the financial statements include the accounts of certain entities consolidated pursuant to FIN 46 or accounted for via proportionate consolidation in accordance with EITF 00-1 but that management has been unable to assess the effectiveness of internal control at those entities due to the fact that the registrant does not have the ability to dictate or modify the controls of the entities and does not have the ability, in practice, to assess those controls.

[1] On October 6, 2004, changes were made to clarify the answer to Question 3 (see footnote 2 and a cross reference added to Question 3 to reference the answer to Question 9), to describe a Type 2 SAS 70 report (see footnote 3) and to address new frequently asked questions (see Questions 19 through 23).

Q2: Is a registrant required to evaluate the internal control over financial reporting of an equity method investment?

A2: The accounts of an equity method investee are not consolidated on a line-by-line basis in the financial statements of the investor, and as such, controls over the recording of transactions into the investee's accounts are not part of the registrant's internal control structure. However, the registrant must have controls over the recording of amounts related to its investment that are recorded in the consolidated financial statements. Accordingly, a registrant would have to consider, among other things, the controls over: the selection of accounting methods for its investments, the recognition of equity method earnings and losses, its investment account balance, etc. For example, a registrant might require that, at least annually, its equity method investees provide audited financial statements as a control over the recognition of equity method earnings and losses. However, nothing precludes a registrant from evaluating the control over financial reporting of an equity method investment, and there may be circumstances where it is not only appropriate but also may be the most effective form of evaluation. For purposes of applying this guidance, we make no distinction between those equity method investments for which the registrant is required to file audited financial statements pursuant to Rule 3-09 of Regulation S-X and those where no such requirement is triggered.

Q3: If a registrant consummates a material purchase business[2] combination during its fiscal year, must the internal control over financial reporting of the acquired business be included in management's report on internal control over financial reporting for that fiscal year?

A3: As discussed above, we would typically expect management's report on internal control over financial reporting to include controls at all consolidated entities. However, we acknowledge that it might not always be possible to conduct an assessment of an acquired business's internal control over financial reporting in the period between the consummation date and the date of management's assessment. In such instances, we would not object to management referring in the report to a discussion in the registrant's Form 10-K or 10-KSB regarding the scope of the assessment and to such disclosure noting that management excluded the acquired business from management's report on internal control over financial reporting. If such a reference is made, however, management must identify the acquired business excluded and indicate the significance of the acquired business to the registrant's consolidated financial statements. Notwithstanding management's exclusion of an acquired business's internal controls from its annual assessment, a registrant must disclose any material change to its internal control over financial reporting due to the acquisition pursuant to Exchange Act Rule 13a-15(d) or 15d-15(d), whichever applies (also refer to the last two sentences in the answer to Question 9). In addition, the period in which management may omit an assessment of an acquired business's internal control over financial reporting from its assessment of the registrant's internal control may not extend beyond one year from the date of acquisition, nor may such assessment be omitted from more than one annual management report on internal control over financial reporting.

Q4: If management, the accountant, or both conclude in a report included in a timely filed Form 10-K or 10-KSB that the registrant's internal control over financial reporting is not effective, would the registrant still be considered timely and current for purposes of Rule 144 and Forms S-2, S-3, and S-8 eligibility?

A4: Yes, as long as the registrant's other reporting obligations are timely satisfied. As has previously been the case, the auditor's report on the audit of the financial statements must be unqualified.

Q5: May management qualify its conclusions by saying that the registrant's internal control over financial reporting are effective subject to certain qualifications or exceptions or express similar positions?

---

[2] The staff intends the term business to include those acquisitions that would constitute a business based upon the facts and circumstances as outlined in Article 11-01(d) of Regulation S-X. An acquisition may not meet the definition of a business in EITF 98-3, "Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business," and would not be accounted for under FASB Statement No. 141, *Business Combinations*, but nevertheless may be a business under the definition in Article 11 used for SEC reporting purposes. This guidance applies irrespective of whether the acquisition is significant under Rule 1-02(w) of Regulation S-X.

A5: No. Management may not state that the registrant's controls and procedures are effective except to the extent that certain problems have been identified or express similar qualified conclusions. Rather, management must take those problems into account when concluding whether the registrant's internal control over financial reporting is effective. Management may state that controls are ineffective for specific reasons. In addition, management may not conclude that the registrant's internal control over financial reporting is effective if a material weakness exists in the registrant's internal control over financial reporting.

Q6: If management's report on internal control over financial reporting does not identify a material weakness but the accountant's attestation report does, or vice versa, does this constitute a disagreement between the registrant and the auditor that must be reported pursuant to Item 304 of Regulation S-K or S-B?

A6: No, unless the situation results in a change in auditor that would require disclosure under Item 304 of Regulation S-K or S-B. However, such differences in identification of material weaknesses could trigger other disclosure obligations.

Q7: When should a registrant determine whether it is an accelerated filer for purposes of determining when it must comply with Items 308(a) and (b) of Regulations S-K and S-B?

A7: As provided in Exchange Act Rule 12b-2, a registrant that is not already subject to accelerated filing should determine whether it is an accelerated filer at the end of its fiscal year, based on the market value of its public float of its common equity as of the last business day of its most recently completed second fiscal quarter. Consideration should also be given to the other components of the Rule 12b-2 definition (i.e. the registrant has been subject to Exchange Act reporting for at least 12 months, has filed at least one annual report, and is not eligible to use Forms 10-KSB and 10-QSB).

Q8: Is a registrant required to provide management's report on internal control over financial reporting, and the related auditor attestation report, when filing a transition report on Form 10-K or 10-KSB?

A8: Yes. Because transition reports filed on Forms 10-K or 10-KSB (whether by rule or by election) must contain audited financial statements, they must also include management's report on internal control, subject to the transition provisions specified in Release No. 34-47986. The transition provisions relating to management's report on internal control should be applied to the *transition period as if it were a fiscal year*. Transition reports on Form 10-Q or 10-QSB are not required to include a management report on internal control.

Q9: Is a registrant required to disclose changes or improvements to controls made as a result of preparing for the registrant's first management report on internal control over financial reporting?

A9: Generally we expect a registrant to make periodic improvements to internal controls and would welcome disclosure of all material changes to controls, whether or not made in advance of the compliance date of the rules under Section 404 of the Sarbanes-Oxley Act. However, we would not object if a registrant did not disclose changes made in preparation for the registrant's first management report on internal control over financial reporting. However, if the registrant were to identify a material weakness, it should carefully consider whether that fact should be disclosed, as well as changes made in response to the material weakness.

After the registrant's first management report on internal control over financial reporting, pursuant to Item 308 of Regulations S-K or S-B, the registrant is required to identify and disclose any material changes in the registrant's internal control over financial reporting in each quarterly and annual report. This would encompass disclosing a change (including an improvement) to internal control over financial reporting that was not necessarily in response to an identified significant deficiency or material weakness (i.e. the implementation of a new information system) if it materially affected the registrant's internal control over financial reporting. Materiality, as with all materiality judgments in this area, would be determined upon the basis of the impact on internal control over financial reporting and the materiality standard articulated in TSC Industries, Inc. v. Northway, Inc. 426 U.S. 438 (1976) and Basic Inc. v. Levinson, 485 U.S. 224 (1988). This would also include disclosing a change to internal control over financial reporting related to a business combination for which the acquired entity that has been or will be excluded from an annual management report on internal control over financial reporting as contemplated in Question 3 above. As an alternative to ongoing disclosure for such changes in internal control over financial reporting, a registrant may choose to disclose all such changes to internal control over financial reporting in the annual report in which its assessment that encompasses the acquired business is included.

Q10: The definition of the term "internal control over financial reporting" does not encompass a registrant's compliance with applicable laws and regulations, with the exception of compliance with the applicable laws and regulations directly related to the preparation of financial statements, such as the Commission's financial reporting requirements. Are all aspects of the rules promulgated under the Sarbanes-Oxley Act, for example, within that definition?

A10: No. While, it may be possible to connect the violation of any law, rule or regulation to the financial statements by observing that if the violation is significant enough it will have a material impact on the registrant's financial statements, we do not believe that compliance with all laws fits within the definition. The Commission's financial reporting requirements and the Internal Revenue Code are examples of regulations that are directly related to the preparation of the financial statements. Conversely, rules requiring disclosure as to the existence of a code of ethics or disclosure as to the existence of an audit committee financial expert are examples of rules promulgated under the Sarbanes-Oxley Act that are not directly related to the preparation of financial statements.

However, as part of management's evaluation of a registrant's disclosure controls and procedures, management must appropriately consider the registrant's compliance with other laws, rules and regulations. Such consideration should include assessing whether the registrant (1) adequately monitors such compliance, and (2) has appropriate disclosure controls and procedures to ensure that required disclosure of legal or regulatory matters is provided. Evaluation of disclosure controls and procedures and internal control over financial reporting in respect of compliance with applicable laws or regulations does intersect at certain points, including, for example, whether the registrant has controls to ensure that the effects of non-compliance with laws, rules and regulations are recorded in the registrant's financial statements, including the recognition of probable losses under FASB Statement No. 5, *Accounting for Contingencies.*

Q11: Must identified significant deficiencies be disclosed either as part of management's report on internal control over financial reporting or elsewhere in a registrant's periodic reports?

A11: A registrant is obligated to identify and publicly disclose all material weaknesses. If management identifies a significant deficiency it is not obligated by virtue of that fact to publicly disclose the existence or nature of the significant deficiency. However, if management identifies a significant deficiency that, when combined with other significant deficiencies, is determined to be a material weakness, management must disclose the material weakness and, to the extent material to an understanding of the disclosure, the nature of the significant deficiencies. In addition, if a material change is made to either disclosure controls and procedures or to internal control over financial reporting in response to a significant deficiency, the registrant is required to disclose such change and should consider whether it is necessary to discuss further the nature of the significant deficiency in order to render the disclosure not misleading. A registrant's auditor that is aware of a significant deficiency is required to communicate the significant deficiency to the audit committee as required by PCAOB Auditing Standard No. 2.

Q12: Many registrants with global operations have a lag in reporting the financial results of certain foreign subsidiaries for financial reporting purposes. For example, a registrant with a December 31 year-end may consolidate the operations of certain foreign subsidiaries with a November 30 year-end. Is this difference in period ends also acceptable in relation to the assessment of internal control over financial reporting?

A12: Yes.

Q13: The Commission's adopting release for its rules pursuant to Section 404 of the Sarbanes-Oxley Act (Release No. 34-47986) provides that the terms "significant deficiency" and "material weakness" have the same meaning for purposes of those rules as they do under generally accepted auditing standards and attestation standards. PCAOB Auditing Standard No. 2 modified the definitions of the terms "significant deficiency" and "material weakness." Does the Commission staff intend to look to the definitions as they existed when the adopting release was issued or as they have been revised by the PCAOB?

A13: When the Commission published its adopting release, the Commission expressed an intention to incorporate the definitions of "significant deficiency" and "material weakness" as they exist in the standards used by auditors of public companies. Looking to the definitions as revised by the PCAOB is consistent with this intention and, accordingly, the SEC staff will apply the PCAOB definitions in interpreting the Commission rules in this area.

Q14: In many situations, a registrant relies on a third party service provider to perform certain functions where the outsourced activity affects the initiation, authorization, recording, processing or reporting of transactions in the registrant's financial statements, such as payroll. In assessing internal controls over financial reporting, management may rely on a Type 2 SAS 70 report[3] performed by the auditors of the third party service providers. If the auditors of the third party service provider are the same as the auditors of the registrant, may management still rely on that report? Additionally, may management rely on a Type 2 SAS 70 report on the third party based on a different year-end?

A14: In situations where management has outsourced certain functions to third party service provider(s), management maintains a responsibility to assess the controls over the outsourced operations. However, management would be able to rely on the Type 2 SAS 70 report even if the auditors for both companies were the same. On the other hand, if management were to engage the registrant's audit firm to also prepare the Type 2 SAS 70 report on the service organization, management would not be able to rely on that report for purposes of assessing internal control over financial reporting. Management would be able to rely on a Type 2 SAS 70 report on the service provider that is as of a different year-end. Note, however, that management is still responsible for maintaining and evaluating, as appropriate, controls over the flow of information to and from the service organization.

Q15: What is the impact of combining the auditor's attestation report on management's assessment of internal controls over financial reporting with the audit report on the financial statements?

A15: Item 2-02 of Regulation S-X permits the auditor to combine the attestation report on management's assessment on internal control with the auditor's report on the financial statements. However, in determining whether to combine the reports, the auditor should take into account any issues that may arise if its audit report on the financial statements is expected to be reissued or incorporated by reference into a filing under the Securities Act.

Q16: Will the SEC be providing guidance on specific considerations relating to internal control over financial reporting for small business issuers?

A16: Although the Commission's final rule implementing Section 404 of the Act does not distinguish between large and small issuers, the Commission, as noted in the release accompanying the final rule, recognized that many smaller issuers might encounter difficulties in evaluating their internal control over financial reporting. The SEC staff would support efforts by bodies such as COSO to develop an internal control framework specifically for smaller issuers.

Q17: To what extent may management rely on the registrant's auditor to assist in its development of an assessment process and documentation process in preparation of issuing management's report on internal control over financial reporting?

---

[3] AU sec. 324 defines a report on controls placed in operation and test of operating effectiveness, commonly referred to as a "Type 2 SAS 70 report". This report is a service auditor's report on a service organization's description of the controls that may be relevant to a user organization's internal control as it relates to an audit of financial statements, on whether such controls were suitably designed to achieve specified control objectives, on whether they had been placed in operation as of a specific date, and on whether the controls that were tested were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the related control objectives were achieved during the period specified.

A17: The auditor is allowed to provide limited assistance to management in documenting internal controls and making recommendations for changes to internal controls. However, management has the ultimate responsibility for the assessment, documentation and testing of the registrant's internal controls over financial reporting.

Q18: What sources of guidance are available to management to assist them in fulfilling their responsibilities regarding management's assessment and documentation of the internal control over financial reporting?

A18: Several sources of guidance are available on the topic of management's assessment of internal control including, for example: the existing books and records requirements; the Commission's final rule on Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports (Release No. 34-47986); and, as referenced in the release on the final rule, the reports published by the Committee of Sponsoring Organizations of the Treadway Commission on internal control.

Q19: How should management treat an inability to assess certain aspects of their internal control over financial reporting in their written report? For example, management has outsourced a significant process to a service organization and it has determined that evidence of the operating effectiveness of the controls over that process is necessary. In addition, the service organization is unwilling to provide either a Type 2 SAS 70 report or access to assess the controls in place at the service organization. Finally, management does not have compensating controls in place within the registrant's internal control over financial reporting that allow them to determine the effectiveness of the controls over the process in an alternative manner.

A19: Item 308 of Regulations S-K and S-B, 17 CFR 229.308(a)(3) and 228.308(a)(3), states that management's annual report on internal control over financial reporting must include a statement as to whether or not internal control over financial reporting is effective. While the staff will allow the exceptions outlined in Questions 1, 2, and 3 above, the disclosure requirement does not permit management to issue a report on internal control over financial reporting with a scope limitation. Therefore, management must determine whether the inability to assess controls over a particular process is significant enough to conclude in their report that internal control over financial reporting is not effective. Further, management is precluded from concluding that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the internal control over financial reporting.

Q20: The Commission's rules specify that management's report must include disclosure of any material weakness in the registrant's internal control over financial reporting identified by management in the course of its evaluation. Must management's report specifically use the term "material weakness"?

A20: While the Commission's rule does not require management to use any specific language in their report, the staff would generally expect that, in order for management to provide full disclosure relating to any material weakness identified by management, management would use the term "material weakness" in their disclosures.

Q21: If a Form 10-K or Form 10-KSB is incorporated into a 1933 Securities Act filing, is a consent required related to the auditor's report on management's assessment of internal control over financial reporting?

A21: Yes. Securities Act Rule 436 (17 CFR 230.436) requires filings under the 1933 Act to include a consent for all accountants' reports included or incorporated into that filing. This includes a consent for the auditor's report on management's assessment of internal control over financial reporting as well as the auditor's report on the financial statements. A new consent for the auditor's report on management's assessment of internal control over financial reporting is required in an amendment to the registration statement (*a*) whenever a change, other than typographical is made to the audited annual financial statements and (*b*) when facts are discovered that may impact the auditor's report on management's assessment of internal control over financial reporting.

Q22: Is an annual report to shareholders that meets the requirements of Exchange Act Rules 14a-3(b) or 14c-3(a) required to include management's report on internal control over financial reporting and the auditor's report on management's assessment of internal control over financial reporting?

A22: We believe that the intent of Section 404 of the Sarbanes-Oxley Act and the Commission's rules is that a registrant's audited financial statements with an accompanying audit report that are contained in or accompany a proxy statement or consent solicitation statement also be accompanied by management's report on internal control over financial reporting and the auditor's report on management's assessment of internal control over financial reporting. We intend to recommend to the Commission that amendments be made to Rules 14a-3 and 14c-3(a) and Item 13 of Schedule 14A to include such a requirement. In the interim, we encourage issuers to include both management's report on internal control over financial reporting and the auditor's report on management's assessment of internal control over financial reporting in the annual report to shareholders when their audited financial statements are included. If management states in their report that internal control over financial reporting is ineffective or the auditor's report takes any form other than an unqualified opinion and these reports are not included in the annual report to shareholders, our view is that an issuer would have to consider whether the annual report to shareholders contained a material omission that made the disclosures in the annual report misleading.

Q23: The Commission's rules implementing Section 404, announced in Release No. 34-47986, require management to perform an assessment of internal control over financial reporting which includes the "preparation of financial statements for external purposes in accordance with generally accepted accounting principles." Does management's assessment under the Commission's rule specifically require management to assess internal control over financial reporting of required supplementary information? Supplementary information includes the financial statement schedules required by Regulation S-X as well as any supplementary disclosures required by the FASB. One of the most common examples of such supplementary information is certain disclosures required by the FASB Statement No. 69, *Disclosures about Oil and Gas Producing Activities.*

A23: Adequate internal controls over the preparation of supplementary information are required and therefore should be in place and assessed regularly by management. The Commission's rules in Release No. 34-47986 did not specifically address whether the supplementary information should be included in management's assessment of internal control over financial reporting under Section 404. A question has been raised as to whether the supplementary information included in the financial statements should be encompassed in the scope of management's report on their assessment of internal control over financial reporting.

The Commission staff is considering this question for possible rule making. Additionally, the Commission staff is evaluating broader issues relating to oil and gas disclosures and will include in its evaluation whether rulemaking in this area may be appropriate. Should there be any proposed changes to the current requirements in this area, they will be subject to the Commission's standard rulemaking procedures, including a public notice and comment period in advance of rulemaking. As a result, internal control over the preparation of this supplementary information need not be encompassed in management's assessment of internal control over financial reporting until such time that the Commission has completed its evaluation of this area and issues new rules addressing such requirements.

Until then, registrants are reminded that they must fulfill their responsibilities under current requirements including Section 13(b)(2) of the Exchange Act and Exchange Act Rules 13(b)(2) of the Exchange Act and Exchange Act Rules 13a-14, 13a-15, 15d-14, and 15d-15.

[*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

Acknowledgments

The AICPA Accounting and Auditing Publications staff wishes to thank Kellie Sclafani, CPA, for her indispensable review of this publication.

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.

* * * *

.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 9000-121*.]

AAM Section 8270

Current Accounting Issues and Risks—2005/06

STRENGTHENING FINANCIAL REPORTING

NOTICE TO READERS
CURRENT ACCOUNTING ISSUES AND RISKS—2005/06

This Financial Reporting Alert is intended to provide accountants with an overview of recent economic, industry, technical, and professional developments that may affect their financial reporting.

This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

AICPA Staff

Written by
Robert Durak, CPA
Director
Accounting and Auditing Publications

Lori L. Pombo, CPA
Technical Manager
Accounting and Auditing Publications

How This Alert Can Help You

.01 The knowledge that this Financial Reporting Alert delivers can assist you in achieving a more robust understanding of the business environment in which your company operates. Also, this Alert delivers information about current accounting and regulatory developments.

New Pronouncements and Other Guidance

Recent Accounting Pronouncements and Related Guidance

.02 Presented below is a list of accounting pronouncements and other guidance issued since last fall. 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 Financial Accounting Standards Board (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 of Financial Accounting Standards No. 152 (December 2004)	*Accounting for Real Estate Time-Sharing Transactions—an amendment of FASB Statements No. 66 and 67* This Statement amends FASB Statement No. 66, *Accounting for Sales of Real Estate*, to reference the financial accounting and reporting guidance for real estate time-sharing transactions that is provided in AICPA Statement of Position (SOP) 04-2, *Accounting for Real Estate Time-Sharing Transactions*. This Statement also amends FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, to state that the guidance for (*a*) incidental operations and (*b*) costs incurred to sell real estate projects does not apply to real estate time-sharing transactions. The accounting for those operations and costs is subject to the guidance in SOP 04-2.

(continued)

FASB Statement No. 153 (December 2004)	*Exchanges of Nonmonetary Assets—an amendment of APB Opinion No. 29* (See summary that follows in this section.)
FASB Statement No. 123(R) (December 2004)	*Share-Based Payment* (See summary that follows in this section.)
FASB Statement No. 154 (May 2005)	*Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3* (See summary that follows in this section.)
FASB Interpretation No. 47 (March 2005)	*Accounting for Conditional Asset Retirement Obligations—an interpretation of FASB Statement No. 143* This Interpretation clarifies that the term *conditional asset retirement obligations* describes a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may not be under the entity's control.
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. 123(R), No. 13, No. 115, No. 124, and No. 150, among others, as well as to FASB Interpretation No. 46(R).
AICPA SOP 05-1	*Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts*
AICPA Technical Practice Aid (TPA) section 1200.06–1200.15 (February 2005) (Nonauthoritative)	"Accounting by Noninsurance Enterprises for Property and Casualty Insurance Arrangements That Limit Insurance Risk"
AICPA TPA section 5400.05 (September 2005) (Nonauthoritative)	"Accounting and Disclosures Guidance for Losses from Natural Disasters—Nongovernmental Entities"
AICPA TPA 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 TPA 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"

.03 Some of the standards are summarized in the following sections. These summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard.

FASB Statement No. 153, *Exchanges of Nonmonetary Assets—an amendment of APB Opinion No. 29*

.04 In December 2004, the FASB issued FASB Statement No. 153, *Exchanges of Nonmonetary Assets—an amendment of APB Opinion No. 29*. The guidance in Accounting Principles Board (APB) Opinion No. 29, *Accounting for Nonmonetary Transactions*, is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. The guidance in that Opinion, however, included certain exceptions to that principle. This Statement amends APB Opinion No. 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange.

.05 FASB Statement No. 153 is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005 (prospective application).

FASB Statement No. 123 (Revised), *Share-Based Payment*

.06 This Statement is a revision of FASB Statement No. 123, *Accounting for Stock-Based Compensation*. This Statement supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and its related implementation guidance.

.07 This Statement establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. It also addresses transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of those equity instruments. This Statement focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. This Statement does not change the accounting guidance for share-based payment transactions with parties other than employees provided in FASB Statement No. 123 as originally issued and Emerging Issues Task Force (EITF) Issue No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction With Selling, Goods or Services." This Statement does not address the accounting for employee share ownership plans, which are subject to AICPA SOP 93-6, *Employers' Accounting for Employee Stock Ownership Plans*.

.08 A nonpublic entity will measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of those instruments, except in certain circumstances. Specifically, if it is not possible to reasonably estimate the fair value of equity share options and similar instruments because it is not practicable to estimate the expected volatility of the entity's share price, a nonpublic entity is required to measure its awards of equity share options and similar instruments based on a value calculated using the historical volatility of an appropriate industry sector index instead of the expected volatility of its share price.

.09 A nonpublic entity may elect to measure its liability awards at their intrinsic value through the date of settlement.

.10 The grant-date fair value of employee share options and similar instruments will be estimated using option-pricing models adjusted for the unique characteristics of those instruments (unless observable market prices for the same or similar instruments are available). If an equity award is modified after the grant date, incremental compensation cost will be recognized in an amount equal to the excess of the fair value of the modified award over the fair value of the original award immediately before the modification.

.11 Excess tax benefits, as defined by this Statement, will be recognized as an addition to paid-in capital. Cash retained as a result of those excess tax benefits will be presented in the statement of cash flows as financing cash inflows. The write-off of deferred tax assets relating to unrealized tax benefits associated with recognized compensation cost will be recognized as income tax expense unless there are excess tax benefits from previous awards remaining in paid-in capital to which it can be offset.

.12 The notes to financial statements will disclose information to assist users of financial information to understand the nature of share-based payment transactions and the effects of those transactions on the financial statements.

.13 This Statement eliminates the alternative to use APB Opinion No. 25's intrinsic value method of accounting that was provided in FASB Statement No. 123 as originally issued. Under APB Opinion No. 25, issuing stock options to employees generally resulted in recognition of no compensation cost. This Statement requires entities to recognize the cost of employee services received in exchange for awards of equity instruments based on the grant-date fair value of those awards (with limited exceptions). Recognition of that compensation cost helps users of financial statements to better understand the economic transactions affecting an entity and to make better resource allocation decisions. Such information specifically will help users of financial statements understand the effect that share-based compensation transactions have on an entity's financial condition and results of operations. This Statement also will improve comparability by eliminating one of two different methods of accounting for share-based compensation transactions and thereby also will simplify existing U.S. generally accepted accounting principles (GAAP). Eliminating different methods of accounting for the same transactions leads to improved comparability of financial statements because similar economic transactions will be accounted for similarly.

.14 The fair-value-based method in this Statement is similar to the fair-value-based method in FASB Statement No. 123 in most respects. However, the following are the key differences between the two:

- Nonpublic entities may elect to measure their liabilities to employees incurred in share-based payment transactions at their intrinsic value. Under FASB Statement No. 123, all share-based payment liabilities were measured at their intrinsic value.
- Nonpublic entities are required to account for awards of equity instruments using the fair-value-based method unless it is not possible to reasonably estimate the grant-date fair value of awards of equity share options and similar instruments because it is not practicable to estimate the expected volatility of the entity's share price. In that situation, the entity will account for those instruments based on a value calculated by substituting the historical volatility of an appropriate industry sector index for the expected volatility of its share price. FASB Statement No. 123 permitted a nonpublic entity to measure its equity awards using either the fair-value-based method or the minimum value method.
- Entities are required to estimate the number of instruments for which the requisite service is expected to be rendered. FASB Statement No. 123 permitted entities to account for forfeitures as they occur.
- Incremental compensation cost for a modification of the terms or conditions of an award is measured by comparing the fair value of the modified award with the fair value of the award immediately

before the modification. FASB Statement No. 123 required that the effects of a modification be measured as the difference between the fair value of the modified award at the date it is granted and the award's value immediately before the modification determined based on the shorter of (*a*) its remaining initially estimated expected life or (*b*) the expected life of the modified award.

- This Statement also clarifies and expands FASB Statement No. 123's guidance in several areas, including measuring fair value, classifying an award as equity or as a liability, and attributing compensation cost to reporting periods.
- In addition, this Statement amends FASB Statement No. 95, *Statement of Cash Flows*, to require that excess tax benefits be reported as a financing cash inflow rather than as a reduction of taxes paid.

.15 This Statement is effective for nonpublic entities as of the beginning of the first annual reporting period that begins after December 15, 2005.

.16 This Statement applies to all awards granted after the required effective date and to awards modified, repurchased, or cancelled after that date. The cumulative effect of initially applying this Statement, if any, is recognized as of the required effective date.

.17 As of the required effective date, all entities that used the fair-value-based method for either recognition or disclosure under FASB Statement No. 123 will apply this Statement using a modified version of prospective application. Under that transition method, compensation cost is recognized on or after the required effective date for the portion of outstanding awards for which the requisite service has not yet been rendered, based on the grant-date fair value of those awards calculated under FASB Statement No. 123 for either recognition or pro forma disclosures. For periods before the required effective date, those entities may elect to apply a modified version of retrospective application under which financial statements for prior periods are adjusted on a basis consistent with the pro forma disclosures required for those periods by FASB Statement No. 123. Nonpublic entities that used the minimum value method in FASB Statement No. 123 for either recognition or pro forma disclosures are required to apply the prospective transition method as of the required effective date.

.18 The FASB has also issued three FSPs related to FASB Statement No. 123(R). They are as follows:

- FSP FAS 123(R)-1, "Classification and Measurement of Freestanding Financial Instruments Originally Issued in Exchange for Employee Services under FASB Statement No. 123(R)" (Issued August 2005)
- FSP FAS 123(R)-2, "Practical Accommodation to the Application of Grant Date as Defined in FASB Statement No. 123(R)" (Issued October 2005)
- FSP FAS 123(R)-3, "Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards" (Issued November 2005)

You should refer to the FASB Web site at www.fasb.org for additional information.

FASB Statement No. 154, *Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3*

.19 In May 2005, the FASB issued FASB Statement No. 154, *Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3*. FASB Statement No. 154 replaces APB Opinion No. 20, *Accounting Changes*, and FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*, and changes the requirements for the accounting for and reporting of a change in accounting principle. This Statement applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. When a pronouncement includes specific transition provisions, those provisions should be followed.

.20 APB Opinion No. 20 previously required that most voluntary changes in accounting principle be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. This Statement requires retrospective application to prior periods' financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. When it is impracticable to determine the period-specific effects of an accounting change on one or more individual prior periods presented, FASB Statement No. 154 requires that the new accounting principle be applied to the balances of assets and liabilities as of the beginning of the earliest period for which retrospective application is practicable and that a corresponding adjustment be made to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period rather than being reported in an income statement. When it is impracticable to determine the cumulative effect of applying a change in accounting principle to all prior periods, this Statement requires that the new accounting principle be applied as if it were adopted prospectively from the earliest date practicable.

.21 FASB Statement No. 154 defines *retrospective application* as the application of a different accounting principle to prior accounting periods as if that principle had always been used or as the adjustment of previously issued financial statements to reflect a change in the reporting entity. This Statement also redefines *restatement* as the revising of previously issued financial statements to reflect the correction of an error.

.22 In addition, FASB Statement No. 154 requires that:

- Retrospective application of a change in accounting principle be limited to the direct effects of the change. Indirect effects of a change in accounting principle, such as a change in nondiscretionary profit-sharing payments resulting from an accounting change, should be recognized in the period of the accounting change.
- A change in depreciation, amortization, or depletion method for long-lived, nonfinancial assets be accounted for as a change in accounting estimate effected by a change in accounting principle.

.23 This Statement carries forward without change the guidance contained in APB Opinion No. 20 for reporting the correction of an error in previously issued financial statements and a change in accounting estimate. This Statement also carries forward the guidance in APB Opinion No. 20 requiring justification of a change in accounting principle on the basis of preferability.

.24 FASB Statement No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005.

Recent FASB EITF Issues and FSPs

.25 The FASB is very active in issuing EITF Issues and FSPs. You should visit the FASB Web site to stay abreast of these many issues and understand those accounting requirements that may pertain to your company's financial statements. Listed below are selected EITF Issues and FSPs that have been issued recently and may have a broad interest.

EITF Issue or FSP	*Title*
EITF Issue No. 01-9	"Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)"
EITF Issue No. 03-1	"The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments"
EITF Issue No. 03-13	"Applying the Conditions in Paragraph 42 of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, in Determining Whether to Report Discontinued Operations"

EITF Issue or FSP	*Title*
EITF Issue No. 04-1	"Accounting for Preexisting Relationships between the Parties to a Business Combination"
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"
EITF Issue No. 04-10	"Determining Whether to Aggregate Operating Segments That Do Not Meet the Quantitative Thresholds"
EITF Issue No. 04-13	"Accounting for Purchases and Sales of Inventory with the Same Counterparty"
EITF Issue No. 05-6	"Determining the Amortization Period for Leasehold Improvements"
FSP FAS 13-1	"Accounting for Rental Costs Incurred during a Construction Period"
FSP FAS 115-1 and FAS 124-1	"The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments"
FSP FAS 123(R)-1	"Classification and Measurement of Freestanding Financial Instruments Originally Issued in Exchange for Employee Services under FASB Statement No. 123(R)"
FSP FAS 123(R)-2	"Practical Accommodation to the Application of Grant Date as Defined in FASB Statement No. 123(R)"
FSP FAS 123(R)-3	"Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards"
FSP FAS 140-2	"Clarification of the Application of Paragraphs 40(b) and 40(c) of FASB Statement No. 140"
FSP 150-5	"Issuer's Accounting under FASB Statement No. 150 for Freestanding Warrants and Other Similar Instruments on Shares That Are Redeemable"
FSP FIN 45-3	"Application of FASB Interpretation No. 45 to Minimum Revenue Guarantees Granted to a Business or Its Owners"
FSP FIN 46(R)-5	"Implicit Variable Interests under FASB Interpretation No. 46(R)"
FSP APB 18-1	"Accounting by an Investor for Its Proportionate Share of Accumulated Other Comprehensive Income of an Investee Accounted for under the Equity Method in Accordance with APB Opinion No. 18 upon a Loss of Significant Influence"

Present Business and Economic Developments That May Affect Your Company

Rising Interest Rates, Rising Energy Costs, Rising Debt Levels, and a Softening Housing Boom

.26 A number of serious threats to the economy and business environment exist. They include:

- Rising interest rates. Remember that approximately half of all U.S. corporate debt outstanding has floating interest rates. Moreover, trillions of dollars worth of derivatives exist, many of which are based on interest rates.
- Soaring gasoline prices. Rising prices threaten a key pillar of the U.S. economy—consumer spending.
- Dangerously high and rising consumer debt levels.
- A softening housing boom in some markets.

Although the economy has been performing nicely, these threats could derail economic growth, possibly affecting your company's business and financial condition.

Hurricanes Katrina and Rita—Accounting Considerations

.27 Hurricanes Katrina and Rita, which severely damaged the Gulf Coast region, present unique issues to accountants. In addition, Katrina and Rita will likely cause disruption to the nation's near-term economic growth, inasmuch as the hurricanes inflicted severe damage to key areas of the nation's energy and shipping infrastructure. However, significant long-term economic effects are not expected. Beyond the possible economic impact the hurricanes may have, accountants should be aware of the issues and information presented here.

Accounting Considerations

.28 As companies assess Katrina and Rita's financial impact on their operations, management will need to properly report the impact in their financial statements. The following questions may arise for losses incurred as a result of the hurricanes:

1. How should losses from a natural disaster of a type that is reasonably expected to reoccur be classified in the statement of operations?
2. When should an asset impairment loss related to a natural disaster be recognized?
3. When should a liability for nonimpairment losses and costs related to a natural disaster be recognized?
4. What is the accounting for insurance recoveries to cover losses sustained in a natural disaster? Also, what are the additional considerations related to business interruption insurance recoveries?
5. What are the required disclosures regarding the impact of a natural disaster?

.29 The AICPA has issued TPA section 5400.05, "Accounting and Disclosures Guidance for Losses from Natural Disasters—Nongovernmental Entities." This guidance answers the above questions and can be obtained at www.aicpa.org/download/acctstd/Natural_disaster_TPA_5400.05.pdf.

.30 The guidance in TPA section 5400.05 states that a natural disaster of a type that is reasonably expected to recur would not meet the conditions of classifying the losses as "extraordinary" in the income statement. The magnitude of loss from a particular natural disaster does not cause that disaster to be unusual in nature or unlikely to recur (the two conditions for an extraordinary item). As of the writing of this Alert, indications are the FASB will conclude that losses from the hurricanes should not be classified as extraordinary. Readers should keep alert to any statements from the FASB on this matter.

Securities and Exchange Commission, IRS, and Department of Labor Activities Related to the Hurricanes

.31 The Securities and Exchange Commission (SEC), the IRS, and the Department of Labor (DOL) are providing relief to victims of the hurricanes in various ways, such as extension of filing deadlines, exemptions from filing requirements, and tax relief. Visit the SEC, IRS, and DOL Web sites at www.sec.gov, www.irs.gov, and www.dol.gov for further information.

Other AICPA Activities Related to Katrina

.32 In addition to the activities previously discussed, the AICPA has implemented several relief efforts and is reaching out to members in the Gulf Coast to help with relief efforts. A Disaster Recovery Resource Center has been established at www.aicpa.org/news/2005/disaster_recovery_resources.htm. This site is full of many resources and information about relief activities related to Katrina, including a disaster response checklist to help financial executives navigate through the complicated task of disaster recovery. The checklist, entitled "Disaster Response: What to Do First—A Checklist for CFOs and Controllers," outlines the issues that need to be addressed including ensuring employee safety, maintaining operations, and evaluating the company's financial situation.

Risks to Developing Economies

.33 Skyrocketing energy costs are threatening many developing economies. Developing economies, especially in Asia (for example, Indonesia, India, Philippines, Thailand, and South Korea), rely heavily on oil and gas. They also import a great deal of that energy. These developing nations spend heavily to subsidize energy prices. As they spend increasing amounts of money, the buying power and soundness of their currencies erode. These nations then face great pressure to raise interest rates to restore the value of their currencies and keep inflation in check. These factors could undermine investor confidence in these developing economies and cause an economic downturn. Energy subsidies were an issue in the 1997 and 1998 Asian economic crisis. Accountants may want to keep an eye on these developing economies. If serious economic difficulty develops, accountants may need to consider the effect such events would have on the company's financial condition. Some of the risks or issues that may need to be considered include the following:

- Economic downturns in foreign economies directly affect the U.S. economy and the business and financial health of U.S. companies.
- Manufacturers, oil producers, ranchers, farmers, high-technology companies, and aerospace businesses are some of the industries that could be affected negatively.
- U.S. companies that have links to countries experiencing economic trouble may see their stock prices lose substantial value.
- Greater risk may exist for entities involved in derivatives, assets, and foreign-currency transactions related to countries embroiled in economic hardships.
- Serious economic difficulty abroad may result in a greater risk of current vulnerability due to certain concentrations.

.34 Accountants involved in financial reporting may need to perform the following if the company is affected by any of these risks or issues:

- Accountants may need to assess the performance of assets and derivatives related to economically troubled nations.
- Accountants may need to consider the appropriate accounting and required disclosures relating to foreign currency translation, transactions arising from the translation of asset and liability positions, and revenue and expense transactions in currencies other than U.S. dollar pursuant to FASB Statement No. 52, *Foreign Currency*.
- Accountants may need to appropriately evaluate the risk of current vulnerabilities due to certain concentrations. Also, accountants should comply with the requirements of SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, if applicable.
- Accountants may need to evaluate related contingencies arising from economic troubles abroad, pursuant to FASB Statement No. 5, *Accounting for Contingencies*.

Underfunded Pension Plans and Other Considerations in Pension Plan Accounting

.35 Many companies across all industries are facing a mounting crisis—underfunded pension plans. A recent Government Accountability Office (GAO) report stated that more than half of the 29,000 private pension plans insured by the federal Pension Benefit Guaranty Corporation (PBGC) were underfunded, and a quarter of the plans were less than 90 percent funded. Simply put, many companies have defined benefit plans in which the obligations owed to retirees exceed the assets in the plans. These companies are faced with pouring large amounts of cash into those plans to meet legal requirements and make up the shortfall. As this crisis worsens, a number of companies are opting to terminate their pension plans.

.36 In addition, many companies have been updating and changing the assumptions they use in accounting for pension plans and other postretirement benefit plans to reflect a changing economic environment.

.37 From a financial reporting perspective, management needs to continuously monitor the key assumptions used in measuring pension benefit obligations, returns on plan assets, and periodic service cost. Principal actuarial assumptions include discount rates, participation rates, and factors affecting the amount and timing of future benefit payments. Changes to key assumptions, even small changes, can significantly affect a company's earnings and financial statements. FASB Statements No. 87, *Employers' Accounting for Pensions*, and No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, indicate that each assumption shall reflect the best estimate solely with respect to that individual assumption on the applicable measurement date. Certain financial statement disclosures may be required and if activity within an existing plan, such as earnings or returns on invested plan assets, has a material impact on the company's liquidity, capital resources, or results of operations, that activity should be discussed in Management's Discussion and Analysis (MD&A).

Classification of Payments Related to Settlement of Pension Liabilities

.38 Contributions to pension plans are reported as operating cash flows because they relate to employee compensation, an item reported as an expense in the income statement. Companies that have entered into agreements with the PBGC typically make payments to the PBGC related to the defined benefit plans that were assumed by the PBGC. Despite the fact that payments made to the PBGC may continue for several years, the cash outflows should not be classified as financing activities in the statement of cash flows.

New Bankruptcy Law's Effect on Small Businesses

.39 The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 was signed into law on April 20, 2005. For small businesses, the new law contains special bankruptcy provisions and is both positive and negative. On the positive side, small businesses will be able to collect debts from individuals and other businesses who have filed for bankruptcy. On the negative side, small businesses that wish to reorganize under the Chapter 11 bankruptcy law will find it more difficult, and more small businesses may not survive bankruptcy.

Other Accounting Issues and Developments

> **Help Desk**—See the "New Pronouncements and Other Guidance" section of this Alert for information about recently issued accounting guidance.

.40 Presented in the following sections are discussions about accounting topics that are of particular interest lately or that have been identified as areas that some accountants have been improperly treating in the financial statements.

Finite Insurance Accounting Risks

.41 Recently, a number of issues have arisen concerning the determination of whether an insurance or reinsurance contract transfers significant insurance (reinsurance) risk. The determination of significant risk transfer is necessary to determine whether the contract is accounted for as an insurance or reinsurance arrangement or whether it is accounted for as a financing arrangement (similar to a loan). These issues have been at the heart of some recent large accounting scandals, in which certain companies improperly treated transactions as insurance, when evidence of risk transfer was lacking. By improperly treating these transactions as insurance, the companies were able to spruce up their financial statements.

.42 Finite insurance, in its most common form, involves a company paying very large premiums to an insurer. These premiums come close to the maximum coverage. If the claim losses end up being less than the premiums, the insurer returns the excess premiums to the company. The insurance company receives a fee and may not risk severe loss if the premiums are very large. The question arises as to whether risk was truly transferred to the insurer.

Accounting Guidance

.43 Paragraph 44 of FASB Statement No. 5, *Accounting for Contingencies*, requires that all insurance and reinsurance contracts indemnify the insured against loss or liability. FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, provides further guidance for determining the transfer of significant insurance risk for reinsurance arrangements. Those contracts that do not transfer significant insurance risk are accounted for as deposits (similar to a financing or loan, with loan repayments taking the form of periodic insurance premium payments).

.44 Regardless of whether a policyholder is a noninsurance or insurance enterprise, an insurance (or reinsurance) contract qualifies for insurance accounting only to the extent that it indemnifies or transfers significant insurance risk from the policyholder to the insurer.

FASB Project Underway to Address Insurance Risk Transfer

.45 The FASB is developing guidance to clarify what constitutes transfer of significant insurance risk in insurance and reinsurance contracts. The project's objective is to define an insurance contract and provide further assistance in identifying those contracts that transfer significant insurance risk. In addition, this project is exploring the notion of bifurcation of insurance contracts into risk transfer and financing segments for purposes of establishing the appropriate accounting for those contract segments.

Expensing Stock Options and Complying With FASB Statement No. 123(R)

.46 As the compliance deadline nears, management at many companies will be adopting the requirements of FASB Statement No. 123(R), *Accounting for Stock-Based Compensation*, and expensing their stock options. The effect on a company's financial statements of expensing stock options could be significant. Data suggests that approximately 20 percent of reported earnings of many corporations would be erased if they had expensed their stock options. Other pronouncements related to FASB Statement No. 123(R) have been issued, including:

- *SEC Staff Accounting Bulletin (SAB) No. 107*. This SAB summarizes the views of the SEC staff regarding the interaction between FASB Statement No. 123(R) and certain SEC rules and regulations and provides the SEC staff's views regarding the valuation of share-based payment arrangements for public companies.
- *FASB Staff Position (FSP) FAS 123(R)-1, "Classification and Measurement of Freestanding Financial Instruments Originally Issued in Exchange for Employee Services under FASB Statement No. 123(R)."*

- *FSP FAS 123(R)-2, "Practical Accommodation to the Application of Grant Date as Defined in FASB Statement No. 123 (R)."*
- *FSP FAS 123(R)-3, "Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards."*
- *SEC Staff Progress Report on Market Approaches to Valuing Employee Stock Options Under SFAS 123R.* This document reports on the SEC's progress in evaluating proposals to value employee stock options.

SEC Statements on Use of Market Instruments to Value Stock Options for FASB Statement No. 123(R)

.47 The SEC Staff Progress Report provides useful information related to the valuation of employee stock options. Among other matters, the documents contained in the progress report state:

- "[W]e have significant doubts based on OEA's [the SEC's Office of Economic Analysis] views as to whether it would be possible to design an instrument that would achieve the measurement objective of Statement 123R by relying on similar contractual terms and conditions." [*Chief Accountant's Statement*]
- "[O]ur analysis indicates that instruments that replicate the terms and conditions of employee stock options or other share-based compensation do not produce reasonable estimates of fair value." [*Office of Economic Analysis*]
- "Differences between the preferences of employees and investors will generally prevent their exercise behaviors from being similar." [*Office of Economic Analysis*]
- "We conclude that the terms-and-conditions approach to the design of a market instrument does not yield a transaction price that is a reasonable measure of the cost of the option grant to the issuer and, thus, will not meet the fair value measurement objective of the standard." [*Office of Economic Analysis*]

If stock option accounting is an issue for your company, you should be familiar with FASB Statement No. 123(R) and its related pronouncements and comply with all requirements.

Buy/Sell Arrangements/Purchases and Sales of Inventory With the Same Counterparty

.48 Buy/sell transactions typically involve contractual arrangements that establish the terms of the agreements to buy and sell a commodity either jointly in a single contract, or separately in individual contracts that are entered into concurrently or in contemplation of one another with a single counterparty. There may be provisions accommodating differences in quantities or grades, receipt and delivery locations, and stipulating that monetary consideration accompany the exchange. Such arrangements may be employed to facilitate the procurement of feedstock for a refinery operation, or to otherwise manage the supply chain or inventory in general. Some companies may find it necessary to enter into a series of these transactions with different counterparties in an effort to obtain a given quantity of feedstock or inventory for a single location. These arrangements are undertaken due to market forces of supply and demand, and they may serve to increase the efficiency with which transportation assets are utilized or to reduce the overall cost of acquiring inventory.

Accounting Guidance

.49 Questions have been raised regarding the accounting for these types of transactions, including:

1. Under what circumstances should two or more transactions with the same counterparty (counterparties) be viewed as a single nonmonetary transaction within the scope of APB Opinion No. 29?

2. If nonmonetary transactions within the scope of APB Opinion No. 29 involve inventory, are there any circumstances under which the transactions should be recognized at fair value?

.50 The FASB has issued EITF Issue No. 04-13, "Accounting for Purchases and Sales of Inventory with the Same Counterparty," which addresses these accounting issues. In addition, the SEC staff has issued letters to certain registrants on the accounting, presentation, and disclosure of buy/sell transactions. An example of the letter is posted on the SEC's Web site at www.sec.gov/divisions/corpfin/guidance/oilgas021105.htm. Registrants who engage in buy/sell transactions should provide the disclosure requested in the sample letter.

Leasing-Related Errors and Restatements

.51 There have been a number of restatements for lease accounting in the following areas: (*a*) amortization of leasehold improvements by a lessee in an operating lease with lease renewals, (*b*) the pattern of recognition of rent when the lease term in an operating lease contains a period where there are free or reduced rents (commonly referred to as "rent holidays"), and (*c*) incentives related to leasehold improvements provided by a landlord/lessor to a tenant/lessee in an operating lease. Presented here is accounting guidance related to these three areas, as communicated recently by the SEC staff.

Amortization of Leasehold Improvements

.52 Leasehold improvements in an operating lease should be amortized by the lessee over the shorter of their economic lives or the lease term, as defined in paragraph 5(f) of FASB Statement No. 13, *Accounting for Leases*, as amended. Amortizing leasehold improvements over a term that includes assumption of lease renewals is appropriate only when the renewals have been determined to be *reasonably assured*, as that term is contemplated by FASB Statement No. 13.

Rent Holidays

.53 Pursuant to the response in paragraph 2 of FASB Technical Bulletin (FTB) 85-3, *Accounting for Operating Leases with Scheduled Rent Increases*, rent holidays in an operating lease should be recognized by the lessee on a straight-line basis over the lease term (including any rent holiday period) unless another systematic and rational allocation is more representative of the time pattern in which leased property is physically employed.

Landlord/Tenant Incentives

.54 Leasehold improvements made by a lessee that are funded by landlord incentives or allowances under an operating lease should be recorded by the lessee as leasehold improvement assets and amortized over a term consistent with the guidance in the section in this Alert titled "Amortization of Leasehold Improvements."

.55 The incentives should be recorded as deferred rent and amortized as reductions to lease expense over the lease term in accordance with paragraph 15 of FASB Statement No. 13 and the response to Question 2 of FTB 88-1, *Issues Relating to Accounting for Leases*, and therefore, it is inappropriate to net the deferred rent against the leasehold improvements.

.56 A company's statement of cash flows should reflect cash received from the lessor that is accounted for as a lease incentive within operating activities and the acquisition of leasehold improvements for cash within investing activities. Evaluating when improvements should be recorded as assets of the lessor or assets of the lessee may require significant judgment.

Revenue Arrangements With Multiple Deliverables

.57 Numerous entities need to comply with the requirements of FASB EITF Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables." Many companies offer multiple solutions to their customers' needs. Those solutions may involve the delivery or performance of multiple products, services, or rights to use assets, and performance may occur at different points in time or over different periods of time. In these situations, accounting for the revenue related to those terms can be complicated.

.58 EITF Issue No. 00-21 addresses how to determine whether an arrangement involving multiple deliverables contains more than one unit of accounting. In applying this Issue, separate contracts with the same entity or related parties that are entered into at or near the same time are presumed to have been negotiated as a package and should, therefore, be evaluated as a single arrangement in considering whether there are one or more units of accounting. That presumption may be overcome if there is sufficient evidence to the contrary. This Issue also addresses how arrangement consideration should be measured and allocated to the separate units of accounting in the arrangement. Readers should refer to the full text of the Issue to understand all of its requirements.

Guidance on Impairment of Investments—Update on EITF Issue No. 03-1

.59 In 2004, to answer questions on evaluating other-than-temporary impairment, the FASB issued EITF Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments." The project included two stages. The first, a disclosure stage, included additional numerical and narrative disclosures for debt and marketable equity securities that have unrealized losses. The second stage included specific measurement and impairment accounting guidance.

Disclosures

.60 In summary, for investments accounted for under paragraph 5(b) and for investments with unrealized losses that have not been recognized as other than temporary, one needs to disclose in tabular form, aggregated unrealized losses by category of investment and the related fair value of those investments. Additionally, these disclosures need to be segregated by current and noncurrent status. Finally, additional, narrative information should be provided, sufficient to allow financial statement users to understand the quantitative disclosures and the information that the investor considered (both positive and negative) in reaching the conclusion that the impairments are not other than temporary. There are also additional disclosures for cost method investments, if applicable. For specific instructions, see the EITF Issue.

Impairment Evaluation

.61 The second stage included accounting guidance, which was set to be effective for reporting periods beginning after June 15, 2004. However, when entities started to put the impairment requirements of the EITF into practice, a number of issues became problematic.

.62 In response to concerns, the FASB issued FSP EITF Issue No. 03-1-1, "Effective Date of Paragraphs 10-20 of EITF Issue No. 03-1," which delayed the recognition and measurement guidance contained in paragraphs 10 through 20 of EITF Issue No. 03-1. The FASB also issued proposed FSP EITF Issue No. 03-1-a, "Implementation Guidance for the Application of Paragraph 16 of EITF Issue No. 03-1," which was renamed and issued as final in November 2005 as FSP FAS 115-1 and FAS 124-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments." This FSP nullifies certain requirements of EITF Issue No. 03-1 and supersedes EITF Topic No. D-44, "Recognition of Other-Than-Temporary Impairment upon the Planned Sale of a Security Whose Cost Exceeds Fair Value." This FSP specifically:

1. Nullifies the requirements of paragraphs 10–18 of EITF Issue No. 03-1
2. Carries forward the requirements of paragraphs 8 and 9 of EITF Issue No. 03-1 with respect to cost-method investments

3. Carries forward the disclosure requirements included in paragraphs 21 and 22 of EITF Issue No. 03-1 and related examples

4. References existing other-than-temporary impairment guidance

.63 This FSP is effective for other-than-temporary impairment analyses conducted in periods beginning after December 15, 2005.

Reminder About the Classification of Cash Receipts From Inventory Sales

.64 Companies may finance the sale of inventory in various ways, such as on account or with a note or sales-type lease receivable (whether long or short term), using various entities in the consolidated group. Paragraph 22a of FASB Statement No. 95, *Statement of Cash Flows*, states that cash receipts from the sales of goods or services are operating cash flows. Paragraph 22a clarifies that classification as an operating activity is required regardless of whether those cash flows stem from the collection of the receivable from the customer or the sale of the customer receivable to others, regardless of whether those receivables are on account or stem from the issuance of a note, and regardless of whether they are collected in the short term or the long term.

.65 Presenting cash flows between a company and its consolidated subsidiaries as an investing cash outflow and an operating cash inflow when there has not been a cash inflow to the company on a consolidated basis from the sale of inventory is not in accordance with GAAP. Similarly, presenting cash receipts from receivables generated by the sale of inventory as investing activities in the company's consolidated statements of cash flows is not in accordance with GAAP.

.66 Management should ensure that footnote disclosure identifies where the cash flows related to the sale of inventory are classified in the consolidated statements of cash flows and explains the nature of the receivables/notes/loans and where the cash flows from these transactions are classified in the consolidated statements of cash flows. Management should also ensure that the line item descriptors on the consolidated statements of cash flows are consistent with those on the consolidated balance sheets and in the financial statement footnotes detailing the components of finance receivables.

Internal Control Deficiencies—Learning From Reported 404 Flaws

.67 Internal control deficiencies reported by public companies, in accordance with regulations related to the Sarbanes-Oxley Act of 2002 (that is, section 404), have been numerous. Looking at the kinds of control weaknesses being reported can be informative to management. Some of those common control weaknesses include:

- Approximately half of internal control weaknesses reported relate to financial systems and procedures. These weaknesses often related to the financial closing process, account reconciliation, and inventory processes.

- Personnel issues, such as unqualified or inadequate finance staffs, were common.

- Other weaknesses related to documentation, revenue recognition, IT systems and controls, lease accounting, and tax accounting.

On The Horizon

.68 You should keep abreast of accounting developments and upcoming guidance that may affect your company. You should check the appropriate standard-setting Web sites (listed below) for a complete picture of all accounting projects in progress. Presented in this section is brief information about certain projects that are expected to result in final standards in the near future. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or generally accepted auditing standards (GAAS).

.69 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 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

Help Desk—The AICPA's standard-setting committees publish exposure drafts of proposed professional standards exclusively on the AICPA Web site (www.aicpa.org). The AICPA will notify interested parties by e-mail about new exposure drafts. To be added to the notification list for all AICPA exposure drafts, send your e-mail address to memsat@aicpa.org. Indicate "exposure draft e-mail list" in the subject header field to help process your submission more efficiently. Include your full name, mailing address and, if known, your membership and subscriber number in the message.

Project on Revenue Recognition

.70 Revenue usually is the largest single item in financial statements, and issues involving revenue recognition are among the most important and difficult that standard setters and accountants face. Because no comprehensive standard on revenue recognition exists, there is a significant gap between the broad conceptual guidance in the FASB's Concepts Statements and the detailed guidance in the authoritative literature. Most of the authoritative literature provides industry or transaction-specific implementation guidance, and it has been developed largely on an ad hoc basis and issued in numerous pronouncements with differing degrees of authority. Those pronouncements include APB Opinions, FASB Statements, AICPA Audit and Accounting Guides, AICPA SOPs, FASB Interpretations, EITF Issues, SEC SABs, and the like. Each focuses on a specific practice problem and has a narrow scope, and the guidance is not always consistent across pronouncements.

.71 The SEC sought to fill the gap in the accounting literature with 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 Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises* (namely, 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 four basic criteria for revenue recognition in AICPA SOP 97-2, *Software Revenue Recognition*, should be a foundation for all basic revenue recognition principles. Those criteria are:

- Persuasive evidence of an arrangement exists.
- Delivery has occurred.

- The vendor's fee is fixed or determinable.
- Collectibility is probable.

.72 Some criticized SAB No. 101 on the basis that the criteria in SOP 97-2 were developed for a particular industry and that broader application of those criteria was neither contemplated nor intended. They asserted that that guidance may not be appropriate for certain recognition issues, including some that the EITF has considered. Others noted that an SAB is designed to provide the SEC staff's interpretive responses and not to change GAAP. For that reason, SABs are issued without an invitation for comment. Critics argued that SAB No. 101 had in fact changed GAAP by promulgating changes in industry practice without the full due process and deliberation that characterize the FASB's decision-making process. Even though the SEC guidance for revenue recognition applies only to SEC registrants, the work done in developing and implementing SAB No. 101 has focused attention on revenue recognition issues and will be very useful in this project.

.73 In response to these issues, the FASB has undertaken a project to develop a comprehensive statement on revenue recognition that is conceptually based and framed in terms of principles. The FASB is partnering with the International Accounting Standards Board (IASB) on this project.

.74 The planned comprehensive revenue recognition Statement will (*a*) eliminate the inconsistencies in the existing authoritative literature and accepted practices, (*b*) fill the voids that have emerged in revenue recognition guidance in recent years, and (*c*) provide a conceptual basis for addressing issues that arise in the future.

Proposed FASB Statements, Interpretations, and Other Guidance

Proposed FASB Statement The Hierarchy of Generally Accepted Accounting Principles

.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 AU section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles. 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 proposed Statement would be effective for fiscal periods beginning after September 15, 2005. Readers should be alert for the issuance of a final Statement, which is expected at the end of 2005.

Proposed FASB Statements Business Combinations *and* Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries

.76 In these proposed Statements, the FASB plans to revise the existing guidance on the application of the purchase method. The following are among the main proposals:

1. That all acquisitions of businesses be measured at the fair value of the business acquired.
2. That substantially all of the assets acquired and liabilities assumed of the acquired business be recognized and measured at their fair values at the acquisition date.
3. That entities that follow U.S. GAAP and international standards apply substantially the same accounting requirements for their business combinations.

.77 Exposure drafts on business combinations, purchase method procedures, and noncontrolling interests were issued in mid-2005. The FASB's goal is to issue the two final Standards in the fourth quarter of 2006. The target effective date for the two proposed Statements is for fiscal years beginning on or after December 15, 2006.

Proposed FASB Statements Accounting for Transfers of Financial Assets, Accounting for Servicing of Financial Assets, *and* Accounting for Certain Hybrid Financial Instruments

.78 The exposure draft *Accounting for Transfers of Financial Assets* is a revision of a June 2003 exposure draft, *Qualifying Special-Purpose Entities and Isolation of Transferred Assets*, and would amend FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The proposed Statement seeks to (*a*) clearly specify the circumstances that require the use of a qualifying special-purpose entity (SPE) in order to derecognize all or a portion of financial assets, (*b*) provide additional guidance on permitted activities of qualifying SPEs, (*c*) eliminate the prohibition on a qualifying SPE's ability to hold passive derivative financial instruments that pertain to beneficial interests held by a transferor, and (*d*) revise the initial measurement of interests related to transferred financial assets held by a transferor. The effective dates associated with this proposed Statement vary; refer to the exposure draft for further information.

.79 The exposure draft *Accounting for Servicing of Financial Assets* would also amend FASB Statement No. 140. The proposed Statement would (*a*) require all separately recognized servicing rights to be initially measured at fair value, if practicable; (*b*) permit an entity to choose between two measurement methods for each class of separately recognized servicing assets and liabilities; and (*c*) require additional disclosures for all separately recognized servicing rights. The proposed Statement would be effective for transactions occurring in the earlier of the first fiscal year beginning after December 15, 2005, or fiscal years that begin during the fiscal quarter in which the Statement is issued.

.80 The proposed Statement *Accounting for Certain Hybrid Financial Instruments* would amend Statement No. 140 and Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Specifically, the proposed Statement would (*a*) permit fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, (*b*) clarify which interest-only strips and principal-only strips are not subject to the requirements of FASB Statement No. 133, (*c*) establish a requirement to evaluate beneficial interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, (*d*) clarify that concentrations of credit risk in the form of subordination are not embedded derivatives, and (*e*) eliminate restrictions on a qualifying SPE's ability to hold passive derivative financial instruments that pertain to beneficial interests that are themselves or that contain a derivative financial instrument. The proposed Statement would be effective after the earlier of fiscal years beginning after December 15, 2005, or fiscal years that begin during the fiscal quarter in which the Statement is issued.

.81 Readers should be alert for the issuance of final Statements, which is expected in the first quarter of 2006. See the FASB Web site at www.fasb.org for complete information.

Proposed FASB Statement Fair Value Measurements

.82 In June 2004, the FASB published an exposure draft of a proposed Statement, *Fair Value Measurements*, which seeks to establish a framework for measuring fair value that would apply broadly to financial and nonfinancial assets and liabilities, improving the consistency, comparability, and reliability of the measurements. The fair value framework would clarify the fair value measurement objective and its application under authoritative pronouncements that require fair value measurements. The exposure draft would replace any current guidance for measuring fair value in those pronouncements and would expand current disclosures. Readers should be alert for the issuance of a final Statement, which is expected in the fourth quarter of 2005. Refer to the FASB Web site at www.fasb.org for complete information.

Proposed FASB Statement Earnings per Share—an amendment of FASB Statement No. 128

.83 This proposed Statement would amend the computations guidance in FASB Statement No. 128, *Earnings per Share*, for calculating the number of incremental shares included in diluted shares when applying the Treasury stock method. Also, this proposed Statement would eliminate the provisions of Statement No. 128 that allow an entity to rebut the presumption that contracts with the option of settling in either cash or stock will be settled in stock. In addition, this proposed Statement would require that shares that will be issued upon conversion of a mandatorily convertible security be included in the weighted-average number of ordinary shares outstanding used in computing basic earnings per share from the date when conversion becomes mandatory. Readers should be alert for the issuance of a final Statement, which is expected to be released in the first quarter of 2006.

Proposed FASB Interpretation Accounting for Uncertain Tax Positions

.84 In July 2005, the FASB published an exposure draft of a proposed Interpretation, *Accounting for Uncertain Tax Positions*, which seeks to reduce the significant diversity in practice associated with recognition and measurement in the accounting for income taxes. It would apply to all tax positions accounted for in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. Specifically, the exposure draft requires that a tax position meet a "probable recognition threshold" for the benefit of the uncertain tax position to be recognized in the financial statements. This threshold is to be met assuming that the tax authorities will examine the uncertain tax position. The exposure draft also contains guidance with respect to the measurement of the benefit that is recognized for an uncertain tax position, when that benefit should be derecognized, and other matters. The effective date of the proposed Interpretation would be as of the end of the first fiscal year ending after December 15, 2005. A final Interpretation is expected to be released in the first quarter of 2006.

Proposed FASB EITF Issues

.85 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.

Proposed FASB Staff Positions

.86 A number of proposed FASB Staff Positions are in progress that address issues related to FASB Statements No. 13, and No. 133, and FIN 46(R). Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/proposed_fsp.shtml for complete information.

AICPA Resource Central

.87 The following publications deliver valuable guidance and practical assistance.

- *Corporations Checklists and Illustrative Financial Statements* (product no. 008935kk). Developed by the AICPA's Accounting and Auditing Publications staff, this practice aid is invaluable to anyone who prepares financial statements and reports for corporations. These disclosure checklists have been designed to help you prepare financial statements and assist you in determining the adequacy of disclosures in the financial statements.

- *Accounting Trends & Techniques—2005* (product no. 009897kk). It is the must-have resource for any CPA who frequently creates or uses financial reports. Filled with current reporting techniques and methods used by the nation's top organizations, this 650-page AICPA bestseller will provide guidance you need to improve your accounting preparation and procedures.

- Practice Aid *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* (product no. 006701kk). Authoritative guidance on cash- and tax-basis financial statements is rather vague and leaves a great deal to professional judgment. Section One of this publication provides nonauthoritative, practical guidance on preparing and reporting on cash- and tax-basis financial statements. Section Two includes example financial statements, disclosures, and other engagement practice aids. The Appendix provides an example checklist to be used for cash- and tax-basis financial statements.

AICPA reSOURCE: Online Accounting and Auditing Literature

.88 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's 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.

Educational Courses

.89 The AICPA has developed a number of continuing professional education (CPE) courses that are valuable to CPAs. Those courses include:

- *FASB Review for Industry* (2005-2006 edition) (product no. 730562kk). Comprehensive coverage of recent FASB, AcSEC, IASB, and EITF pronouncements is provided in this course geared to the specific interests of the CPA in corporate management.

- *Accounting Update: A Review of Recent Activities* (2005 edition) (732761kk). This course keeps you current and shows you how to apply the most recent financial accounting and reporting standards. Highlights include FASB Interpretation No. 46 on variable interest entities, fair value concepts and measurements, and the revised FASB Statement No. 123 on share-based payment.

- *AICPA's Annual Accounting and Auditing Update Workshop* (2005 edition) (product no. 736181kk, text; also available in video and DVD formats with a manual). 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.

- *Accounting for Income Taxes: Applying SFAS No. 109* (product no. 732790kk). No other area in accounting is as far reaching, and requires knowledge of a vast number of topics in financial and tax accounting, as accounting for deferred taxes. This course addresses the application of this complex standard to many common differences between financial accounting and tax compliance. You will gain a sound knowledge of the theory of deferred taxes and how this theory can be applied to practical situations. Many practical examples are included to illustrate the theory, and the information is presented so you will be able to apply this theory to any other situation that you may encounter.

- *The AICPA's Guide to Consolidations, Goodwill and Other Consolidation Issues* (product no. 735129kk). Learn how FASB Statements No. 141 and No. 142 have changed the rules for business combinations and goodwill accounting. Develop standards for applying purchase accounting and how to allocate the acquired entity now that it's the only game in town under FASB Statement No. 141. Identify variable interest entities' impact under FASB Interpretation No. 46(R). Learn how FASB Statement No. 142 deals with goodwill from initial recognition to the annual impairment review requirements.

.90 For a listing of additional courses available, please download the *Fall/Winter 2005 AICPA CPE Catalog* at https://media.cpa2biz.com/Publication/05_fall_winter_FINAL.pdf. You can also check at https://www.cpa2biz.com/CPE/default.htm for availability of any more recent catalogs.

Online CPE

.91 AICPA InfoBytes, offered exclusively through CPA2Biz.com, is AICPA's flagship online learning product. Selected as one of *Accounting Today's* top 100 products for 2003, AICPA InfoBytes now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 ($369 nonmembers) for a new subscription and $119 ($319 nonmembers) for the annual renewal. Divided into one- and two-credit courses that are available 24/7, AICPA InfoBytes offers hundreds of hours of learning in a wide variety of topics. To register or learn more, visit www.cpa2biz.com/infobytes.

Webcasts

.92 Stay plugged in to what's 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 on the discussion. If you can't make the live event, each Webcast is archived and available on CD-ROM.

CFO Quarterly Roundtable Series

.93 The CFO Roundtable Webcast Series—brought to you each calendar quarter—is designed to cover 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

.94 The SEC Quarterly Update Webcast Series—brought to you each calendar quarter—showcases the profession's leading experts on what's "hot" at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and CorpFin activities, these hard-hitting sessions will keep you "plugged-in" to what's important. A must for both 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 Satisfaction Center

.95 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.

Technical Hotline and Ethics Hotline

.96 Do you have a complex technical question about GAAP, other comprehensive bases of accounting (OCBOA), or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with their answer. You can reach the Technical Hotline at (888) 777-7077.

.97 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.

Conferences

.98 Among the many interesting conferences the AICPA offers, there is one that might interest you. Held late each fall, the AICPA National Construction Industry Conference presents a comprehensive program revealing latest trends and developments in the construction industry. The conference offers a national perspective and addresses the newest trends in conducting business, among other topics.

.99 For additional information, contact CPA2biz at its Web site, www.cpa2biz.com.

Web Sites

AICPA Online and CPA2biz

.100 Here is a unique opportunity to stay abreast of matters relevant to the CPA profession! AICPA Online, at www.aicpa.org, informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, www.cpa2biz.com offers you all the latest AICPA products.

.101 *Current Accounting Issues and Risks—2005/06* will be published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share those with us. Any other comments that you have about the Alert would also be appreciated. You may e-mail these comments to rdurak@aicpa.org, or write to:

Robert Durak, CPA
AICPA
Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881

[*The next page is 9000-161.*]

AAM Section 8280

Employee Stock Option Accounting: FASB Statement No. 123(R), SEC SAB No. 107, and Other Recent Authoritative Developments

NOTICE TO READERS
EMPLOYEE STOCK OPTION ACCOUNTING:
FASB STATEMENT NO. 123(R),
SEC SAB NO. 107, AND OTHER
RECENT AUTHORITATIVE DEVELOPMENTS

This Financial Reporting Alert was authored by Louis P. Le Guyader, Ph.D., CPA, under a commission from the AICPA. Some of the passages in this Alert represent the views of the author. This Financial Reporting Alert has not been approved, disapproved, or otherwise acted upon by any senior technical committee of the AICPA and has no official or authoritative status. Authoritative accounting guidance in the United States is issued principally by the Financial Accounting Standards Board and the Securities and Exchange Commission.

Written by Louis P. Le Guyader, Ph.D., CPA

Edited by Karin Glupe, CPA
Technical Manager
Accounting and Auditing Publications

Robert Durak, CPA
Director
Accounting and Auditing Publications

Preface and Acknowledgements

The author thanks the AICPA for commissioning this Financial Reporting Alert and is especially grateful for the support shown by the principal editor, Robert Durak. Thanks are also due to the reviewer, who has prompted many useful changes. The author also thanks his students and colleagues at Princeton University for the opportunity to discuss various aspects of this accounting rule and to test ways to explain it. Particular thanks are due to Burt Malkiel, Bob Kimmel, David Blair, and Yacine Ait-Shalia at Princeton's Bendheim Center for Finance; Alan Blinder of Princeton's Center for Economic Policy Studies; and John Mulvey of the Financial Engineering Department at Princeton's School of Engineering. The author thanks Trevor Harris, Stephen Penman, and Jim Ohlson, and the other active members of the Columbia University Graduate School of Business' Center for Excellence in Accounting and Security Analysis. Thanks are also due to the accounting faculty of New York University's Stern School, who share my continued interest in fair value accounting and accounting for risk and financial instruments. Thanks are due to students at Columbia University's School of International and Public Affairs and Princeton University's Woodrow Wilson School for helping demonstrate that the central accounting principles of Financial Accounting Standards Board (FASB) Statement of

Financial Accounting Standards No. 123(R), *Share-Based Payment*, can easily be mastered. The author thanks particularly Whit Broome and the faculty of the University of Virginia's McIntire School and the joint finance and accounting seminars at Marquette University for screening methods of presenting valuation methodologies for ESOs.

Errors communicated to the author in this description of FASB Statement No. 123(R) will be corrected and posted at www.kerlouet.org (see below). For those readers responsible for compliance with these rules, there is no substitute for reading FASB Statement No. 123(R) and Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 107 and they should do so.

Internet Support for This Financial Reporting Alert

The author will support this work from time to time with an Internet depository located at www.kerlouet.org (see the Stock Options tab). This electronic depository will contain any corrections to the work that come to the attention of the author. It will also feature periodic updates on new SEC rules and announcements relevant to FASB Statement No. 123(R) and additional resources as the topics of fair value estimation and employee stock option (ESO) accounting policy progresses. This Internet site will contain downloadable copies or links to documents cited in this work. Purchasers of this Financial Reporting Alert should obtain their user name and password by writing to the author; readers who identify errors requiring corrections, or who have information requests, should also write directly to the author. The Author can be reached at lleguyad@aol.com.

The AICPA does not monitor the author's content on the Web site indicated above and is not connected in any way with that Web site. The AICPA is not responsible for the content contained at www.kerlouet.org.

About the Author

Louis P. Le Guyader has been active in the capital markets as an accountant and banker for over 30 years. He returned to PricewaterhouseCoopers (PWC) while completing his doctorate in accounting at Columbia University, where he was the Coopers and Lybrand Scholar. At PWC he specialized in various aspects of accounting and disclosure for financial instruments, hedging, risk management, and fair value methodology as a member of the National Office and as a founder of the Financial Risk Management Group. He has published several texts on accounting policies for derivatives, hedging, and the use of special-purpose entities in structured finance. As a banker he has specialized in international and cross-border financings, including the use of derivative and structured finance. At Columbia, his dissertation in financial accounting addressed the topic of financial risk and risk modification. He has been an independent accounting consultant since 2000 and has held faculty positions at Columbia University's Graduate School of Business and Princeton University. He is a New York State CPA.

Executive Overview of FASB Statement No. 123(R)[1]

.01 The accounting for employee stock options (ESOs) and other equity and equity-linked instruments that are exchanged by a public entity in return for services is governed by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 123(R), *Share-Based Payment*. The measurement of the cost of the service must now be based on the grant-date fair value of the award (generally, the ESO). The cost must be recognized over the period over which the employee renders the service, most often understood to be the vesting period of the ESO. If the award is a liability instrument, its recognized cost based on fair value must be remeasured at each reporting date through the instrument's settlement date; the fair value changes will be recognized as a cost of compensation. A nonpublic entity that finds that it is not possible to reasonably estimate the fair value of the award because the expected volatility to the fair value cannot be estimated practicably can base the fair value of the award using an appropriate industry sector

[1] The full summary of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 123(R), *Share-Based Payment*, can be found on pages ii and iii of the full text of the accounting standard.

volatility index. A nonpublic entity may elect to measure its award of liability instruments at their intrinsic value. The grant-date fair value of the equity-linked instruments will be measured using option pricing models with adjustments to parameters and other inputs to reflect the unique characteristics of the instruments. Modifications of equity awards require the recognition of additional fair value. Excess tax benefits will be recognized as an addition to paid-in capital and cash retained as a result will be presented as a financing cash flow in the statement of cash flows. The write-off of unrealized tax benefits, absent an offsetting amount, will be recognized as income tax expense. The notes to the financial statements will disclose information on the nature of share-based transactions and their effects on the financial statements as a whole.

Introduction

.02 U.S. generally accepted accounting principles (GAAP) will require companies to expense the cost of ESOs, starting with their fiscal years that begin after June 15, 2005. The effective date for FASB Statement No. 123(R) was delayed by the Securities and Exchange Commission (SEC), in a press release dated April 14, 2005. That announcement was made after the release of SEC Staff Accounting Bulletin (SAB) No. 107, *Share-Based Payment,* on March 29, 2005, and FASB Statement No. 123(R) on December 14, 2005. The original effective date was interim periods beginning after June 15, 2005 (that is, the quarter beginning July 1, 2005, for calendar year companies). Voluntary expensing of the cost of ESOs has been permitted since the issuance of FASB Statement No. 123, *Accounting for Stock-Based Compensation,* in October 1995. The central requirements for this accounting principle are described in FASB Statement No. 123(R) and additional implementation guidance has been provided through the issuance of SAB No. 107. This Alert explains the accounting for ESOs by describing FASB Statement No. 123(R), summarizing SAB No. 107, and supplementing this knowledge with additional information developed by the capital markets and the accounting field.

.03 The FASB issued FASB Statement No. 123(R) in December 2004, after nearly two years of redeliberation of FASB Statement No. 123, which was originally issued in 1995.[2] The central provisions of FASB Statement No. 123(R) require "[a] public entity to measure [and recognize] the cost of [ESOs] based on [their] grant-date fair value"[3] where the "grant-date fair value of [the ESOs] . . . will be estimated using option-pricing models adjusted for the unique characteristics of those instruments. . . . "[4] The statement also contains related guidance on certain tax issues associated with ESOs (see Appendix B of FASB Statement No. 123(R)) and disclosures that must be provided in the notes to the financial statements.

.04 SAB No. 107 contains implementation guidance emphasizing that the "grant-date fair value" per FASB Statement No. 123(R) should be the equivalent of an "exchange price" for ESOs, a provision that must be evaluated by the SEC issuer in light of the fact that ESOs are neither traded nor transferred in any market.

.05 The accounting rules for ESOs in FASB Statement No. 123(R) and SAB No. 107 have three main parts: fair value measurement of the financial instruments, recognition on the balance sheet, and recognition of the compensation cost of ESOs in the income statement. Users will need to understand their ESO contracts completely to apply the relevant provisions of FASB Statement No. 123(R); "Section I: What Are Employee Stock Options?" in this Alert describes the characteristics of ESOs. A description of the economic controversies that surround ESOs, including the accounting issues addressed by FASB Statement No. 123(R), are discussed in this Alert in "Section II: What Is the Controversy Behind Stock Option Expensing?" FASB Statement No. 123(R) is summarized in the third section, and the likely effects of FASB Statement No. 123(R) are addressed in the fourth section. A summary of SAB No. 107 is presented in Section V. The fair value measurement of ESOs is further described in Section VI. Methods of minimizing ESO expense are summarized in Section VII. Section VIII provides a summary of the most recent authoritative developments from the SEC and the FASB.

---

[2] The controversy surrounding the question of accounting policy for employee stock options (ESOs) has been significant to the FASB's standard-setting agenda for at least eight years.

[3] FASB Statement No. 123(R), page ii.

[4] FASB Statement No. 123(R), page iii.

Section I: What Are Employee Stock Options?

.06 The scope of FASB Statement No. 123(R) and the accompanying guidance of SAB No. 107 provide accounting rules for "share-based payments," which are compensation arrangements in which "an entity exchanges its equity instruments for goods or services." Generally, FASB Statement No. 123(R) will apply when (1) the employing entity issues an equity-linked derivative contract to its employee in exchange for the employee's time and effort[5] and (2) the equity derivative contract is settled by the delivery of equity shares, instead of cash or access to some cash-producing market mechanism. The equity-based contract is labeled an ESO for the purposes of this Alert. For an ESO, the employer's contract counterpart must be an employee, and the contract must generally take the form of an over-the-counter derivative contract, which is a type of executory contract.

.07 The status of the contract counterpart is a critical characteristic of ESOs. ESOs almost always combine some element of compensation in lieu of salary with an equity-sharing between business partners. Employees could certainly describe ESOs as rewards for their "sweat equity." There is a wide range of compensation agreements across entities. Sometimes the ESO is the only compensation paid, but more frequently it is one of several components of a compensation package that includes salary, incentive pay, and benefits. Under the provisions of FASB Statement No. 123(R), ESOs must be treated as a substitute for cash salary. In SAB No. 107, the SEC buttresses this policy decision by pointing out that in the income statement, the ESO compensation cost should be displayed on the same line item as any other salary expense.

.08 The form of the ESO contract fits easily into the general definition of a derivative as displayed in paragraph 6 of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as described in the following table.

Defining an Employee Stock Option as a Derivative Instrument Using FASB Statement No. 133 Definitions [1]

FASB Statement No. 133, Paragraph 6: Characteristics of a Derivative	*Standardized Employee Stock Options Terms*
At least one "underlying," and at least one "notional amount" or payment provision or both	The employee stock option (ESO) underlying is the issuer's equity stock. One way to express the notional amount is the number of shares times the market price at the grant date.
Requires "no initial investment" or an initial investment below the exchange price for similar instruments [2]	Options are normally exchanged for an up-front premium, which satisfies this initial investment characterization. [3]
Terms require net settlement and (in the case where it cannot be settled outside the contract) it provides for delivery of an asset with a value that is equivalent to net settlement.	When an ESO is exercised, the employee-holder pays the strike value in cash to the issuing employer-entity and receives equity shares. The equity shares can be sold into the market for cash at the current market price without restriction.

[1] Copyright © 2005, Louis P. Le Guyader. Used by permission.

[2] Please refer to the article "Feltham-Ohlson Parameterization of ESOs," by Louis P. Le Guyader, 2005, which is available at www.kerlouet.org.

[3] In ESOs, the premium exchanged is not cash, but the employee's labor. The fair value of the ESO estimated at the grant date is both the best estimate of the exchange price for the ESO and the initial investment that satisfies this definition.

[5] An employee may receive an equity award in the form of an equity derivative (generally, an ESO) or shares with some restrictions (generally, restricted stock). It is easiest to consider option-pricing models as suiting the valuation of ESOs and similar derivative instruments.

.09 Immediately after a series of derivative losses in the period 1993–1994, the SEC Chief Accountant staff explained that there could be a high risk of unexpected potential loss for derivative financial instruments that were not adequately presented in the entity's SEC reports. Within the category of derivatives, options and all short positions in general were considered the riskiest form of contracts for the purpose of achieving transparent reporting. The FASB's response to this concern in the case of most financial derivatives was the issuance of FASB Statement No. 133, which imposes the central requirement that derivatives should be recognized on the balance sheet and measured at the carrying amount, which should equal the fair value of that instrument. FASB Statement No. 123(R) was the FASB's specialized response to the case of ESOs. (The FASB chose not to include ESOs under the scope of FASB Statement No. 133 because of the special considerations that apply to ESOs as compared with other financial derivative instruments. See paragraph 11(b) of FASB Statement No. 133.)

.10 The ESO contract is normally more complex than exchange-traded options or shorter maturity over-the-counter options. The contract terms that differentiate ESOs from other options include:[6]

- A long time to maturity, usually more than three years and normally five years or longer.
- An initial period before the contract is "vested" and during which (1) the employee is sometimes considered to be delivering the services for which the contract is exchanged and (2) exercise is not permitted.
- An exercise period[7] during which the holder can exercise at any time.
- A fixed expiration date.[8]
- Forfeiture in the case of termination of employment.
- No transferability.
- No secondary market trading possibility.
- Relative ease in altering the contract terms after the initial grant date.

.11 The last contract term deserves some elaboration. Each ESO is a contract that can stand "on its own" with respect to the context in which it is issued and the prospect that it can be altered. Alteration normally occurs in a voluntary renegotiation between the employer and the employee. Two instances have occurred frequently as examples of the ability to alter the terms of the ESO after the initial grant date:

---

[6] This list is not meant to be exhaustive. The contract form of ESOs remains very diverse and relatively uncatalogued. A separate issue is the frequency with which ESOs are awarded in a form that they should be considered equity or liability items for purposes of financial statement presentations. The author and the AICPA reviewers of this text know of no study that has yet been completed on this question. ESO arrangements designed to be settled with cash or a cash-producing market mechanism should be reviewed for potential classification as a liability; ESOs designed to be settled through the transfer of shares should be reviewed for potential classification as equity. The accountant's and auditor's examination of whether a financial instrument is designed to or actually does result in cash settlement has proven a systematically difficult topic, including similar questions of classification under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Users of FASB Statement No. 123(R) should conduct complete reviews of the ESO contract, their settlement provisions, and the issuer's experience with settlement practice before accepting a suggested balance sheet classification as liability or equity.

[7] The exercise period within an ESO contract term can be clearly documented within the ESO contract but is affected by other contracts or policies of the issuer to which the ESO holder-employee is subject. For example, senior executives may hold exercisable ESOs but may be prohibited from exercising during "blackout" periods around, for example, earnings releases, other key developments, or the normal operations of the Securities and Exchange Commission (SEC) Regulation FD.

[8] ESOs are contracts and, as such, when documented normally carry a fixed expiration date. This is akin to the "maturity date" of a debt instrument issued as a liability or purchased as an "investment in a marketable security." The ESO contract can end before the contractual maturity date if it is "accelerated." Acceleration is sometimes triggered by an event that the accountant and auditor can verify, such as the termination of the holder's employment. Fixed expiration dates that are subject to acceleration and the restrictions identified in FASB Statement No. 123(R) give rise to the need to carefully estimate the expected term of the ESO or in some cases derecognize it from the financial statements.

1. When the market for the entity's equity drops without chances of near-term recovery, the expiration date is extended, or the strike price is lowered as a means of preserving the use of the contract as an incentive tool.

2. Due to the transition provisions included in FASB Statement No. 123(R), the entity asks to accelerate the vesting date, thereby carving out the altered ESO from the provisions of FASB Statement No. 123(R).[9]

.12 In a typical ESO option contract, the entity issues the option to the employee and assumes the prospective risk that it will have to deliver its equity shares to the holder at the strike price when the market price is above that level. The entity is an "option writer" and the ESO represents a "written" or "short" option position. A written option means that the entity is placed in the position of prospectively delivering shares to the employee. The standard ESO contract never provides for the delivery of shares from the employee to the entity.[10] The entity must obtain shares for delivery in the market or, if permitted, use shares already in its possession.[11]

.13 The "option" form of the contract represents a one-sided bargain for the employee. The employee is permitted but not required to exercise the ESOs; if the market price equals or is less than the strike price, the ESO is presumably not exercised. However, if the employee decides to exercise the ESO when the market price is greater than the strike price, the entity is required to honor the exercise of the option and deliver the shares; therefore, the entity can only suffer an economic loss, and never a gain, as a result of the exercise of the ESO contracts.[12] That loss equals the option's intrinsic value, which the employee perceives as the bargain element of the ESO. In financial economics, the intrinsic value[13] of an option is always:

Number of shares × (Market price – Strike price) subject to exercise

.14 Employees are normally very favorable to an ESO grant due to the "limited liability" conditions that are standard to every option: The employee can never lose money; the minimum outcome is never less than a "zero" payout; the exercise of the option normally is only accompanied by an economic gain; and it is normally easy to "cash out" on the date of exercise by selling the shares in the market.[14]

.15 From the entity's point of view, the ESO represents a prospective loss at least equal to the intrinsic value that is reserved for the employee. In this respect, the ESO is a cost that represents a discount to the market value of the shares issued to the ESO holder.

.16 For example, if an ESO is issued with a strike price of $10 per share for 100 shares and exercise is permitted, the employee may choose to exercise the shares when the shares are trading in the market for $15

---

[9] For a recent research report on this phenomenon see the Bear-Stearns Equity Research, Accounting and Tax Policy, "Spring-Cleaning: Companies Accelerate Vesting of Stock Options," April 7, 2005.

[10] If the employee would be able to deliver shares to the entity, the contract would take the form of a written put option from the entity's point of view.

[11] In some state jurisdictions and in many ESO issuers, there are some combinations of legal and governance limitations placed on the way the entity obtains shares to service its ESO obligations.

[12] This ignores the potential economic benefit and creation of wealth the entity receives from the employee's labor.

[13] FASB Statement No. 123(R)'s definition of *intrinsic value* is consistent with the financial economics definition of the term. The glossary of FASB Statement No. 123(R) states in part that intrinsic value is "the amount by which the fair value of the underlying stock exceeds the exercise price of the option." In the case of a public entity, the market price of its stock is generally understood to be the best estimate for the fair value of its stock. For a nonpublic entity, volatility of the entity's stock cannot be determined from observable changes in its stock price, as the stock is not traded. In these cases FASB Statement No. 123(R) defines a *calculated value* as a measure based on a substituted historical volatility. See the FASB Statement No. 123(R) Glossary, which is Appendix E to the accounting standard.

[14] The employee's retail broker sometimes can advise on whether exercise of the options is appropriate, or whether retaining the shares is preferable to selling them for cash. The broker could be called on to execute the trades of the equity securities.

(assuming exercise is permitted). If exercise occurs, the entity receives $10 per share and issues all the shares. Before FASB Statement No. 123(R), the entity would only record the option exercise on the exercise date. On the exercise date the entity would record:

Debit cash (at $10 per share)	$1,000	
Credit common stock (net of discount of $5 per share)		$1,000

.17 The reader of the financial statements could ascertain the realized dilution effect on the exercise date by observing the number of shares issued below market price as reported in the equity section of the balance sheet. If the company had to enter the market to obtain the 100 shares to cover the written ESOs, the company would have paid $15 per share for shares that it would distribute under the ESOs for only $10. The $5 per share loss would be a true cash outflow, but by convention, before FASB Statement No. 123(R), that loss would not have been reported as an earnings loss. However, it is rare that an entity places itself in this position. Most entities cover their ESO exposure by either reissuing shares held in treasury (to the extent this is both legal and permitted) or issuing new shares (to the extent this has been properly authorized).[15]

.18 Thus, the employee is paid whatever intrinsic value the market will permit; the amount and the timing presumably depend on external market factors outside of the entity's control. The intrinsic value cash flows are derived not from the entity but between the market and the employee. On the other hand, the equity financing cash flows (cash flows upon exercise) do flow between the employee and the entity at the strike price within the ESO contract.

.19 The complexity of ESO contracts is self-evident. The fact that ESOs are derivatives in the entity's own equity and that they create a legal and economic obligation to deliver shares at an unfavorable price has created some unique accounting policy issues and matters of debate. Since the issuance of FASB Statement No. 123(R) in December 2004 it has also become apparent that management of the issuer's ESO profile adds to this complexity. Employees may perceive some benefit from renegotiation of ESO contract terms after the initial grant date, especially if these contract alterations increase the chance of a profitable ESO exercise. In some cases contractual changes may not represent appropriate managerial conduct (for example, back dating ESO awards to reflect favorable current market conditions or to address the financial needs of an employee). The transition provisions for FASB Statement No. 123(R) also permitted some relief from the provisions of the accounting standard for ESOs whose terms were modified before the standard took effect. (The issuer's incentive to modify the ESOs in this case was to achieve a grandfathering of the contract and so exempt it from the recognition provisions of FASB Statement No. 123(R).) The financial statement preparer and the issuer's auditor should be particularly attentive to all contract alteration activity.

Section II: What Is the Controversy Behind Stock Option Expensing?

.20 ESO compensation that appeared to be excessive triggered the perceived need for FASB Statement No. 123(R) and "stock option expensing." Two other factors contributed to this need: earnings manipulation and the element of surprise investors felt when ESO pay was reported. Detractors of FASB Statement No. 123(R) suggest that the standard should not take effect because they believe it cannot be implemented efficiently and because it damages ESO use as one of the most powerful incentive formulas available to the labor market. The tension between these opposing camps has led to the controversy that continues to this day.

ESO Compensation and Earnings Manipulation

.21 Potential ESO pay rises with an entity's stock price. If that stock price has been conditioned to respond to earnings, and if managers are unscrupulous and manipulate earnings upward, the stock price

[15] The use of the law and the emergence of best practices in corporate governance could be used to temper some of the excesses in the use of ESOs.

can be improperly inflated. Two overriding themes in recent accounting scandals have been the improper accounting treatment of off-balance-sheet transactions, and earnings manipulation.[16] The complaint that ESO compensation is excessive seems appropriate in cases where the executive responsible for earnings manipulation also benefits from an artificially high stock price.[17]

ESO Compensation as Undisclosed Compensation

.22 That ESO compensation exists at all sometimes comes as a surprise to many investors. Some investors see ESO compensation as "secret pay," especially when they learn of it not from the audited financial statements but from press releases that are sometimes tied to SEC enforcement actions. In the last 10-year period before the introduction of FASB Statement No. 123(R), the accounting for ESOs was governed by FASB Statement No. 123, *Accounting for Stock-Based Compensation*, and FASB Statement No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure—an amendment of FASB Statement No. 123*. These standards encouraged but did not require the recognition of stock compensation expense related to ESOs; they only required audited disclosures about ESOs in the notes to the financial statements. The persistent anecdotal reports of investors' surprise regarding the uses of ESO compensation suggest that these disclosures were not informative, or worse, never read.

.23 At the same time, there is an intuitive rejection of the notion that a paper contract can yield high compensation and a common misunderstanding about where the cash paid to the employee comes from. The cash comes from the market when the employee sells the shares he or she has purchased at a bargain. It does not come from the SEC issuer—it is not a cash outflow of the entity, but it is the entity's opportunity cost.[18] The leverage that is inherent to every derivative sometimes works against the ability to communicate the prospective cash flow attributes of the ESO transparently.

The FASB's Solution—Fair Value Accounting

.24 Financial instruments that are derivatives, options, and written or short positions, and that are significantly leveraged, have concerned the SEC for some time, because of their accounting complexity. ESOs possess all four of the aforementioned characteristics. When faced with a similar concern about unwanted surprises from other financial derivatives, the FASB sought to make the use of financial instruments understandable,[19] by issuing FASB Statement No. 133 in 1998.

.25 The FASB's philosophy to improve accounting for all financial instruments has been to recognize them on the balance sheet, using the fair value of the instrument as the carrying amount. Fair value accounting had been introduced by certain FASB accounting standards, including FASB Statement No. 133, in an attempt to change the traditional historical-cost-based accounting model. Appendix A of this Alert provides a summary of other key standards that have been issued as part of the FASB's project on financial instruments.

.26 The current accounting model requires the measurement of fair value of certain items, while other values are required to be determined by their historic costs. Most financial statements prepared under

---

[16] For a summary of the concern that the Securities and Exchange Commission (SEC) has shown about earnings manipulation, see the 1998 speech, "Numbers Games," given by former SEC Chairman Arthur Levitt at New York University's Law School. The speech can be found in the SEC Chairman archives on www.sec.gov.

[17] See, for example, the details of compensation arrangements and earnings manipulation tactics within evidentiary deposits used to gain guilty pleas from or convict former WorldCom executives.

[18] In his economics textbook, N. Gregory Mankiw explains the difference between economic profit and accounting profit. Not all opportunity costs, especially implicit opportunity costs, are captured by the accounting model. FASB Statement No. 123(R) creates a method for recording the opportunity costs associated with ESOs in a manner that hastens the convergence of economic and accounting profit.

[19] This paraphrases one of 10 points, or policy imperatives, designed to clean up the capital markets discussed by President George W. Bush immediately after the fall of Enron.

1994–2005 era GAAP therefore represent a "mixed attributes" accounting model, combining some historic cost measures with fair value measures.[20] A complete fair value accounting model requires that:

- An item that is recognized in the financial statements must be carried on the balance sheet using a carrying value equal to its fair value.
- This carrying value should be updated to the item's current fair value at each reporting date, with the changes in fair value from the previous reporting date recorded in income (earnings or other comprehensive income).

.27 The FASB considers fair value to be the best measure for reporting financial instruments. The FASB has documented its preference to display unrealized gains and losses related to fair value fluctuations from financial instruments in income generally because, among other things, the opportunity costs of these values are considered to be relevant—they should be provided to the investor. FASB Statement No. 123(R) is the newest effort to apply that concept to yet another class of financial instruments.[21] FASB Statement No. 123(R) uses elements of both fair value and historic cost approaches to account for ESOs, starting from the estimation of the grant-date fair value of the ESOs. (See "Section VI: What Is the Value of a Stock Option?" in this Alert for an explanation of the logic underlying this approach.)

.28 FASB Statement No. 123(R) therefore requires that ESOs be recognized on the balance sheet at fair value, and that the cost represented by the grant date fair value be recorded or charged to earnings as an expense. The resulting increase in expenses would potentially reduce the combined ill effects of earnings manipulation and "secret pay" sentiment felt by investors as a result of the use of ESOs. The threefold accounting improvements (balance sheet recognition, fair value measurement, and expensing through earnings) are expected to help mitigate inappropriate forms of ESO compensation and the lack of accounting transparency that accompanied such ESO transactions.

Arguments Against the Implementation of FASB Statement No. 123(R), and the FASB's Response

.29 FASB Statement No. 123(R) detractors have assembled a powerful arsenal of arguments against the fair value accounting approach. Due to the forcefulness of their arguments, they have successfully delayed the effective date of FASB Statement No. 123(R) from 2005 to an effective date starting with fiscal 2006.

.30 Public policy makers who are involved in the "capital markets cleanup" are concerned that FASB Statement No. 123(R) will not add to an understanding of how these financial instruments are used. They point out that until earnings are made more transparent, the inclusion of ESO expenses on the income statement provides new manipulation opportunities, thereby causing the income statement to be even less transparent. Financial engineers and financial economists also suggest that FASB Statement No. 123(R) should be further postponed or rescinded because it cannot be implemented. They claim there is no reliable way to estimate an ESO fair value: the ESO contract is too complex to fit into models that were not intended for valuing ESOs, and the value derived in a mark-to-model valuation methodology will never be akin to an exchange price. However, accounting regulators have recently reminded the market, that, in effect, a potentially flawed statistic can still be sufficient for purposes of achieving the policy objectives of FASB Statement No. 123(R). The SEC has also stated that it would accept future improvements in any SEC issuer's valuation methodology if the issuer made a retrospective criticism of values lodged in previous financial statements; this level of reasonableness is almost a safe harbor that enables FASB Statement No. 123(R) to move forward with an acceptable level of measurement risk.

---

[20] For an explanation of the mixed attributes accounting model, see the FASB Financial Accounting Series Special Report, "Major Issues Related to Hedge Accounting," Jane B. Adams and Corliss J. Montesi, October 1995.

[21] FASB and SEC rules generally split all financial instruments into two categories: derivatives and other financial instruments, which include debt and equity.

.31 Computer scientists and systems experts point out that FASB Statement No. 123(R) requires substantial computer support, which may not be available. If systems have not been configured to support FASB Statement No. 123(R) and enable fair value measurement, or the available systems cannot be integrated into a general ledger package, according to systems experts, either FASB Statement No. 123(R) may not be feasible or more time should be given before it becomes effective. Similar arguments won postponements of the effective dates of FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* and FASB Statement No. 133. The SEC considered these comments when it delayed the effective date for FASB Statement No. 123(R) to fiscal 2006.

.32 The labor market reaction to the FASB Statement No. 123(R) ESO controversy has been mixed. In larger manufacturing organizations, labor unions have supported ESO expensing. They believe that union members have effectively been impoverished to the extent that the employer's resources are allocated to executives through ESOs.[22] On the other hand, high tech industry workers in particular have taken the position that the decreased use of ESOs, which has been the secondary effect of the accounting deliberations, has hurt the high tech industry as a whole. In the high tech industry, ESOs are seen as the most efficient incentive for workers to perform at a time when the employing entity has an insufficient cash flow to pay salaries at the entity level. A repeated defense of ESO compensation is that the cash payment received by the employee is paid by the market, not by the entity. Such compensation strategy uses a sweat equity philosophy: the market value of the entity increases only if workers perform; otherwise the entity becomes bankrupt. ESOs are merely a means to give workers their share of the market wealth that has been created by their own efforts.

.33 That argument then provokes an expected reaction from outside existing shareholders, who decry the dilution risk that accompanies the exercise of ESOs. However, certain segments of investors remain convinced that ESOs will not lead to dilution if there is a compensating increase in the market value of the entity. The dominant reason the entity becomes more valuable is that wealth is created by the properly induced worker. These FASB Statement No. 123(R) detractors, including the high tech industry, see ESOs as equity transactions, not as earnings events. Recall the siren call of the Enron whistleblower who reminded Congress that a basic accounting concept is that earnings are not derived from changes in equity. However, FASB Statement No. 123(R)'s response to this argument is that basic accounting exclusions may not apply because of the way the ESO equity derivative contract is structured or because of the way the ESO derivative is settled in practice.

.34 Accounting theoreticians at major universities, after accepting the inevitability of expensing, have joined the arguments by asking for improvements to FASB Statement No. 123(R). This has been incorrectly perceived by the "antiexpensing crowd" as further evidence that FASB Statement No. 123(R) should be terminated. To the contrary, the FASB has a successful record of updating standards after their issue date to reflect new information from the market that justifies renewed deliberations. For example, FASB Statement No. 133 has been amended by three subsequent accounting standards (FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133—an amendment of FASB Statement No. 133*; FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities—an amendment of FASB Statement No. 133*; and FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*), and there are ongoing deliberations in various FASB venues (the Emerging Issues Task Force (EITF), the Derivative Implementation Group (DIG), and the full FASB itself).

.35 Proposals to amend FASB Statement No. 123(R) have mostly focused on aligning its accounting policies to a full fair value accounting model, including:

---

[22] In the case of accounting irregularities such as those uncovered at WorldCom and Tyco, the claim that executives have impoverished workers and investors alike seems valid. One would wonder how union members would argue their cause if they were granted ESOs and those grants were terminated by the company as a reaction to FASB Statement No. 123(R).

- Marking-to-market the ESOs on every reporting date, as with any other derivative.
- Recognizing and developing a link to one form of the underlying item, on which ESOs may be matched to treasury shares.
- Eliminating some inefficiencies in the way ESO fair values are recorded (see Section V).
- Removing, or reversing, the expense from the financial statements on the ESO expiration date if they expire and are worthless.
- Finding ways to account for the equity financing attribute of the ESO transaction more transparently.
- Opening the possibility that other comprehensive income (see FASB Statement No. 130) should be used to charge ESO expenses and subsequent fair value changes, rather than earnings.
- Urging that the balance sheet location for the "ESO derivative account" be either in equity or liabilities, but not both (see FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*).

.36 These proposals signify the heated nature of the ESO controversy over the past 10 years. By far, the stock option expensing debate outside of the FASB has focused on "no expensing through earnings" and informing the market that "no valid valuation methodology exists." For many years, these two critical policy controversies dwarfed other stock-compensation-related issues before the FASB; with the release of FASB Statement No. 123(R), related accounting topics are now being debated in depth.[23]

Section III: Summary of FASB Statement No. 123(R)

.37 FASB Statement No. 123(R) requires expensing the cost of ESOs and also provides accounting policies for other types of share-based payments.

Scope[24]

.38 FASB Statement No. 123(R) applies to any transaction in which the entity makes payment through a share-based contract or other arrangement:

1. A share-based payment is one where the entity issues or offers to issue share instruments or incurs a certain type of liability.
   a. The share instruments may be the entity's shares, options on its shares, or certain other equity instruments.
   b. The liability must be based on, or indexed to, the share price or the price of some other equity instrument, or the liability requires or may require settlement by issuing the entity's shares or other equity instrument.
2. The payment (that is, share issuances) may be made in return for goods or services.
3. The payee may be an employee or other supplier.

ESOs are share-based payments to employees exchanged for services and settled with the issue of shares.

---

[23] ESO accounting is enabled by the migration to fair value accounting for all financial instruments. Some of the more recent suggestions for improvements of FASB Statement No. 123(R) did not appear within the FASB discussions since the fair value principles had only recently been applied in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and FASB Statement No. 133. The FASB's approach is to provide for extensive deliberations and due process when considering all accounting policy suggestions.

[24] FASB Statement No. 123(R), paragraph 4.

The Central Accounting Policies

.39 The central accounting policies of this statement pertain to recognition and measurement.

1. *Recognition.* The entity must recognize the cost of share-based payments (including ESOs) in the financial statements when the goods or services are received. The entity may need to recognize an asset when the share-based payment contract is created in advance of the receipt of the goods or services.[25] The compensation represented by the share-based contract may represent an expense (compensation expense) in current earnings or may be capitalized as part of the cost to acquire an asset (compensation cost).[26]

2. *Measurement.* The value of the payment shall be measured at fair value as follows:

   a. *If the payment is to a nonemployee.* The value is that of the goods or services received if that value is more reliably measurable than the fair value of the equity instruments in question.

   b. *In all other cases.* The value is the fair value of the equity instruments issued, *except in certain cases when the payment is to an employee,* the calculated value or intrinsic value may be used in place of the fair value.[27]

.40 FASB Statement No. 123(R) addresses transactions with employees and nonemployees as well as various forms of share-based payment contracts. For nonemployee transactions or transactions in which the payee is not clearly an employee, the reader should consult FASB Statement No. 123(R) or other governing GAAP.[28] The remainder of this summary is focused on employee share-based payments in the form of an equity-based option contract (an ESO transaction).

.41 In addition, the full text of FASB Statement No. 123(R) must be consulted for the treatment of certain transactions with related parties and certain other exceptions. Some employee purchase plans are not governed by FASB Statement No. 123(R) because they are not ESOs (see paragraphs 12 and 13 and Appendix A of FASB Statement No. 123(R)); these plans are "noncompensatory." However, the introduction of option features to a noncompensatory plan may cause that plan to be considered an ESO and so require the application of FASB Statement No. 123(R). Examples of such features include the right to purchase shares at a discount to the market price (akin to an option strike price), or the right to withdraw from the plan without financial penalty (akin to the right but not the obligation to exercise an option). If the services are paid for by incurring a liability to the employee, the fair value of that liability must be remeasured[29] at the end of each reporting period through settlement. (For other remeasurement provisions, see the following section.)

Specific Accounting Rules for ESOs

.42 Paragraph 10 of FASB Statement No. 123(R) states: "[The] cost of services received from employees in exchange for [employee stock options] . . . shall be measured based on the *grant-date fair value* of the . . . [ESOs issued]."

---

[25] FASB Statement No. 123(R), paragraph 5 and footnote 4.

[26] FASB Statement No. 123(R), paragraph 5 and footnote 5.

[27] For the definitions of fair value, calculated value and intrinsic value as used in FASB Statement No. 123(R), see paragraph 7 and the Glossary of FASB Statement No. 123(R). See Section V for a discussion of fair values for use in FASB Statement No. 123(R). The reader is urged to consult expected FASB standard *Fair Value Measurement,* when that guidance is released, as it may apply to FASB Statement No. 123(R).

[28] The term *employee* is defined in FASB Statement No. 123(R)'s Appendix E, the Glossary.

[29] The FASB Statement No. 123(R) notion of "remeasurement" is the same as the financial economics notion of "marking a financial instrument to market," also expressed colloquially sometimes as truing-up the value of an instrument.

The Fair Value Accounting Principles Within FASB Statement No. 123(R)

.43 FASB Statement No. 123(R) recognizes that exchange prices for ESOs or similar instruments are not available to use as the fair value. In such a case, a valuation methodology must be used to estimate the fair value. The fair value of an ESO is expected to have a value different from its intrinsic value, that is, it has time value. The underlying equity share itself does not have time value.[30]

.44 ***The Fair-Value-Based Method.*** Under the fair-value-based method, the grant-date fair value is "[estimated] . . . based on the share price and other pertinent factors . . . at the grant date." The fair value is "not re-measured in subsequent periods"[31] unless the compensation award qualifies for treatment as a liability. "Liabilities . . . are . . . remeasured . . . [subsequent to the grant-date] . . . [on] each reporting date until the liability is settled."[32]

.45 The fair value estimate must reflect the terms of the ESO contract that are considered relevant to the value of that contract. The effects of nontransferability and nonhedgeability, as well as any postvesting restrictions on selling shares, are thought to be factors that could be represented in the entity's estimate of the "expected term" of the ESO.[33] However, certain ESO terms, including some forfeiture provisions, would not affect the fair value.[34] Other contingent events such as a "clawback" are excluded from the fair value calculation until they actually occur.[35]

.46 ***The Calculated Value Method.*** The calculated value method estimates the ESOs' fair value by substituting "the historical volatility of an appropriate industry sector index for the expected volatility . . . in an option-pricing model."[36] This method is used by a nonpublic entity when it is impracticable to estimate the expected volatility of its equity security price. In other words, attempts to arrive at estimates of expected volatility, including comparison with another public entity's historical, expected, or implied volatility, have not yielded a suitable estimate. Only in the case of nonpublic entities may a "calculated value" be substituted for the fair value.[37]

.47 ***The Intrinsic Value Method***. In certain limited cases it is not "possible to reasonably estimate the fair value of an [ESO] because of the complexity of its terms."[38] In this case the accounting for the instrument is "based on its intrinsic value, re-measured each reporting date through the date of exercise or settlement."[39]

Rules for Estimating the Fair Value of ESOs and Valuation Techniques

.48 Paragraph A7 of FASB Statement No. 123(R) relies on the Glossary from FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements,* for a definition of *fair value*:

---

[30] FASB Statement No. 123(R), paragraph 22 and footnote 12. See Section V of this Alert for a summary of Staff Accounting Bulletin (SAB) No. 107, *Share-Based Payment*, and Section VI of this Alert regarding the fair value of an option.

[31] FASB Statement No. 123(R), paragraph A2.

[32] FASB Statement No. 123(R), paragraph A6.

[33] FASB Statement No. 123(R), paragraph A3.

[34] FASB Statement No. 123(R), paragraph A4.

[35] FASB Statement No. 123(R), paragraph A6.

[36] FASB Statement No. 123(R), Appendix E.

[37] See FASB Statement No. 123(R), paragraph 23, and Section VI of this Alert.

[38] FASB Statement No. 123(R), paragraph 24.

[39] FASB Statement No. 123(R), paragraph 25.

"[Fair value is the] . . . amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale."[40]

.49 FASB Statement No. 123(R) uses the concept of *value in a current exchange*[41] and applies it to ESOs that are classified as either liabilities or equity instruments. The FASB Statement No. 123(R) rules summarized below generally apply to the estimation of fair value for ESO-type contracts, focusing on the "fair-value-based method" described above.

.50 The valuation technique applied should satisfy certain conditions. The resulting fair value, while representing an "exchange price," must also have certain substantive characteristics. FASB Statement No. 123(R) lists "the minimum set of substantive characteristics"[42] that should be considered in valuing any option-like instrument, assuming that "the market price is not available":

a. The exercise price of the option.

b. The expected term of the option. . . .

c. The current price of the underlying share.

d. The expected volatility of the price or the underlying share for the expected term of the option.

e. The expected dividends on the underlying share . . . ([subject to certain exceptions]).

f. The risk-free interest rate(s) for the expected term of the option."[43]

.51 Acceptable valuation techniques for ESOs "estimate the fair value . . . at a single point in time (for example, at the grant date) . . . [which] is not a forecast of what the estimated fair value of those instruments may be in the future."[44] Potentially appropriate valuation methodologies include the use of "an option-pricing model." "A lattice model (for example, a binomial model) and a closed-form model (for example, the Black-Scholes-Merton formula)" are examples of option-pricing models "based on established principles of financial economic theory" that "meet the requirements of FASB Statement No. 123(R)" and can be modified to incorporate the critical characteristics of ESOs.[45] Having identified these models, the FASB has not stated a "preference for a particular valuation technique"[46] and the work of the FASB Options Valuation Group has not been used to establish such a preference. The entity is responsible for establishing reasonable and consistent assumptions and estimates[47] in the course of using a valuation technique and is expected to change techniques on a prospective basis if the new choice is likely to result in a "better estimate of fair value."[48]

.52 Estimation of fair value in the case of ESOs is considered difficult in part because of the lack of a traded market in the instruments and the restrictions that the terms of the instruments represent, which some

[40] Readers of this Alert and FASB Statement No. 123(R) implementers in general are encouraged to stay abreast of regulatory evolution of the term *fair value*. After the issuance of FASB Statement No. 123(R) in December 2004, the SEC issued a number of documents summarizing their view of valuation methodologies and addressed some specific attempts at market innovation for purposes of FASB Statement No. 123(R) implementation. More broadly, at the date this Alert was written, the FASB was in the final stages of completing and issuing its new accounting standard on fair value, *Fair Value Measurements*. That standard, in particular, should be considered in one's ongoing implementation of FASB Statement No. 123(R), pursuant to the spirit expressed by the SEC staff in SAB No. 107 that improvements in valuation methodologies over the course of time would be expected.

[41] FASB Statement No. 123(R), paragraph A7.

[42] FASB Statement No. 123(R), paragraph A11.

[43] FASB Statement No. 123(R), paragraph A18.

[44] FASB Statement No. 123(R), paragraph A12.

[45] See FASB Statement No. 123(R), paragraph A13.

[46] FASB Statement No. 123(R), paragraph A14.

[47] FASB Statement No. 123(R), paragraphs A23 and A24.

[48] FASB Statement No. 123(R), paragraphs A17 and A23.

financial economists believe should affect the fair value estimate. FASB Statement No. 123(R) provides for this difficult setting when noting that "*restrictions* and conditions inherent in equity instruments awarded to employees are treated differently depending on whether they continue in effect after the requisite service period" (that is, the vesting period). For example, the "inability to transfer *vested* equity share options to third parties or the inability to sell vested shares . . . is considered in estimating the fair value [of the ESOs and the] effect of nontransferability and nonhedgeability . . . is taken into account . . . [in] an option's *expected term*."[49] By contrast, the notion that ESOs may be forfeited before the ESO rights have been earned (presumably some time before the end of the vesting period or in certain cases, loss of employment) is addressed by FASB Statement No. 123(R) by "recognizing compensation cost only for awards for which employees render the requisite service."[50]

.53 SAB No. 107 provides further implementation guidance on ESO valuation using fair value models (see the following section). FASB Statement No. 123(R) also includes several examples to demonstrate its accounting policies with special attention paid to valuation considerations. In addition, Appendix A of FASB Statement No. 123(R) and SAB No. 107 address certain limitations to valuation techniques and manners in which to address such limitations within the measurement goals of FASB Statement No. 123(R).

Balance Sheet Classification of ESO instruments

.54 The expense or cost of the ESO instrument is recorded in the income statement, according to the provisions of FASB Statement No. 123(R). The offset to the recognition of cost is a balance sheet account that recognizes the existence of the derivative contract (much as FASB Statement No. 133 requires balance sheet recognition of all derivative instruments within its scope). ESO transactions may be classified as a liability or as a component of equity, depending on the circumstances surrounding the transaction.

.55 The reader must examine the details of the ESO contract arrangement and follow the detailed rules within FASB Statement No. 123(R) to arrive at the proper classification (see paragraphs 29 through 35 of FASB Statement No. 123(R) and, where applicable, references to other FASB guidance, including FASB Statement No. 150). These classification provisions provide specific guidance on the following types of ESO arrangements:

1. A call option on another instrument classified as equity.
2. Puttable or callable shares requiring the employer to repurchase them.
3. Options that are indexed to shares that are classified as liabilities.
4. Certain option settlement provisions that will require that the ESO instruments are settled in cash.
5. Options with certain indexing to market factors other than an underlying equity instrument.
6. Certain conditions or the occurrence of contingent events, under which the substantive arrangement of the ESO contract calls into question the issuing entity's ability to deliver the equity shares when the ESO is exercised or requires cash settlement.
7. Certain provisions requiring the employer to withhold part or all of an award.
8. A broker arrangement permitting the employee to execute a "broker-assisted cashless exercise."[51]

Timing for the Recognition of Compensation Cost

.56 Generally FASB Statement No. 123(R) treats the requisite service period (RSP) as the vesting period in the ESO contract. If the RSP extends over more than one reporting period, the accounting should reflect

---

[49] FASB Statement No. 123(R), paragraph 17. For the terms that are in *italics* please refer to the Glossary in FASB Statement No. 123(R).

[50] FASB Statement No. 123(R), paragraph 18.

[51] FASB Statement No. 123(R), paragraph 35.

not only the recognition of the ESO cost but also the RSP; the cost of the ESO should be matched to the RSP. FASB Statement No. 123(R) also contains detailed guidance on how to estimate the RSP.

.57 ***If the ESO Is Accounted for as an Equity Instrument.*** If the ESO is classified as equity, the compensation cost is "recognized over the [RSP], with a corresponding credit to equity (paid-in capital)."[52] In addition, "previously recognized compensation cost . . . is not reversed . . . if the [RSP has ended and the instrument] expires unexercised (or unconverted)."[53]

.58 Paragraphs 51 through 57 of FASB Statement No. 123(R) also provide guidance on how to account for modification of ESOs that are treated as equity instruments. Modifications are "treated as an exchange of the original award for a new award."[54] Examples of some of the modifications covered include inducements, equity restructurings, repurchases or cancellations of awards, and cancellation and replacement of awards.

.59 ***If an ESO Is Accounted for as a Liability Instrument.*** Changes in fair value (or the value used for FASB Statement No. 123(R) recognition purposes) after the grant date and during the RSP for an ESO accounted for as a liability should be recognized as compensation cost over that RSP. Changes in fair value (or the value used for FASB Statement No. 123(R) recognition purposes) after the RSP for an ESO accounted for as a liability should be recognized as compensation cost in the period in which the changes occur.

FASB Statement No. 123(R) Share-Based Payments and Taxation

.60 Paragraph 58 of FASB Statement No. 123(R) summarizes the tax issues and related accounting that are relevant to the ESO issuer.

> Income tax regulations specify allowable tax deductions for [ESO] instruments. [As of December 2004 . . . IRS regulations allowed] tax deductions . . . [for the] intrinsic value of [the ESO] on a specified date.

.61 The treatment for timing differences that arise due to differences in tax law as compared with GAAP require application of FASB Statement No. 109, *Accounting for Income Taxes*. There are other potential GAAP reporting issues that may arise due to differences between the GAAP and tax treatment of ESOs, over the period ranging from the grant date to the expiration date, which are described in paragraphs 59 through 63 of FASB Statement No. 123(R), and illustrated in that Statement's Appendix A.

Required Disclosures

.62 Reporting entities must disclose for each share-based arrangement. According to paragraph 64 of FASB Statement 123(R):

a. The nature and terms of [the arrangement] . . . and the potential effects on shareholders

b. The effect of compensation cost [of the arrangement] on the income statement

c. The method of estimating the fair value of the goods or services received, or the fair value of the equity instruments granted [under the arrangements] during the period

d. The cash flow effects [from the arrangements].[55]

Additional guidance is contained in paragraphs 64, 65, A240, and A241 of FASB Statement No. 123(R).

---

[52] FASB Statement No. 123(R), paragraph 39.

[53] FASB Statement No. 123(R), paragraph 45.

[54] FASB Statement No. 123(R), paragraph 51.

[55] FASB Statement No. 123(R), paragraph 64.

EPS Implications

.63 Under FASB Statement No. 128, *Earnings per Share*, share-based arrangements covered by FASB Statement No. 123(R) must be treated as "potential common shares in computing diluted earnings per share"[56] with some conditions and exceptions. See paragraphs 30 to 35 of FASB Statement No. 128 for additional guidance on "contingently issuable shares" and paragraphs 21 through 23 for guidance on "the treasury stock method for equity instruments."[57]

.64 Appendix B to this Alert contains a listing that can be used as an index to the examples and illustrations contained in FASB Statement No. 123(R).

Section IV: What Are the Likely Effects of FASB Statement No. 123(R)?

.65 The issuance of FASB Statement No. 123(R) has resulted in significant alteration in compensation behavior. The FASB Statement No. 123(R) requirement to expense ESO compensation will most likely lead to a substantial reduction in the use of the ESO contracts, a trend to less favorable contract terms, and the evolution of financial engineering and accounting measurement technology to facilitate the measurements required by FASB Statement No. 123(R).

.66 ESO contracts are being replaced by restricted stock, issued with less favorable terms, or deleted from entity compensation plans entirely. There is now a decreased likelihood that ESOs will be a pervasive uncontrolled form of enrichment. At the same time, younger high tech companies may now be more reluctant to use ESOs as a means of retaining high quality talent.

.67 It should come as no surprise that the pace of innovation in financial engineering for ESO valuations has quickened since FASB Statement No. 123(R) was issued. Now that fair value calculations are mandatory for ESOs, improved valuation models are being announced. Most important, the responsibility for creating a suitable valuation methodology has migrated from financial economists to accountants and auditors.[58] The SEC has facilitated this valuable improvement in knowledge through some of the valuation guidance contained in SAB No. 107.[59]

.68 The end of the antiexpensing debate and the new period of financial engineering have also seen a renewed consideration of improvements to accounting policy for ESOs, including some proposed amendments to FASB Statement No. 123(R) that have been presented to the SEC and the FASB.[60]

Section V: Summary of SEC SAB No. 107

.69 On March 29, 2005, the SEC Staff, acting through the Office of the Chief Accountant and the Division of Corporation Finance, issued SAB No. 107 to provide "guidance regarding the application of . . . FASB Statement No. 123(R)." The SEC staff issued SAB No. 107 as an effort to explain and simplify the detailed technical provisions of FASB Statement No. 123(R), especially the guidance on fair value measurement, which incorporates the current GAAP measurement guidance of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, and the implementation experience of other standards on financial instruments.

---

[56] FASB Statement No. 123(R), paragraph 66.

[57] FASB Statement No. 123(R), paragraphs 66 and 67, respectively.

[58] See the recent financial engineering work on ESOs by Louis P. Le Guyader (www.kerlouet.org).

[59] See the recent work by Mark Rubinstein (www.in-the-money.com) and that of Shoven and Bulow (www.stanford.edu).

[60] See the recent accounting work on ESOs by Louis P. Le Guyader (www.kerlouet.org) and the Columbia University CEASA Policy Papers by James A. Ohlson and Stephen Penman.

Below is a summary of the key provisions of SAB No. 107, with emphasis on the guidance that should be applied to the fair value measurement process for stock options. A full copy of the text is available for download on the SEC Web site at www.sec.gov.

A Summary of Stock Option Accounting Under FASB Statement No. 123(R), as Interpreted by SAB No. 107

.70 Stock option expensing covers three major topics:

1. The determination of what constitutes compensation for accounting purposes.

2. The accounting policy for the recognition of compensation costs.

3. The measurement principles that should be used to arrive at that cost.

.71 SAB No. 107 interprets FASB Statement No. 123(R) to require that any compensation for services provided by employees be recognized as a cost in the financial statements, and to eliminate past accounting practices to defer compensation on the balance sheet *before* services are provided.

.72 The effect of FASB Statement No. 123(R) and SAB No. 107 is that if an SEC issuer uses any form of stock options in lieu of cash payments to employees for services rendered, the cost of the stock options is measured on the grant date at their fair value, and charged to earnings over the period of time that the compensated services are provided. In releasing SAB No. 107, the SEC staff's goal was to assist SEC issuers in their implementation of FASB Statement No. 123(R), thereby improving the quality of the accounting information given to investors and other users of accounting information. The following table summarizes the topics addressed by SAB No. 107.

Principal Topics Covered by SAB No. 107

1. Use of FASB Statement No. 123(R) for nonemployee transactions.
2. Nonpublic entities that become public.
3. Valuation methods.
4. Assumptions used in valuation methods.
5. FASB Statement No. 123(R) and certain redeemable financial instruments.
6. Classification of compensation expense.
7. Non-GAAP financial measures.
8. First-time adoption of FASB Statement No. 123(R) in an interim period.
9. Capitalization of compensation cost.
10. Accounting for income taxes.
11. Modification of stock option contracts before the adoption of FASB Statement No. 123(R).
12. Foreign private issuers.
13. Management's discussion and analysis disclosures after the adoption of FASB Statement No. 123(R).

.73 The SEC staff has been well versed in the complexities of other implementation periods for accounting standards on financial instruments or those standards requiring software to enable implementation.[61] SAB No. 107 therefore uses the notion of a "reasonable" range of actions to comply with the valuation requirements of FASB Statement No. 123(R). Indeed, the opposite would be cause for concern: It is unlikely that any singular valuation method to determine the fair value of stock options would be so preferable as to cause the SEC to dispose of alternative methods as "incorrect" or "wrong." Nonetheless, the flexibility of implementation that the SEC staff has extended is meant to apply to the initial implementation period of FASB Statement No. 123(R). The SEC expects that, as with any other business process, over time the range of choices and reasonable actions will narrow and "best practices" will emerge.

Summary of Key SAB No. 107 Guidance

Use of FASB Statement No. 123(R) for Nonemployee Transactions

.74 FASB Statement No. 123(R) is not meant to supersede existing GAAP for nonemployee transactions. In general, if a particular nonemployee share-based payment transaction does not appear to be specifically governed by GAAP, selected FASB Statement No. 123(R) provisions can be used as analogies to account for such transactions.

Nonpublic Entities That Become Public

.75 A private company (a nonpublic entity) may measure its liabilities under stock options at their intrinsic value under FASB Statement No. 123(R) as described in paragraph 38 or select the alternative "calculated value," as described in footnote 23 to FASB Statement No. 123(R) and paragraphs A43 through A48. The choice of intrinsic value given to nonpublic entities "is an exception from what the [FASB] considers to be" a preferable measurement method. (see paragraph B142). However, nonpublic entities retain the choice to use "fair value [that] is the conceptually preferable measurement attribute" (see paragraph B143). The SEC's SAB No. 107 highlights the special case of "nonpublic entities" that are transitioning to "public entity" status (see the Glossary of FASB Statement No. 123(R) for definitions of those terms). For share options that are granted prior to the date it becomes a public entity, and for which the nonpublic entity had selected the calculated value method, the SEC staff believes the entity should continue to use that approach. If the share options are subsequently modified, repurchased, or canceled by the public entity, the form of the change should be evaluated under FASB Statement No. 123(R). Under the appropriate circumstances, any incremental compensation cost would be measured under fair value. If on the other hand the nonpublic entity had issued stock options that are liability awards accounted for using intrinsic value (which is not preferable to fair value), then upon the date the entity becomes a public entity, it should measure the liability awards at their fair value. The public entity, however, may not retrospectively apply the "fair-value-based" approach to awards granted prior to the date it becomes public (see SEC SAB No. 107, Section B). The entity must also disclose in public filings any change in measurement policy and the basis for value estimation in management's discussion and analysis (MD&A). Such disclosure should also conform to other SEC policies.

Valuation Methods

.76 The objective of FASB Statement No. 123(R) is to measure stock options at the grant date, which is the earliest possible date, using the fair value, which is the most reliable measure for financial instruments

---

[61] The provisions of FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, were postponed to allow time to complete software development. A similar need for systems support led the FASB to postpone the effective date for FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, which became the primary reason for FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133—an amendment of FASB Statement No. 133*. FASB Statement No. 133 then was amended a total of four times in the hope of perfecting the accounting implementation. The issuance of FASB Statement No. 123(R) resulted in further modifications to FASB Statement No. 133.

accepted by GAAP. Since observable market prices for stock options, or similar financial instruments, are not available as the best evidence of fair value, SEC issuers must rely on a "second best" fair value. SEC issuers are therefore expected to estimate the fair value using a valuation technique also known as the mark-to-model approach.

.77 The value of an ESO can reasonably be expected to change from the grant date to the expiration date (or exercise date) as market factors including the underlying stock price and expectations about the future changes in the stock price of the issuer change over time. The fair values used for reporting should be proxies for the actual price that would be paid for the stock options. It is possible that good faith estimates may significantly differ from the settlement value of the stock options.

.78 FASB Statement No. 123(R) does not specify any one valuation method as preferable. Any valuation technique used must satisfy three characteristics to meet the fair value measurement objective:

1. The method used must be applied consistently in conformity with FASB Statement No. 123(R).
2. The method must be based upon established principles of financial economics theory as generally applied in that field.
3. The method must reflect all substantive characteristics of the stock option instrument.[62]

.79 The SEC staff has indicated that SEC issuers will be granted flexibility in selecting models as long as each of these three characteristics has been met. Therefore, an SEC issuer does not necessarily have to select the most complex valuation model because the SEC would not object to the use of other models that meet the aforementioned characteristics. Third-party or expert valuation is neither required nor expected. However, the entity should acquire the requisite expertise to value the stock options.

.80 Future changes in valuation methods (techniques or models) are permitted within the reporting goals of FASB Statement No. 123(R). This type of change would not be considered a change in accounting principle and would not require a preferability letter from its independent accountants; disclosure of the change would, however, be appropriate. The SEC staff warns that frequent changes would not be expected.

Assumptions Used in Valuation Methods

.81 FASB Statement No. 123(R) discusses two specific technical terms used in the accounting rules for stock options: expected volatility and expected term.

.82 ***Expected Volatility.*** Some option models, such as the Black-Scholes-Merton model, use a parameter known as volatility, which is a measure of how much an entity's stock price changes (equity prices are the option's "underlying market factor").[63] Volatility can be estimated, depending on the circumstances, in forms known as implied volatility and historical volatility. Expected volatility is the estimated future volatility of equity prices for use in valuation models.

.83 FASB Statement No. 123(R) does not specify how to measure expected volatility. The estimate used by the SEC issuer should be a "likely" match to the estimate that a marketplace participant would use. The SEC staff believes that SEC issuers should use best faith estimates to identify and use sufficient information, including implied volatility, historical volatility, or both measures, to estimate expected volatility.

---

[62] In general, the reader can think of "substantive characteristics" to include any term of the financial contract that would affect its valuation in efficient markets under normal circumstances.

[63] *Market factor* is a term used by the SEC in FR-48, "The Market Risk Rule." Market factors include interest rates, foreign exchange rates, commodity prices, and equity prices.

.84 *Implied volatility.* This is the volatility assumption inherent in the market prices of an entity's traded options or financial instruments with characteristics similar to options. SEC issuers are reminded that implied volatility is likely to be a suitable measure if the SEC issuer has other equity instruments traded in the market, including options and embedded options. The estimation process should be applied consistently; however, if new or different information becomes available that is relevant to estimating the expected volatility, this information should be incorporated into the model.

.85 If traded options are used to estimate expected volatility, the following should be considered in evaluating the market data:

1. The volume of market activity in the underlying shares and traded options.
2. The ability to "synchronize" variables used to derive implied volatility by selecting prices from markets trading at similar times and by measuring volatility as close as possible to the grant date of each series of options.
3. The similarity of the exercise price and term length of the traded options to the exercise price and term length of the employee stock options.

.86 *Historical volatility.* SEC issuers who estimate expected volatility by computing historical volatility should consider the period of time over which volatility is calculated—either the estimated or contractual term of the options—and should also note the following:

1. Weighing more recent periods more heavily than earlier periods in contracts with long terms may not be appropriate.
2. Use of other periods of time, other than the expected or contractual term of the option, to derive the estimate of volatility is admissible if it results in improving the estimate.
3. The intervals over which data is taken to form the estimate must be "appropriate and regular."
4. The selection of the frequency in data points must be sufficient to provide enough data points.
5. A consistent point in time within each interval should be selected.
6. The selection and use of data should be sensitized and adjusted to consider future events that would alter the volatility estimate.

In rare cases, a certain period of time may be excluded from the data; if any such exclusion exists, the SEC issuer must be prepared to support this statistical decision.

.87 It is expected that SEC issuers could, in certain circumstances, reasonably conclude that exclusive reliance on either historical or implied volatility would provide an estimate of expected volatility that meets the measurement objectives of FASB Statement No. 123(R). FASB Statement No. 123(R) contains a list of factors that SEC issuers should consider in this regard; SAB No. 107 contains further criteria for the SEC issuer to consider if intending to rely on only either implied volatility or historical volatility.

.88 FASB Statement No. 123(R) requires the SEC issuer to disclose the expected volatility and the method used to establish it. The SEC staff expects the disclosure to include whether implied volatility, historical volatility, or some combination of both is used to derive expected volatility. In addition, the SEC issuer is expected to satisfy the requirements of other SEC disclosure rules regarding critical accounting estimates, such as SEC Release No. FR-60, "Cautionary Advice Regarding Disclosure About Critical Accounting Policies." and SEC Release No. FR-72, "Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations," by including an explanation of the method used, and the basis for the company's conclusions.

.89 Other methods of estimating expected volatility are acceptable, assuming the SEC issuer includes appropriate adjustments as detailed in the full text of SAB No. 107. The overall goal is for each SEC issuer to use an expected volatility estimate that as closely as possible suits the volatility that the market ascribes to its securities, thereby achieving the measurement objectives of FASB Statement No. 123(R).

.90 ***Expected Term.*** The FASB documented its opinion that the expected term of stock options should be the assumed basis for the fair value estimates on the ESO contracts. The contractual term is not used, since the option holder typically exercises the option before the end of the option's contractual term. The expected term is a valuation parameter that can capture the effects of nonhedgability, nontransferability, and forfeitability of stock options. In such cases where the expected term captures these effects, no other adjustments to the valuation parameters are needed. The expected term, however, may not be shorter than the vesting period of the option contract; the end of the vesting period coincides with the first possible exercise date and this date would represent the shortest time span that the options can exist.

.91 The complexity of valuing financial instruments can be overcome by placing similar instruments in groups and applying the valuation techniques to the group as a whole. The SEC staff believes that this can be accomplished for an entity that frequently grants options with as few as one or two groups. Approaches to estimating the expected term are considered reasonable if they result in an option fair value that is an equivalent to an "exchange price" for the option. Subsequent changes to the term estimates may be reasonable if new evidence is found; changes would not invalidate the reasonableness of the original expected term assumption.[64] SAB No. 107 details additional comparative information that might, if used, contribute to estimates of the expected term, when a company determines that its historical stock option exercise activity does not provide a reasonable basis for the estimate of the expected term.

.92 The SEC staff recognizes the following terms as "plain vanilla" stock option terms:

1. Options are granted at-the-money.
2. Exercisability depends only on the employee performing the necessary services through the vesting period.
3. Employment termination before vesting results in option forfeiture.
4. Employment termination after vesting results in a limited time to exercise the stock options.
5. The options are nontransferable and nonhedgeable.

.93 If a company has issued plain vanilla stock options and chooses not to rely on historical exercise data, the SEC staff would accept a "simplified" method for estimating the expected term:

Expected Term = (Vesting Term + Original Contract Term)/2

Once elected, the simplified method must be applied consistently to all "plain vanilla" stock options and this choice should be disclosed in the financial statement footnotes. The SEC staff expects that a sufficient amount of market data on stock options exercises will become available over time, so that the simplified method would not be used after December 31, 2007.

FASB Statement No. 123(R) and Certain Redeemable Financial Instruments

.94 SEC issuers must evaluate whether stock options should be presented as liabilities under FASB Statement No. 123(R), or alternatively, as either equity or outside of permanent equity (also known as "temporary equity") in accordance with SEC Accounting Series Release No. 268, *Presentation in Financial Statements of "Redeemable Preferred Stocks"* (ASR 268) and related guidance. Certain redeemable financial

[64] *Expected term* in the case of FASB Statement No. 123(R) is similar to *expected maturity* as it is used in FR-48, "The Market Risk Rule."

instruments may cease to be governed by FASB Statement No. 123(R) because "the rights conveyed by the instrument to the holder are no longer dependent on the holder being an employee of the entity." In this instance, the financial instruments should be reviewed for application of ASR 268 or other accounting rules under GAAP.

.95 If an instrument qualifies for recognition as temporary equity, the amount that should be presented as temporary equity is generally equal to the fair value of the instrument multiplied by the percentage vested.

Classification of Compensation Expense

.96 The compensation expense to employees from stock options, even if a noncash amount, should be reported in the income statement on the same line as the cash basis salary paid to those employees. There is no guidance given as to the exact line item in the income statement that should be used to disclose these amounts. Separate disclosure to highlight the location and amount of compensation expense related to share-based payment transactions may be appropriate.

Non-GAAP Financial Measures

.97 SEC issuers may wish to provide a non-GAAP measure of earnings in which the cost of stock options is excluded from net income; such disclosures must abide by the provisions of Regulation G and Item 10(e) of Regulation S-K. If such non-GAAP measures are shown, the SEC issuer must demonstrate the usefulness of excluding stock option expenses to the extent that they are nonrecurring items; the disclosure should not be used as an attempt to smooth earnings. If the stock option expense is excluded from the entity's internal accounts to evaluate performance, the SEC issuer may have a basis to conclude that the exclusion of the expense in a non-GAAP measure disclosure satisfies the requirements of Item 10(e) of Regulation S-K. In such cases, disclosures should include both the reason for the presentation of the non-GAAP financial measure and, if material, the additional purposes for using that measure within the entity. SEC issuers should also consult the June 2003 SEC document *Frequently Asked Questions Regarding the Use of Non-GAAP Measures* to confirm that the disclosures are not misleading.

.98 In MD&A, SEC issuers should discuss the trends and variability of the entity's earnings and analyze specific line items if it is relevant to understanding a company's performance. Such narratives may be especially helpful in the case of noncash expenses from stock options that are likely to be nonrecurring. The SEC issuer must also be aware of certain prohibitions in FASB Statement No. 123(R) and SEC rules regarding the exclusion of stock option expense in pro forma income statements.

First Time Adoption of FASB Statement No. 123(R) in an Interim Period

.99 This section of SAB No. 107, issued on March 29, 2005, has largely been superseded by the April 14, 2005, announcement from the SEC Chief Accountant that the effective date of FASB Statement No. 123(R) would be postponed to the start of fiscal years beginning on or after June 15, 2005.

.100 SEC issuers are not permitted to apply FASB Statement No. 123(R) retrospectively. This means that in general, cumulative effects adjustments should be recorded on the date of adoption of FASB Statement No. 123(R), and *not* any date before the adoption date (including the beginning of the fiscal year in which adoption occurs).

.101 While the action of the SEC Chief Accountant postpones the required effective date of FASB Statement No. 123(R), SEC issuers may still early adopt the provisions of FASB Statement No. 123(R).

Capitalization of Compensation Cost

.102 SEC issuers may accumulate inventory costs during a manufacturing process in the form of compensation paid through stock options. SAB No. 107 states that:

1. Deferral of FASB Statement No. 123(R) costs through inventory accounts is expected as long as the costs are properly reflected in subsequent periods through earnings, normally through cost of sales; this deferral process is consistent with the matching principle and relies on inventory accounting rules outside of FASB Statement No. 123(R).

2. Inventory tracking systems that predate FASB Statement No. 123(R) may not be able to incorporate FASB Statement No. 123(R) costs at the same level of detail as more recent stock compensation costs. A period-end adjustment to the overall inventory balance for FASB Statement No. 123(R) costs would be acceptable and would not in itself negate the claim that internal controls are effective, as required by the SEC's rules implementing Section 404 of the Sarbanes-Oxley Act of 2002 (see SEC Release No. 34-47986).

Accounting for Income Taxes

.103 If the entity deducts more in compensation costs for tax purposes than for financial reporting purposes, any resulting excess tax benefits must be reported as additional paid-in capital. If current period tax deductions are less than the cumulative compensation cost reported for financial reporting, the entity should write off the deferred tax asset, net of any valuation allowance, against any remaining additional paid-in-capital from previous awards. The remaining balance of the write-off, if any, should be recognized in the income statement. Thus, FASB Statement No. 123(R) necessitates the tracking of tax attributes relating to share-based payment transactions. FASB Statement No. 123(R) does not specify the date that the entry to additional paid-in capital should be calculated, though the SEC notes that the calculation would not be required on the date FASB Statement No. 123(R) is adopted. FASB Statement No. 123(R) also does not require disclosure of the additional paid-in capital available for offset; the SEC notes that a company only needs to calculate the additional paid-in capital available for offset when the company's deductions per the tax return are less than the relevant deferred tax asset, and to ensure that a sufficient amount of paid-in capital is available for the offset of the deduction shortfall.

Modification of Stock Option Contracts Before the Adoption of FASB Statement No. 123(R)

.104 Under certain circumstances, the earnings' impact on some stock options under FASB Statement No. 123(R) can be mitigated if those contracts are modified before the adoption of FASB Statement No. 123(R) by accelerating the vesting date. The SEC interprets FASB Statement No. 123(R) to mean that this specific modification would result in the recognition of the remaining amount of the compensation cost in the period in which the modification is made. The test of whether such a modification has been made is if the employee could exercise the options after the modification, whereas before the modification he or she could not. Since the entire amount of the compensation cost would have been recognized under rules in effect before the adoption of FASB Statement No. 123(R), no further cost would be recognized in the income statement after adopting FASB Statement No. 123(R). Significant modification of option terms necessitates disclosures of the terms of the modifications and the reasons for the modifications, particularly if a company accelerates the vesting of out-of-the-money options before adopting FASB Statement No. 123(R).

Foreign Private Issuers

.105 The SEC staff believes that application of the measurement provisions of International Financial Reporting Standard No. 2, *Share-Based Payment*, would result in a fair value measurement that is consistent with the fair value objective of FASB Statement No. 123(R). Thus, reconciling items between International Financial Reporting Standards and U.S. GAAP should typically not occur within the guidelines of SEC Form 20-F, though certain other reconciling items may still in fact occur.

MD&A Disclosures After the Adoption of FASB Statement No. 123(R)

.106 An SEC issuer may use different accounting policies subsequent to the adoption of FASB Statement No. 123(R) than with previous applicable rules for stock option accounting reflected in Accounting Principles

Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*; FASB Statement No. 123, *Accounting for Stock-Based Compensation*; and FASB Statement No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure—an amendment of FASB Statement No. 123* Also, changes to measurements required by FASB Statement No. 123(R) may occur as SEC issuers refine their ability to form assumptions and estimates. Both differences may result in material changes to the SEC issuer's financial statements over time and so affect the comparability of financial statements.

.107 SEC issuers should consider including the following MD&A disclosures:

- The transition method selected and the financial statement impact in current and future reporting periods.
- The accounting method for stock options before adoption of FASB Statement No. 123(R), and the impact, or lack of impact, on the prior financial statements.
- Modifications made to stock options before adoption of FASB Statement No. 123(R) and the rationale behind such modifications.
- Differences in valuation methodologies or assumptions used to estimate fair value upon adoption of FASB Statement No. 123(R), as compared to the methodologies or assumptions previously used.
- Changes in quantity or type of instruments used in share-based plans (for example, changes from stock options to restricted shares).
- Changes in the terms of share-based payment arrangements.
- Discussion of any one-time effect upon the adoption of FASB Statement No. 123(R), such as any cumulative adjustments.
- Total compensation cost for nonvested awards that are not yet recognized and the weighted average period over which the nonvested awards are expected to be recognized.

Special Topics

Receivables From Sale of Stock

.108 When capital stock is issued to the entity's officers in return for a receivable before cash payment is made, the receivable is deducted from equity and is not presented as an asset, as consistent with Rule 5-02.30 of Regulation S-X; the requirement remains to separately list those receivables in the balance sheet.

Accounting for Expenses or Liabilities Paid by Principal Stockholder(s)

.109 If a company is named as a defendant in litigation, and a principal stockholder transfers a portion of his or her shares to the plaintiff in order to settle such litigation, the value of the shares transferred should be recorded as an expense in the company's income statement and as a credit to additional paid-in capital. The SEC staff believes that the substance of such a transaction is the payment of a company expense through contributions by a stockholder, and that such accounting treatment is in accordance with the provisions of paragraph 11 of FASB Statement No. 123(R).

Section VI: What Is the Value of a Stock Option?

.110 While SAB No. 107 provided guidance on a variety of topics related to FASB Statement No. 123(R), much of the guidance in SAB No. 107 focused on assumptions used in fair value methodologies; this section will further explore fair value accounting for ESOs, as required by FASB Statement No. 123(R) and SAB No. 107. An in-depth discussion of fair value accounting is necessary, as a complete implementation of FASB Statement No. 123(R) requires the understanding of how accounting entries related to FASB Statement No. 123(R) incorporate the use of fair value estimates, what the estimates represent, and the validity of the valuation methodology that is used to derive the estimate.

The Debits and Credits for ESO Fair Values

.111 The most basic accounting entry related to FASB Statement No. 123(R) would be to record the entire ESO fair value estimate as an expense, or debit, and to record a balancing credit in equity (or in some cases liabilities). Therefore, if an ESO's grant-date fair value is determined to be $200, the required entry would be to debit compensation cost for $200 and to credit an employee stock option liability account (or, depending on the circumstances, an equity account) for $200.

.112 A subtle aspect of FASB Statement No. 123(R) is that in cases in which the ESO is to be recorded in the equity portion of the balance sheet, the fair value will not be remeasured.[65] In these cases, the measurement process is greatly simplified and conducted on only one date, the ESO grant date.

.113 The use of the grant-date as the proper time to recognize the cost of the ESO in the financial statements reflects the FASB's objective of recognizing the value of contractual compensation arrangements in the financial statements. It also reflects the goal of applying recognition criteria for financial instruments consistently. The use of the grant date to recognize ESOs is consistent with the requirement to recognize other classes of derivatives on the analogous date: the start date for swaps, the purchase date for exchange traded futures and options, and the transaction date for forwards and over-the-counter options. The use of the grant date for recognizing compensation cost is also consistent with the policy of recognizing securities on the trade or acquisition date, not the settlement date.

.114 The overall valuation methodology must consider all the critical terms of the ESO derivative contract through its expiration date.[66] The valuation methodology also needs to use the best estimate of each parameter on the grant date. For example, the use of a volatility estimate that is two years old for a current valuation would not be appropriate; also, the use of interest rate and volatility estimates from different periods would possibly lead to an estimation error. As a result the valuation methodology must be robust enough to capture all contract terms and yet be flexible enough to use parameters that can be retrieved efficiently. The methodology also must be verifiable.

ESO Fair Value Within the GAAP Definition of Fair Value

.115 SAB No. 107 explains that the ESO fair value measurement should be the equivalent of an exchange price for the ESO. Some consider this to be an unrealistically high measurement standard because ESOs are more illiquid than most over-the-counter derivatives contracts; they are principal-to-principal contracts that are not traded, not transferable, and not hedgeable. Because no current price exists for ESOs, the issuing entity must rely on a mark-to-model methodology. FASB Statement No. 123 explained that the fair value of

---

[65] In the complete form of fair value accounting for a financial instrument, the instrument is recognized at its fair value when purchased, if exchange traded, or created, or if in the form of a principal-to-principal contract. At each subsequent reporting date, the fair value is updated and changes from the original fair value (so-called fair value flows) are recorded in income (either earnings or other comprehensive income). The updating of the fair value measure is generally the same as marking-to-market or remeasurement. Various permutations of fair value accounting for financial instruments are found in FASB Statement No. 115 and FASB Statement No. 133. Fair value notions are also used throughout GAAP to record the cost of an asset or liability on the date it is acquired or to restate carrying amounts on the balance sheet to the lower-of-cost-or-market (LCM) when a permanent impairment of the item's fair value has occurred.

[66] It is understood that a "critical term" is one that is value-relevant—the decision to include it or exclude it from the valuation methodology alters the fair value estimate itself.

ESOs could be extracted from option models such as the Black-Scholes-Merton Option model. More recently binomial models have been highlighted as an effective alternative.[67]

.116 Neither the FASB nor the SEC has selected any one model or approach as the most suitable approach for the measurement tasks within FASB Statement No. 123(R). Experts continue to disagree, and change their opinions, as they consider approaches that might meet the SEC goal of estimating fair values that are, in effect, exchange prices.

.117 The full fair value of the ESO can change over time as the entity issues new contracts. In SAB No. 107, the SEC recognizes that the market's skill in valuing ESOs will increase once FASB Statement No. 123(R) is implemented. In some cases, the full fair value is not used if the entity's own stock (the underlying) is not traded in an exchange market, as is the case for private companies. The absence of a public market in the private entity's stock is an example of the setting that may cause estimating the expected volatility of the entity's stock to be impracticable. The alternative measures for fair value permitted under FASB Statement No. 123(R) discussed elsewhere in this Alert can then be used as a fair value for reporting purposes if the appropriate conditions for such a substitution are met.

Valuation Methodologies: The Accounting and Auditing Approach Compared to the Financial Engineering Approach

The Financial Engineering Approach

.118 This is a valuation methodology that relies on a mark-to-model approach using any one of a number of models and associated estimates of parameters that the entity in its judgment believes is suitable to its form of ESO contract and that achieves the measurement objective of FASB Statement No. 123(R) of estimating the equivalent of an ESO exchange price. Examples of those approaches include "closed form" solutions such as the family of models within the Black-Scholes-Merton models, the lattice models that include the binomial model, and separate methods of estimating parameters such as expected maturity and expected volatility that are needed to operate these models.

.119 The difficulties in applying these methods are numerous: public policy issues, limits on the use of the financial economic theory underlying the valuation methodology, and the apparent inability to achieve an "exchange price equivalent."

.120 ***Public Policy Issues.*** Substantial arguments were displayed to the FASB to discourage the financial statement recognition of ESOs due to the perceived inability to value the derivatives with sufficient quality to justify placement in the financial statements. SAB No. 107 must be consulted for guidance on how to implement FASB Statement No. 123(R) using models that are "flawed but the best available." SAB No. 107 also gives guidance on how to migrate to improved methods over time and reconcile future values based on those improved methods to weaker methods used at the effective date of the standard.

.121 ***Limitations on Available Financial Economic Theory.*** Existing financial economics has taken the approach that existing models or attempts to modify those models for the purpose of ESO valuation are producing superior valuations as compared to the simple and unadjusted use of basic option pricing methods. A consistent observation is that the resulting values, at least at grant date, are high as compared with the valuation experts' "economic intuition" of a preferred but as-yet unsubstantiated fair value. However, there is also uniform agreement that the specific contract provisions of ESOs result in many potential valuation errors, with only limited narrowing since December 2004, when FASB Statement No. 123(R) was released.

---

[67] During the deliberations for FASB Statement No. 123(R), the FASB established the Options Valuation Group, which met with the FASB to provide information on the choice of and operation of various methodologies. At various times in the last 15 years of ESO deliberations that led to the issuance of FASB Statement No. 123(R), the FASB has also met with leading academic financial economists who are experts in the use of option valuation tools.

.122 ***Inability to Achieve a Verifiable "Exchange Price Equivalent."*** The continued dialogue within the financial engineering community is that even a new class of improved valuation methodologies continues to fall short of an "exchange price equivalent." Only one valuation technique has the attribute that Wall Street traders, not valuation experts, have informally considered it a replication of the pricing methodology that is performed on their trading desks.[68]

.123 While the FASB considered the advice of the Options Valuation Group to formulate the fair value guidelines in FASB Statement No. 123(R), it declined to specify any one model as the best alternative, nor would it list the models that may be considered suitable for the entity. FASB Statement No. 123(R) only specifies that the methodology must rely either on current prices (which are not available for ESOs as well as the similar assets that might be used as proxies) or a model that applies fundamental principles of "financial economic theory . . . [that] are generally applied in that field."[69]

The Accounting and Auditing Approach

.124 Accountants often describe the fair value of an option as having two parts:

Fair Value FOR ANY OPTION = [Time Value + Intrinsic Value]MAX VALUE ZERO[70]

The accounting formula applies to any option regardless of the complexity of the option contract or the nature of, or lack of, the "price discovery" system for the contract as a financial instrument.[71] Many financial instrument portfolios contain illiquid positions in derivatives and other financial instruments. The valuation issues in this instance are identical to those presented by ESOs. In both cases current exchange prices do not exist, broker confirmations are not available, and standard financial engineering approaches fail (see below).

.125 Unlike other option contracts, the intrinsic value will not be realizable until the vesting date. On the date the ESO option holder chooses to exercise, the time value becomes irrelevant and one can think of the option value as being its intrinsic value, even if that value is zero. The fair value of the ESO might become much greater than the grant date fair value if the option becomes in-the-money (for instance, early during the exercise period, when there is still substantial time value). Conversely, the fair value of the ESO may be zero by the time the expiration date is reached, in the case when the ESO is both out-of-the-money and not exercised, as there would be no time left to allocate to the time value estimate.

.126 The grant-date fair value will normally entirely reflect time value as ESOs are written at-the-money or out-of-the-money. But does this fair value represent the actual compensation cost if the realizable intrinsic value may be a different amount, even zero? The answer is yes: the grant-date fair value is a reasonable estimate of the future expected compensation cost because it is based on option valuation methodology that estimates the future cash flow and then discounts it to the present. The estimate of an option's fair value is similar to the estimate of the fair value of a debt security based on the simple "net present value" calculation. The option methodology arrives at a discounted present value by using both interest rate and probability-type factors (regardless of the model selected), whereas the net present value method applied to a fixed income security uses only an interest rate in the discounting process.

.127 FASB Statement No. 123(R) applies the following remeasurement principles to ESOs. (See Section III on the detailed accounting provisions of FASB Statement No. 123(R).)

1. *If the ESO is recorded as a liability.* Subsequent to the grant date, the ESO is treated as a derivative classified as a liability; in a manner consistent with FASB Statement No. 133, the ESO is remeasured on every reporting date and changes in its fair value are recorded as compensation costs using the earnings rules that apply to the ESO contract.

---

[68] See Le Guyader paper, "A Simple Way to Recognize Stock Options at Fair Value in Income" (2006) available at www.kerlouet.org.

[69] See FASB Statement No. 123(R), paragraph A13.

[70] See the Internet support site for this Alert, www.kerlouet.org, for the paper that discusses this type of notation.

[71] *Price discovery* is a term of art used by financial engineers. It means that the market price for an item is readily observable. The quality of price discovery depends on the nature of the market for the item, including volume and frequency of trading.

2. *If the ESO is classified as equity.* Subsequent to the grant date, the ESO is treated as an equity instrument; in a manner consistent with GAAP for other equity instruments, the ESO is not remeasured, thereby preventing the recognition of earnings from an equity item.

.128 The method easily defeats the criticisms that an ESO cannot be valued for reporting purposes. It can be used to measure the fair value of the ESO on the grant date and at any subsequent remeasurement date required under FASB Statement No. 123(R). The audit approach locates proxies for the ESO that are traded or efficiently valued and that, with a possible adjustment factor, can act as substitutes for the ESO. These proxies can result in a reportable fair value that meets the SEC description of an exchange price.

.129 The auditing approach to ESO valuation is based on established principles of financial economic theory, specifically the equivalency of a derivative to its replicating portfolio under no arbitrage conditions. In turn the grant-date fair value is the sum of the fair value of component instruments in the replicating portfolio. These fair values are market values of similar instruments, or mark-to-model values of similar instruments when observable market prices are not available. When valuations are performed, the modeling techniques are applications of the fundamental propositions of corporate finance, including the time value of money and risk-neutral valuation.[72] Finally the auditing approach to valuation is consistent with the FASB Statement of Financial Concepts No. 7 definition of *fair value*, which is designed to be a "*value in a current exchange*."[73] The component values and the aggregation of an ESO fair value mirror the "amount [at which] instruments with the same characteristics . . . would be exchanged."[74]

Matching Valuation Methodology to Contract Terms and Parameter Specifications

.130 The principle valuation difficulty with respect to ESOs is that they contain many contract terms that are relevant to valuation, but such terms are either excluded from valuations or poorly specified in newer models built for ESOs. The ESO contract terms that reappear as valuation issues include:

1. The length of the contracts.
2. The treatment of the vesting period.
3. The contract provisions for termination or alteration of the contract if employment is terminated.

.131 Even if a model perfectly reflected the ESO contract terms, there would still be difficulty in selecting the parameter values to be used as inputs to the model to generate fair values. Since ESOs are both long dated and permit exercise at any time during a potentially lengthy exercise period, the expiration date of the ESO contract seems to consistently overstate the expected maturity of the contract.[75] Option models and modern financial economic theory have many ways to estimate the volatility and associated probability factors. In the case of ESOs, the volatility estimate must suit the particular ESO issuer and must also be consistent with the terms of the ESO contract: a three-year volatility estimate on the S&P 500 would not be a likely estimate of volatility for a seven-year ESO contract on a small biotechnology company that has just gone public. The summary of SAB No. 107 includes a discussion of the issues that should be considered in specifying expected maturity and expected volatility.

---

[72] For more detailed guidance, see the fair value guidelines of FASB Statement No. 123(R) incorporated in its Appendix A under the title "Fair Value of Instruments Granted in a Share-based Payment Transaction."

[73] See FASB Statement No. 123(R), paragraph A7.

[74] See FASB Statement No. 123(R), paragraph A8.

[75] In other regulations on the market risk posed by derivatives, the SEC has recognized that any financial instrument with an imbedded put or prepayment option (with the option being held by the entity's counterpart or investor) is likely to result in an expected maturity shorter than the stated maturity. Residential mortgages are one class of assets with this prepayment risk. See the SEC Market Risk Rule in SEC FRR 48.

Section VII: How Can Stock Option Expense Be Minimized?[76]

.132 Companies will most likely begin to seek ways of reducing their stock compensation expense, as a large percentage of the reporting entities within the FASB constituency continue to debate the provisions of FASB Statement No. 123(R). The battle against FASB Statement No. 123(R) was focused on two fronts: opposition to recognizing compensation expense and claims that the value used for expensing was not determinable for accounting purposes. Although the press has recounted that FASB Statement No. 123(R) has generally been well received, some rough surveys show the acceptance rate to be no more than 50 percent in various industry segments.

.133 Given this history, it is not surprising to find evidence of alternative means of compensation or modified ESO contract terms designed to minimize the expense reported for stock options. The four general strategies that have emerged are (1) ESO contract modification, (2) substitution of other forms of compensation, (3) adjustment of the valuation parameters, and (4) the potential deferral of compensation charges.

ESO Contract Modification

.134 If an entity wishes to minimize the expense representing ESO compensation, it can alter ESO contract terms that are captured in valuation methodologies in order to produce a favorable measurement outcome. The form of the contract modification would need to reflect some care over whether the goal is minimizing grant-date fair value or minimizing the cumulative fair values recorded over the life of the contract. In addition, many of these contract modifications can act only to reduce the entity's expense by reducing the compensation paid to the worker.

.135 Regardless of the valuation methodology, some of the following contract changes to standard option contract provisions would reduce the contract value and the expense recognized:

1. The term of the option is shortened.
2. The vesting period of the option is lengthened.
3. The strike price is raised.
4. The exercise features are constrained in some way that makes exercise during an in-the-money period less likely.

Substitution of Other Forms of Compensation

.136 In the early stages of the FASB Statement No. 123(R) deliberations, some proponents of stock option expensing were discovered to be using restricted stock and eliminating the ESO as a compensation tool. Even those who opposed stock option expensing on policy grounds (the need to define core earnings and eliminate manipulation of earnings before adding another expense variable to the income statement) favored the substitution of restricted stock for ESOs.

.137 The use of restricted stock is thought to minimize the moral hazard opportunities represented by ESOs. As a leveraged option derivative, ESOs escaped easy detection and measurement; the accounting standards before FASB Statement No. 123(R), which were more disclosure-based, were criticized for the poor way in which they reported the dilution risk of ESOs. The award of restricted stock, however, attacks the problem of dilution risk by actually issuing shares. Investors are more able to encourage control of unwanted

[76] The author and the AICPA staff do not mean to suggest or support earnings management schemes or devices that would bias fair value to a minimum or a maximum value. The reader is reminded that the goal of ESO fair value measurement is to provide a fair value in financial statements that reflects an "exchange price" (see Section III).

dilution when they see issuances of additional shares. Also, employees are more likely to have an incentive attachment to the entity when they own shares that may be lost, rather than have a choice but not an obligation to purchase shares sometime in the future, as in the case of ESOs.

.138 However, the substitution of restricted stock for ESOs comes at a price. The incentive arrangement between the entity-employer and the stock holder-employee does not duplicate the contractual relationship of the ESO, and the dilution risk becomes realized at an early stage of the compensation arrangement.

Adjustment of the Valuation Parameters

.139 The structure of most fair-value models used in the ESO valuation process calls for estimating relatively sophisticated financial variables. These variables are estimated from more basic capital market variables. Capital market estimates of volatility ranging from implied volatility to historical volatility may appear in the form of “expected volatility.” The probability that the ESO will be exercised before its expiration date is reflected in an estimate of the “expected maturity” of the contract. Aside from the “no exercise” feature during the vesting period, exercise features may be limited by other specific contract terms, including forfeiture and nontransferability.

.140 The value of any option can be minimized by any one of the following means:

1. Reducing the estimate of volatility.
2. Shortening its term.
3. Interpreting the contract to contain a legal exercise limitation.

The Potential Deferral of Compensation Charges

.141 FASB Statement No. 123(R) includes guidance for amortizing the cost of the ESO over the life of the vesting period, as described in the previous sections. In addition, SAB No. 107 states that some ESO costs may be capitalized as inventory, as such ESO costs may be deemed to be a labor cost related to inventory. The compensation expense related to the ESOs would subsequently be recognized as cost of sales once the inventory is sold.

Section VIII: Regulatory Actions Affecting FASB Statement No. 123(R) Since Issuance

.142 After the issuance of FASB Statement No. 123(R) in December 2004, the SEC and the FASB acted promptly to issue additional guidance and clarification on topics such as the effective date of the accounting standard, guidelines for measuring the fair value of the instruments recognized in the financial statements, and other issues that the constituents of the accounting rulemaking process have put to these regulators. The additional guidance began with the issuance of SEC SAB No. 107 and continues with the issuance of FASB staff positions on specific implementation topics. The following sections summarize the key provisions of the items that the SEC and FASB have issued since December 2004.

Statements of the SEC Chief Accountant

.143 The SEC Chief Accountant has been very active in the implementation of FASB Statement No. 123(R). On the date FASB Statement No. 123(R) was issued, the SEC Chief Accountant noted that the standard resulted in the principal regulatory goal of providing "more comparable information in financial statements."[77] In this statement he encouraged financial statement preparers and their auditors to "use their best judgment" concerning the difficult tasks of "[using] assumptions and estimates . . . and some of the inputs to valuation models" and noted that the SEC staff was preparing to provide appropriate implementation guidance.

.144 On March 29, 2005, the Chief Accountant announced the release of SAB No. 107, which among other things "provides the staff's views regarding the valuation of [ESOs]."[78] This announcement reiterates the general understanding that the issuance of FASB Statement No. 123(R) had been "controversial . . . [and the result of FASB deliberations and discussions that were] extensive and far-reaching." As forecasted in FASB Statement No. 123(R) and SAB No. 107, the hoped-for improvement in FASB Statement No. 123(R) should be an ongoing process in which the SEC "will continue to monitor [FASB Statement No. 123(R)] implementation . . . and . . . consider the need for additional guidance as necessary." That additional guidance has been issued through subsequent announcements of the SEC and further implementation guidance and accounting rules issued by the FASB described below. SAB No. 107 is described in Section V of this Alert.

.145 On April 14, 2005, the SEC Chief Accountant announced a postponement of the required effective date of FASB Statement No. 123(R) to the beginning of the next fiscal year after June 15, 2005, which for most public SEC reporting companies with calendar year ends means that the statement can be implemented as of January 1, 2006. The SEC noted that the additional implementation time, among other things, would allow companies to "change their accounting systems in a more orderly fashion and should allow auditors to conduct more consistent audit and review procedures."[79]

Statement of the SEC Chairman

.146 On September 9, 2005, the SEC Chairman announced the release of informal SEC staff progress reports on the "evaluation of proposals to value employee stock options for financial reporting purposes."[80] When FASB Statement No. 123(R) was issued, the FASB noted that in its early implementation fair values might need to be estimated from "mark-to-model" procedures as employee stock options and similar instruments were not traded; the FASB also expressed the hope that eventually, traded markets in such instruments would emerge, and that the resulting market prices would represent an improvement in fair values used for financial reporting purposes. One SEC issuer had worked for some months to create a traded instrument whose values could be used as a proxy or an indirect indicator of the fair value of ESOs that the company issued to employees. As part of this innovation, the issuer sought the assurances of the SEC that the proxy market prices would be suitable, and possibly the best estimate, of ESO fair values. It is widely understood that SEC Chairman Cox's announcement was the strongest statement that the SEC was willing to make on the proposed innovation; the SEC's announcement did not mention the issuer directly.

SEC Chairman Announcement

.147 The SEC Chairman encouraged continued market innovation, which he saw as "robust efforts . . . that have the potential to accurately measure the cost of [ESOs, although the current SEC views are] subject to ongoing assessment." He emphasized the current position of the SEC and the FASB that when available, current market prices, for example, those derived from "the use of an appropriate market instrument . . . [have] distinct advantages over a [mark-to-model] approach." The SEC announcement included separate

---

[77] See SEC Chief Accountant Statement on FASB Statement No. 123(R), December 16, 2004.

[78] See SEC Office of the Chief Accountant and Division of Corporation Finance Release Staff Accounting Bulletin, March 29, 2005.

[79] See "Commission Amends Compliance Dates for FAS123(R) on Employee Stock Options," issued April 14, 2005.

[80] See SEC Press Release 2005-129 of September 9, 2005, "Statement of Chairman Christopher Cox regarding use of Market Instruments in Valuing Employee Stock Options," available at www.sec.gov/news/press/2005-129.htm.

announcements by the SEC Chief Accountant and the release of reports on the topic of ESO valuation by the SEC's Office of Economic Analysis.

Statement by the SEC Chief Accountant

.148 Simultaneously with the SEC Chairman's announcement, the SEC Chief Accountant issued a statement concerning the SEC staff's assessment of "several different strategies being considered by issuers in an attempt to bring market forces to bear on the valuation of employee stock options."[81] He notes that while the "measurement objective [of FASB Statement No. 123(R)] is to estimate the grant-date fair value of the [ESOs], . . . the FASB did not attempt to consider the appropriate design of an instrument that might [proxy for the ESOs in order to derive] a market-based value of [ESOs]." The SEC Chief Accountant stated that he and the SEC staff were now "comfortable that it should be possible to design [such proxy] instruments . . . and further . . . [the SEC had] significant doubts based on [Office of Economic Analysis]'s views, as to whether it would be possible to design [such a proxy] . . . instrument . . . by relying on similar contractual terms and conditions [of an actual ESO contract]." While this speech could not address the specific discussion brought before the SEC Chief Accountant by an identified SEC issuer, he encouraged "continuing . . . research on methods to obtain estimates of fair value for [ESOs]." Thus, as of November 30, 2005, absent other regulatory findings, mark-to-model approaches to estimate the fair value of ESOs continue to appear to be more efficient ways to meet the measurement objectives of FASB Statement No. 123(R) than market-based approaches.

Memorandum Issued by the SEC Office of Economic Analysis

.149 The SEC Chief Accountant's statement of September 9, 2005, references an August 31, 2005, Memorandum issued by members of the SEC Office of Economic Analysis on the topic of the use of proxy instruments to derive a FASB Statement No. 123(R) fair value for ESOs.[82] The memorandum describes "[a] market-based approach [as involving a proxy] instrument that will be traded among willing buyers and sellers, and the use of the instrument's market price as a reasonable estimate of the grant-date fair value of the [ESOs]." The summary of the economic analysis is that attempts at replicating the contractual terms of the ESOs fail to produce a reasonable estimate of fair value for purposes of FASB Statement No. 123(R) but that approaches that "track the future flows of *net obligations* facing the company or *net receipts* . . . can yield reasonable estimates of fair value as defined in [FASB Statement No. 123(R)]." Of interest is that the SEC's SAB No. 107 prompted many approaches with various instruments designed for market trading in the hopes of allowing the derivative of a FASB Statement No. 123(R) fair value; thus while SAB No. 107 prompted valuable market research and potential innovation, further work is anticipated to map those market innovations into sound accounting policy and compliance. The memorandum then addresses two approaches within the question of *instrument design*: the "tracking" approach, and the "terms and conditions" approach.

.150 In the tracking approach, one attempts to create an instrument whose cash payouts "are identical to the [net cash flows under the ESO contract]." Such traded instruments would not face the restrictions common to ESO contracts on trading or hedging. Without these restrictions, the SEC holds out the possibility that the resulting market price would be a "reasonable estimate of fair value."

.151 In the terms and conditions approach, the traded contract replicates all the terms and conditions of an ESO contract, including the restrictions mentioned above. The SEC's current belief is that there are inherent

---

[81] See "Speech by SEC Staff: Statement Regarding Use of Market Instruments in Valuing Employee Stock Options," by Donald T. Nicolaisen, Chief Accountant, U.S. Securities and Exchange Commission, September 9, 2005, available at www.sec.gov/news/speech/spch090905dtn.htm.

[82] See the SEC Office of Economic Analysis Memorandum, "Economic Evaluation of Alternative Market Instrument Designs: Toward a Market-based Approach to Estimating the Fair Value of Employee Stock Options," August 31, 2005, available at www.sec.gov/news/extra/memo083105.htm.

difficulties with such an instrument that will likely prevent its market price from being a reasonable estimate of fair value.

.152 In a previous memorandum, the SEC Office of Economic Analysis had characterized the valuation methods cited in FASB Statement No. 123(R), notably the Black-Scholes-Merton and Binomial option pricing models, as "conventional and well-known."[83] This memorandum, which prepared the ground for the issuance of SAB No. 107, summarizes the rationale for the accounting policy required by FASB Statement No. 123(R) (the expensing of ESOs), the historical reliance of the FASB and the SEC on the identified pricing models for purposes of ESO valuation, and the SEC's economic perspective on the difficulty SEC issuers face in obtaining "reliable parameters and inputs . . . for estimating the value" of ESOs by the identified standard methods. The body of that memorandum represents an incentive for all auditors to rely on the detailed valuation guidance the FASB and the SEC have already issued on the estimation of ESO fair value in the body of FASB Statement No. 123(R) and SAB No. 107 and their precursors in the regulatory literature, notably, FASB Statement No. 123.

FASB Actions: FASB Statement No. 123(R) FSPs, FASB Statement No. 133 Revisions, and New Standards

.153 The FASB has continued to improve accounting guidance on financial instruments by issuing specific implementation guidance for FASB Statement No. 123(R). The DIG has taken action on FASB Statement No. 133 that may affect FASB Statement No. 123(R) implementation and the new proposed accounting standard, "Fair Value Measurement."

New FASB Statement No. 123(R) Implementation Guidance From FASB Staff Positions

.154 The FASB has posted three relevant FASB Staff Positions (FSPs) and one proposed FSP to its Web site since August 2005.

1. FSP FAS123(R)-1. This staff position is on the topic of balance sheet recognition and measurement of financial instruments representing share-based payments under FASB Statement No. 123(R) whose holder ceases to be an employee of the issue of the freestanding instrument. It was posted to the FASB Web site on August 31, 2005. If the freestanding instrument was subject to FASB Statement No. 123(R) when issued to the holder, the issuer should continue to recognize and measure that instrument under FASB Statement No. 123(R), unless the instrument is modified after the holder ceases employment; in the case of such modification, "recognition and measurement of the instrument should be determined [by] . . . other applicable GAAP."[84] The financial statement preparer is expected to implement this guidance effective with its adoption of FASB Statement No. 123(R) using one of two methods described in paragraph 7 of the FSP.

2. FSP FAS123(R)-2. This staff position is on the topic of the grant-date share-based payments being subject to FASB Statement No. 123(R) on the date they are granted, but the determination of that date can be difficult. It was posted to the FASB Web site on October 18, 2005. The grant date is the date when "mutual understanding of the key terms and conditions of [the share-based payment to an employee] shall be presumed to exist . . . if . . . the award is a unilateral grant [which will not be further negotiated] . . . and [notice of the award to the employee can be expected] within a relatively short time period from the date [the award is approved under the issuer's relevant rules of corporate governance]."[85] The financial statement preparer is expected to implement this guidance effective with the adoption of FASB Statement No. 123(R) or, if that date preceded the posting of the FSP on

[83] See the Office of Economic Analysis Memorandum, "Economic Perspective on Employee Option Expensing: Valuation and Implementation of FAS123(R)," March 18, 2005, available at www.sec.gov or www.kerlouet.org.

[84] FSP FASB Statement No. 123(R)-1, paragraph 6.

[85] FSP FASB Statement No. 123(R)-2, paragraph 5.

the FASB Web site, the first reporting period for which financial statements are prepared after the FASB Web site posting date.

3. FSP FAS123(R)-3. This staff position is on the topic of "accounting for the tax effects of share-based payment awards [subject to FASB Statement No. 123(R)]."[86] It was posted to the FASB Web site on November 10, 2005. The FSP details the method described in paragraphs 68 and 81 of FASB Statement No. 123(R) for allocating amounts representing tax benefits to the additional paid-in capital account of the financial statement preparer and provides an alternative transition method of financial statement recognition, together with examples. The financial statement preparer is expected to implement the transition guidance in paragraph 81 until such time as it elects to implement the modified guidance permitted under FSP FASB Statement No. 123(R)-3; the election to use the modified guidance is a one-time election that must be taken not later than one year from the initial adoption of FASB Statement No. 123(R).

4. Proposed FSP FAS123(R)–d. The FASB staff is proposing a new FSP on the topic of the balance sheet classification as liability or equity of certain ESOs. At the date of the publication of this Financial Reporting Alert, the topic had been posted on the FASB Web site (www.fasb.org) and remained open for comment through January 31, 2006. The proposed guidance would amend paragraphs 32 and A229 of FASB Statement No. 123(R) concerning ESOs that "allow for cash settlement upon occurrence of a contingent event" and addresses two issues: (1) the stipulation of "the probability of the contingent cash settlement event occurring" and (2) an alternative "grandfathering [of] existing" ESOs. The final form of the FSP would be applied upon initial adoption of FASB Statement No. 123(R) with an effective date stated upon posting of the final FSP on the FASB Web site, which is expected to occur some time after January 31, 2006. A link to the final FSP will be available to readers of this Financial Reporting Alert on www.kerlouet.org (see Stock Options tab).[87]

New Implementation Guidance on FASB Statement No. 133 Derivatives

.155 There has been a significant change in guidance on how to implement the fair value provisions of FASB Statement No. 133 with respect to certain derivative instruments. Share-based payments that take the form of equity-linked derivatives are subject to the fair value guidance provided in FASB Statement No. 123(R). However, as the FASB proceeds to issue a standard on fair value measurement, the additional implementation on fair value for derivatives in the case of FASB Statement No. 133 is relevant. This new FASB Statement No. 133 guidance is consistent with the guidance on fair value provided by the SEC as previously described, and the guidance that is expected to be part of the fair value guidance within the new accounting standard is expected shortly.

.156 On December 17, 2004, the FASB DIG posted a revision to FASB Statement No. 133 Implementation Issue No. C3 to the FASB Web site (DIG No. C3[88]). DIG No. C3 was originally issued on February 17, 1999, and this revision was cleared on December 15, 2004, in coordination with the FASB's issuance of FASB Statement No. 123(R). DIG No. C3 addresses which accounting rules apply to contracts such as ESOs after the employee ceases to be an employee of the ESO issuer. In such a circumstance, FASB Statement No. 123(R) would cease to apply, but the equity-linked derivative would then be subject to the provisions of FASB Statement No. 133. In addition, contracts that take the form of ESOs but are granted to nonemployees are subject to the accounting rules of FASB Statement No. 133, not FASB Statement No. 123(R), although certain scope exceptions within FASB Statement No. 133 may continue to apply.

---

[86] FSP FASB Statement No. 123 (R)-3, paragraph 4.

[87] The Final FSP was posted on the FASB Web site after the date this Alert was finalized. A summary of the final FSP is available at the Internet support Web site for the Alert.

[88] See FASB Statement No. 133 Implementation Issue No. C3, "Scope Exceptions: Exception related to Share-Based Payment Arrangements," posted on the FASB Web site at www.fasb.org.

New Fair Value Measurement Guidance Expected

.157 The FASB is planning to issue a new accounting standard tentatively titled *Fair Value Measurements*. The standard is expected to "define fair value [and establish] a framework for measuring fair value." It is understood to address the problem of "different definitions of fair value and limited guidance for applying those definitions within GAAP."[89]

.158 The accounting standard is expected to define *fair value* as the price that would be received for an asset or paid to transfer a liability in a current transaction between marketplace participants in the reference market for the asset or liability. In the absence of a transaction involving the entity, the estimate of fair value is determined by reference to a hypothetical transaction for the asset or liability at the measurement date (the effective valuation date).

.159 This is understood to be consistent with the guidance on fair value contained in FASB Statement No. 123(R) and the additional guidance provided by the SEC. In particular, while the estimate of fair value from actual market prices is preferred, in the case of ESOs and under the current valuation conditions examined in the most recent memorandum issued by the SEC Office of Economic Analysis, a mark-to-model approach with special attention to the selection of model inputs and parameters is expected to require the continued best judgment of financial statement preparers and their auditors.

Additional Disclosures Proposed by the SEC

.160 The Securities and Exchange Commission acted on January 17, 2006 to promulgate additional disclosures about executive compensation that would rely upon and emphasize the need for FASB Statement No. 123(R) information. (See SEC Press Release 2006-10, available at www.sec.gov/news/press/2006-10.htm.) The proposed rule is intended to require new narrative disclosure to "elicit clear and more complete disclosures on the compensation of the [entity's] principal executive officer, principal financial officer, [and] the three other highest paid executive officers and directors." As proposed, the rule will require a new narrative section on compensation that will include a reorganized "Summary Compensation Table." Among other things, this table would include "[a] dollar value will be shown for all stock-based awards, including stock and stock options, measured at grant date fair value, computed pursuant to Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, to provide a more complete picture of compensation and facilitate reporting total compensation." A full copy of the SEC press release is available at the SEC Web site (www.sec.gov) and the Web site supporting this Financial Reporting Alert (www.kerlouet.org); the latter will be updated from time to time for new portions of the proposed SEC disclosure rule that must interact with FASB Statement No. 123(R).

Summary

.161 Fair value accounting for ESOs has been the matter of much heated debate over the past few years. FASB Statement No. 123(R) is the FASB's attempt to bring an end to such debate and brings consistency to voluntary expensing and valuation practices that were permitted before its effective date. The FASB recognizes that valuation methodology for ESOs is a relatively young branch of financial economic theory; therefore, both FASB Statement No. 123(R) and SAB No. 107 emphasize the need to tailor generic option-pricing models to the intricate and detailed contract terms of the ESOs. Users of FASB Statement No. 123(R) must be prepared to acquire the requisite knowledge to evaluate their ESO contracts, obtain a reliable and verifiable fair value, and prepare the required accounting and disclosure entries.

---

[89] See progress reports on the planned release of FASB Statement of Financial Accounting Standards No. 15X, *Fair Value Measurements*, at www.fasb.org.

.162

Appendix A: Summary of the FASB Project on Financial Instruments

Key Milestones in the FASB's Financial Instruments Project Leading to FASB Statement No. 123(R), *Share-Based Payment* [1]

Statement of Standards	*Issued (Amended)*	*Title*	*Key Developments Within the FASB Financial Instruments Project for ESO Accounting*
AICPA Issues Paper 86-2	March 1986	*Accounting for Options*	1. Demonstrates common features of all option and related fair value attributes. 2. Documents for options "Fair value = Time value + Intrinsic value."
FASB Statement No. 105	March 1990	*Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*	1. Requires disclosure of the notional amounts of financial instruments in the notes to financial statements (as part of disclosures about financial instruments with off-balance-sheet risk of accounting loss).
FASB Statement No. 107	December 1991	*Disclosures about Fair Value of Financial Instruments*	1. Requires disclosure of fair value for financial instruments, both on- and off-balance-sheet. 2. Extends the use of fair value as the relevant measure.
FASB Statement No. 115	May 1993	*Accounting for Certain Investments in Debt and Equity Securities*	1. Extends the use of fair value as the measurement principle to all asset classes for securities within the scope except for "held-to-maturity securities." 2. Provides income recognition rules for fair value changes (charge to earnings or OCI [2]).
FASB Statement No. 119	October 1994	*Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*	1. Excludes ESOs from scope. 2. Extends the fair value disclosure requirements for financial instruments to include derivatives.
FASB Statement No. 123	October 1995	*Accounting for Stock-Based Compensation*	1. Defines but does not require a *fair value-based method* for ESOs.

(continued)

Statement of Standards	*Issued (Amended)*	*Title*	*Key Developments Within the FASB Financial Instruments Project for ESO Accounting*
			2. Permits the use of the *intrinsic value method* with required pro forma disclosures of income using the fair value method. *Result: ESOs remain "off balance sheet."*
FASB Statement No. 128	February 1997	*Earnings per Share*	1. Specifies methods for computing EPS for both common stock and potential common stock. 2. Relates treasury stock method to ESOs.
FASB Statement No. 133	June 1998 (1999, 2000, and 2001)	*Accounting for Derivative Instruments and Hedging Activities*	1. Excludes ESOs from scope. 2. Reaffirms fair value as the measurement principle for derivatives. Result: Derivatives are recognized on-balance-sheet.
FASB Statement No. 123R	December 2004	*Share-Based Payment*	Requires mandatory ESO expensing at grant-date fair value.

[1] Copyright © 2005 Louis P. Le Guyader. All rights reserved. This exhibit is an update of an exhibit presented by the author during his dissertation defense at Columbia University in 1998. *Used by permission.*

[2] The FASB Concepts Statements define *comprehensive income* as the sum of earnings and "other comprehensive income (OCI)." OCI rules can be found in FASB Statement No. 130, *Reporting Comprehensive Income*.

FASB Statement No. 123(R) represents the FASB's most recent progression to recognize all derivatives on the balance sheet using fair value as the measure. Much of the fair value measurement, recognition, and disclosure principles had been developed for derivatives and financial instruments other than ESOs.

.163

Appendix B: Summary of Examples and Illustrations Contained in FASB Statement No. 123(R)

FASB Statement No. 123(R) Paragraph	*FASB Statement No. 123(R) Classification*
A59–A74	Explicit, Implicit and Derived Requisite Service Periods
A67–A69	Share-Based Payment Award with a Performance Condition and Multiple Service Periods
A70–A71	Share-Based Payment Award with a Service Condition and Multiple Service Periods
A72–A74	Share-Based Payment Award with Market and Service Conditions and Multiple Service Periods
Appendix A Illustrations	
A75–A76	Illustration 1—Definition of Employee
A77–A78	Illustration 2—Determining the Grant Date
A79–A85	Illustration 3—Service Inception Date and Grant Date
A86–A104	Illustration 4—Accounting for Share Options with Service Conditions
A86–A96	Illustration 4(a)—Share Options with Cliff Vesting
A94–A95	Illustration 4(a)—Share Options with Cliff Vesting—Income Taxes
A96	Illustration 4(a)—Share Options with Cliff Vesting—Cash Flows from Income Taxes
A97–A104	Illustration 4(b)—Share Options with Graded Vesting
A99–A101	Illustration 4(b)—Share Options with Graded Vesting—Graded Vesting Attribution Method
A102–A104	Illustration 4(b)—Share Options with Graded Vesting—Straight-Line Attribution Method
A105–A110	Illustration 5—Share Option with Multiple Performance Conditions
A105–A108	Illustration 5(a)—Share Option Award under Which the Number of Options to Be Earned Varies
A109–A110	Illustration 5(b)—Share Option Award under Which the Exercise Price Varies
A111–A113	Illustration 6—Other Performance Conditions
A114–A120	Illustration 7—Share Option with a Market Condition (Indexed Exercise Price)
A121–A124	Illustration 8—Share Unit with Performance and Market Conditions

(continued)

FASB Statement No. 123(R) Paragraph	*FASB Statement No. 123(R) Classification*
A125–A126	Illustration 9—Share Option with Exercise Price That Increases by a Fixed Amount or a Fixed Percentage
A127–A133	Illustration 10—Share-Based Liability (Cash-Settled SARs)
A132–A133	Illustration 10—Share-Based Liability (Cash-Settled SARs)—Income Taxes
A134–A148	Illustration 11—Share-Based Equity and Liability Awards Granted by a Nonpublic Entity
A134–A136	Illustration 11(a)—Share Award Granted by a Nonpublic Entity
A135–A136	Illustration 11(a)—Share Award Granted by a Nonpublic Entity—Income Taxes
A137–A142	Illustration 11(b)—Share Award Granted by a Nonpublic Entity That Uses the Calculated Value Method
A143–A148	Illustration 11(c)—Share-Based Liability Award Granted by a Nonpublic Entity That Elects the Intrinsic Value Method
A149–A159	Illustration 12—Modification and Settlements
A149–A150	Illustration 12(a)—Modification of Vested Share Options
A151	Illustration 12(b)—Share Settlement of Vested Share Options
A152–A154	Illustration 12(c)—Modification of Nonvested Share Options
A155	Illustration 12(d)—Cash Settlement of Nonvested Share Options
A156–A159	Illustration 12(e)—Equity Restructurings
A157	Illustration 12(e)—Equity Restructurings: Original Award Contains Antidilution Provisions
A158–A159	Illustration 12(e)—Equity Restructurings: Original Award Does Not Contain Antidilution Provisions
A160–A170	Illustration 13—Modification of Awards with Performance and Service Vesting Conditions
A162–A163	Illustration 13(a)—Type I (Probable-to-Probable) Modification
A164–A165	Illustration 13(b)—Type II (Probable-to-Improbable) Modification
A166–A167	Illustration 13(c)—Type III (Improbable-to-Probable) Modification
A168–A169	Illustration 13(d)—Type IV (Improbable-to-Improbable) Modification
A170	Illustration 13(e)—An Additional Illustration of a Type III (Improbable-to-Probable) Modification
A171–A189	Illustration 14—Modifications That Change an Award's Classification
A172–A180	Illustration 14(a)—Equity-to-Liability Modification (Share-Settled Share Options to Cash-Settled Share Options)

FASB Statement No. 123(R) Paragraph	*FASB Statement No. 123(R) Classification*
A178–A180	Illustration 14(a)—Equity-to-Liability Modification (Share-Settled Share Options to Cash-Settled Share Options)—Income Taxes
A181	Illustration 14(b)—Equity-to-Equity Modification (Share Options to Shares)
A182–A184	Illustration 14(c)—Liability-to-Equity Modification (Cash-Settled SARs to Share-Settled SARs)
A185–A188	Illustration 14(d)—Liability-to-Liability Modification (Cash-Settled SARs to Share-Settled SARs)
A189	Illustration 14(e)—Equity-to-Liability Modification (Share Options to Fixed Cash Payment)
A190–A191	Illustration 15—Share Award with a Clawback Feature
A192–A197	Illustration 16—Certain Noncompete Agreements and Requisite Service
A198–A201	Illustration 17—Tandem Award—Share Options or Cash-Settled SARs
A202–A210	Illustration 18—Tandem Award—Phantom Shares or Share Options
A211–A219	Illustration 19—Look-Back Share Options
A220–A221	Illustration 20—Employee Share Purchase Plans
A222–A224	Illustration 21—Book Value Share Purchase Plans (Nonpublic Entities Only)
A225–A232	Illustration 22—Liability Classification and the Interaction of This Statement with Statement 150
A225–A226	Illustration 22—Liability Classification and the Interaction of This Statement with Statement 150—Applying the Classification Criteria in Statement 150
A227–A229	Illustration 22—Liability Classification and the Interaction of This Statement with Statement 150—Classification of Certain Awards with Repurchase Features
A230–A232	Illustration 22—Liability Classification and the Interaction of This Statement with Statement 150: Subsequent Accounting for Certain Freestanding Financial Instruments
A230–A239	Illustration 23—Effective Dates and Transition Methods
A233	Illustration 23(a)—Effective Dates and Transition Methods
A234–A239	Illustration 23(b)—Transition Using the Modified Prospective Method
A241	Minimum Disclosures
Pages 139–141	Share Option Plan
Pages 141–142	Performance Share Option Plan

.164

Appendix C: Other Resources for Readers

The accounting guidance for implementers of FASB Statement of Financial Accounting No. 123(R), *Share-Based Payment*, as of January 31, 2006, includes the following documents, which can be accessed through the Web site www.kerlouet.org unless otherwise noted:

1. Precursors to FASB Statement No. 123(R) available at www.fasb.org:
   a. Accounting Principles Board Opinion 25, *Accounting for Stock Issued to Employees*
   b. FASB Statement No. 123, *Accounting for Stock-Based Compensation*
   c. FASB Statement No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure—an amendment of FASB Statement No. 123*

2. Other FASB Documents available at www.fasb.org
   a. FASB Statement No. 123(R)
   b. FASB Statement No. 123(R): Questions and Answers as of December 16, 2004
   c. FASB Staff Interpretations of FASB Statement No. 123(R)

3. SEC Documents available at www.sec.gov
   a. SEC Staff Accounting Bulletin No. 107, *Share-Based Payment*
   b. Announcements, Press Releases and other documents from the SEC Commission, the SEC Chairman, the SEC Chief Accountant and the SEC Office of Economic Analysis

4. Related FASB Actions (related documents are available at www.fasb.org)
   a. FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, guidance on fair value measurement for certain non-ESO derivatives
   b. FASB plan to issue accounting standard, *Fair Value Measurement*
   c. FASB and International Accounting Standards Board Fair Value Option (or Free Choice) Project

[*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

Acknowledgments

The AICPA Accounting and Auditing Publications staff express our special thanks to Hiram Hasty, CPA, who made extensive contributions to this publication. His knowledge of the risk assessment standards and auditing in general was invaluable. In addition, the staff expresses our thanks to Chuck Landes, CPA, for his indispensable review of this publication and to Lyn Graham, CPA, for working closely with the author on key aspects of the risk assessment standards.

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:

---

[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.

(continued)

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	

(continued)

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"

(continued)

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

(continued)

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

(continued)

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.

(continued)

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.

---

[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.

---

[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.

---

[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?

---

[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

[*The next page is 9001.*]

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. Users of this manual are urged to refer directly to applicable authoritative pronouncements when appropriate.

These examples illustrate the body of various reports. For comment on addressing and dating of the report, see AAM section 9100.

Examples which are assembled from illustrative reporting language set forth in Statements on Auditing Standards (SASs) and Statements on Standards for Accounting and Review Services (SSARSs) include citation of the particular source and its location in *AICPA Professional Standards.*

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 (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.

TABLE OF CONTENTS

[*The next page is 9101.*]

AAM Section 9100
Format of Accountants' Reports

Report Preparation

.01 Firms should develop standard policies and procedures for preparing and issuing reports. The following are some suggested report preparation policies:

- *Letterhead.* The report should be presented on firm letterhead.
- *Addressee.* The report should be addressed to the board of directors, stockholders, partners, general partner, proprietor, or to the company whose financial statements are being audited. If the firm was engaged by others, the report should be addressed thereto.

The Board of Directors
XYZ Credit Union
City, State Zip Code

- *Salutation.* A salutation should not be included on the report.
- *Report signing.* The firm name should be manually signed by the engagement partner. The words "Certified Public Accountants" should be excluded from the signature if they are a normal part of the firm's letterhead.
- *Report dating.* Audit reports should not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion.
  — The date should be presented at the bottom of the page along with the city and state, if not included in firm letterhead, as follows:

City, State
April 5, 20XX

  — If significant subsequent events are discovered before the report is issued, but after the original report date, the report should be dual-dated for the subsequent event.

  — Subsequent events affecting previously issued reports that are being reissued will also cause the report to be dual-dated. The following illustrates dual-dating:

City, State
February 26, 20XX, except for Note X as to which the date is
April 5, 20XX

- *Level of service.* The level of service performed and the nature of the report are typically outlined in the engagement letter. The letter should be revised for any significant changes from the original understanding with the client, such as, in the event of a step-up or step-down in the level of service.
  — The partner should approve any step-up or step-down in level of service. A step-up in level of service may occur after obtaining a revised understanding with the client. A step-down in level of service should occur only after carefully evaluating the reasons for the change because the reasons for the change may also affect the report on lower levels of service. Limitations on the scope of an audit, for example, may also preclude issuing a review or compilation report.

— If more than one level of service is performed for financial statements of the same period (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. The four standards of reporting stated in AU section 150.02 (AICPA, *Professional Standards*, vol. 1) are:

a. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles (GAAP).

b. The report shall identify those circumstances in which GAAP has not been consistently applied in the current period in relation to the preceding period.

c. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

d. The report shall contain either an expression of opinion regarding the financial statements taken as a whole, or a statement that an opinion cannot be expressed. When an opinion cannot be expressed, the reasons should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility, the auditor is taking.

Standard Report

.03 The standard auditor's report prescribed by AU section 508, *Reports on Audited Financial Statements*, (AICPA, *Professional Standards*, vol. 1), should be used when the auditor has formed an opinion, based on the application of GAAS,[1] that the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in accordance with GAAP. The opinion should include an identification of the United States of America as the country of origin of those accounting principles (for example, accounting principles generally accepted in the United States of America or U.S. generally accepted accounting principles). It should address all financial statements presented. A standard auditor's report for the presentation of comparative financial statements is illustrated in AAM section 9210.010.

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 in the following sections, are:

- *Explanatory language.* A wide variety of situations may arise that require a modification of the standard auditor's report, without affecting the expression of an unqualified opinion. Some of the more common of such situations are going-concern problems, part of the financial statements have been audited by another auditor, or a significant change in accounting principles. The explanatory paragraph for situations that do not affect the auditor's opinion should be placed after the opinion paragraph.

- *Qualified opinion.* Qualified opinions result from two general categories of situations: scope limitations and departures from GAAP. A scope limitation arises when the auditor has been unable to perform all of the auditing procedures he or she believes are necessary to express an unqualified

[1] AU section 508.08, *Reports on Audited Financial Statements*, (AICPA, *Professional Standards*, vol. 1), requires an identification of the United States of America as the country of origin of those standards (for example, auditing standards generally accepted in the United States of America or U.S. generally accepted auditing standards).

opinion on the financial statements. Financial statements containing a material departure from GAAP, including inadequate disclosures in the financial statements, may lead the auditor to qualify his or her opinion. Both situations require that an explanatory paragraph, preceding the opinion paragraph, be included that describes the nature of the scope limitation or the departure from GAAP.

- *Disclaimer of opinion.* A disclaimer of opinion may be required when:
  - — The scope of the audit has been restricted so significantly that the auditor does not have a basis for forming an opinion on the financial statements. In this case, an explanatory paragraph, preceding the disclaimer paragraph, should be included in the auditor's report to explain all significant reasons for the disclaimer.
  - — The auditor is not independent, in which case a one-paragraph disclaimer is issued (applies for publicly held entities only). A compilation report with a lack of independence noted should be issued for nonpublic entities.
- *Adverse opinion.* An adverse opinion should be expressed on financial statements that do not present fairly the entity's financial position, results of operations, or cash flows in conformity with GAAP. In other words, the auditor concludes that the financial statements are *not* fairly presented in accordance with GAAP. Issuance of an adverse opinion requires inclusion of an explanatory paragraph, preceding the opinion paragraph, that explains all of the reasons for the adverse opinion and, if practicable, the effects of the subject matter of the adverse opinion on the financial statements.

Scope Limitations

.05 Restrictions on the scope of an audit, whether imposed by the client or by circumstances such as the timing of the auditor's work, the inability to obtain sufficient, competent evidential matter, or an inadequacy in the client's accounting records, may require a qualified opinion or a disclaimer of opinion. Deciding whether to qualify or disclaim is a matter of judgment, and generally the primary factor in this decision is the materiality of the financial statement items affected. However, other factors should be considered, such as the pervasiveness of the effects of the omitted auditing procedures and the nature of the financial statement items affected.

Departures From GAAP

.06 ***Unacceptable Principles.*** Significant departures from GAAP require that the auditor issue either a qualified or adverse opinion. Choosing between a qualified or adverse opinion depends on the magnitude of the departure. While the materiality of the effects of the departure is a primary consideration, the auditor should also consider the pervasiveness of the departure, such as the number of financial statement items affected, the importance of the departure to the organization's activities and its ability to obtain funding, and the dollar effect of the departure on individual financial statement items as well as the statements as a whole.

.07 For both qualified and adverse opinions, an explanatory paragraph should be included, preceding the opinion paragraph, that describes all of the substantive reasons for the auditor's opinion, and the effects on the financial statements, if readily determinable. If it is not practical to determine the effects of the departure, the explanatory paragraph should contain a statement to that effect. If information about the effects of the departure are described in the notes, the explanatory paragraph can be shortened by referring to the note.

.08 ***Inadequate Disclosure.*** Departures from GAAP include not just inappropriate application of accounting principles, but also omitted or inadequate disclosures in the financial statements. Such situations require the auditor to add an explanatory paragraph, preceding the opinion paragraph, that describes the nature of the inadequate or omitted disclosure and, if practical, the information that should have been disclosed. The significance of the omitted or inadequate disclosure will determine whether a qualified or adverse opinion is appropriate.

.09 *Report Modification.* The opinion paragraph for a qualified opinion due to a departure from GAAP should include the words "except" or "exception" and a reference to the explanatory paragraph that describes that departure. Adverse opinions should include language such as "do not present fairly" and should also include a reference to the explanatory paragraph. A qualified opinion indicating a departure from GAAP is presented in AAM section 9240.020. An adverse opinion indicating a departure from GAAP is presented in AAM section 9220.01.

Errors, Fraud, and Illegal Acts

.10 If the financial statements are materially affected by an error, fraud or illegal act that has not been properly accounted for and disclosed, a qualified or adverse opinion should be considered. If the auditor is precluded from applying necessary procedures or from obtaining sufficient information to conclude whether an error, fraud or illegal act that could be material to the financial statements has occurred, a qualified or disclaimer of opinion should be issued. All such matters should be discussed immediately with the engagement partner.

.11 If a client will not accept modification of the report under the circumstances above, the firm should consider withdrawing from the engagement and consulting with legal counsel.

Consistency Exceptions

.12 Accounting changes affecting consistency include:

- A change from one generally accepted accounting principle to another method, practice or principle that is different from the one previously used.
- A change from an unacceptable to an acceptable principle (correction of an error).
- A change in financial statement classification that significantly affects financial position or results of operations (for example, classification of an item in earnings from operations as other income or expense).
- A change in reporting entity.

.13 Accounting changes not normally affecting consistency include:

- Initial adoption of an existing accounting principle for a new event or transaction.
- Insignificant reclassification.
- Correction of errors not involving a principle.
- Changes in accounting estimates.

.14 The nature of the accounting change will determine whether prior periods should be restated or a cumulative adjustment should be included in current activities. In either event, the change should be disclosed in the notes to the financial statements and in the auditor's report in a separate paragraph following the opinion paragraph. The auditor's concurrence with a change is implicit unless he or she takes exception to the change. The opinion paragraph would be standard unless the change is to an unacceptable principle or method, the change is not justified, or a prospective change of a principle requiring retroactive adjustment is not discussed. In such situations, either a qualified or adverse opinion should be issued.

Uncertainties

.15 Uncertainties are significant circumstances, events, or transactions affecting the financial statements, the outcome of which cannot be reasonably estimated. Uncertainties are a particularly complex area because they can result in a qualified or adverse opinion due to a departure from GAAP, or a qualified opinion or disclaimer due to a scope limitation. Uncertainties include, but are not limited to, contingencies covered by FASB Statement No. 5, *Accounting for Contingencies*, and matters related to estimates covered by SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties* (AICPA, *Technical Practice Aids*).

.16 ***Uncertainties Not Requiring Modification of the Opinion.*** AU section 508.29 states that when the auditor has concluded that sufficient information supports management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, an unqualified opinion ordinarily is appropriate.

.17 ***Scope Limitations.*** A qualified opinion or disclaimer of opinion may be required if the auditor is unable to obtain sufficient information to support management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements. In some ways, information about uncertainties may always be considered insufficient because it is dependent on future, unknown events. However, if the auditor determines that information did or does exist, but it is unavailable to him or her (for example, because the information was destroyed or management will not allow the auditor to have access to it), the auditor should consider modifying the report for a scope limitation.

.18 ***Departures From GAAP.*** AU section 508.45 describes three categories of departures from GAAP involving risks or uncertainties:

- Inadequate disclosure
- Inappropriate accounting principles
- Unreasonable accounting estimates

.19 A qualified or adverse opinion due to a departure from GAAP may be necessary if the auditor concludes that a matter involving an uncertainty has not been appropriately disclosed in the financial statements in conformity with GAAP.

.20 Also, a departure from GAAP may exist if management has made inappropriate estimates of future events in applying accounting principles (such as the use of unreasonable expected lives of depreciable assets for calculating depreciation) or in making other accounting estimates.

.21 ***Going-Concern Uncertainties.*** If the auditor concludes that there is substantial doubt about the organization's ability to continue as a going concern, the situation should be described in an explanatory paragraph, following the opinion paragraph. The explanatory paragraph should describe the principal events and conditions related to the going concern, their possible effects on the financial statements, management's plans for corrective actions, and the auditor's conclusion that substantial doubt exists. AU sections 341.12–.13, *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 must indicate the degree of responsibility, if any, taken for this information. A separate report on the supplementary information or a separate paragraph in the report on the basic financial statements may be used to report on supplementary information. If a separate report is issued, it should be on the firm's letterhead and be signed. The report date should be the same as for the basic financial statements.

.24 Reports on supplementary information should express or disclaim audit assurance. The nature of the engagement and the extent and results of testing of supplementary information will determine the firm's responsibility in each circumstance. If a separate report on the supplemental information is issued, the first sentence of that report should refer to the report on the basic financial statements.

Reporting on a Single Statement

.25 In certain circumstances, an engagement to audit a single financial statement may be accepted. Generally these engagements, called "limited reporting engagements," are a result of the client needing a single financial statement to fulfill a contractual requirement, such as an organization that must provide its landlord with an audited income statement for purposes of calculating rent. Also, entities that have never been audited often request an audit of the statement of financial position only for the first year, with the intention of having audits of the entire financial statements in the future. Generally such engagements are accepted as long as there is a legitimate reason for the limited engagement, and provided there are no restrictions on access to information underlying the financial statements or on the scope of the procedures the auditor needs to perform. In such engagements, an unqualified opinion can be expressed on the financial statement the auditor was engaged to audit. If the other financial statements are presented, a disclaimer of opinion should be issued on those statements. An unqualified opinion on a single statement audit is presented in AAM section 9210.030.

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 required. Findings of the specialist that indicate the financial statements are not in accordance with GAAP may require a qualified or adverse opinion.

Lack of Independence

.28 For public entities, whenever the auditor is not independent with respect to a client whose financial statements have been audited, a disclaimer of opinion should be issued. The PCAOB, through PCAOB Rule 3600T, has provisionally designated Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.01) of the AICPA Code, and Interpretations and rulings thereunder, as they existed on April 16, 2003 and Standard Nos. 1, 2, and 3, and Interpretations 99-1, 00-1, and 00-2 of the Independent 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 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 successor auditor. The successor should represent that his or her audit has not revealed any matters that may have a material effect on the prior-period financial statements.

.31 If the firm reissues its report without change, the previous report date should be used. If the financial statements or the report of the prior period are revised, the report should be dual-dated as to the event or matter causing the revision. There should be no reference to the report or the work of the successor auditor.

Reissuance of the Audit Report Subsequent to the Date of Original Issue[2]

.32 Occasionally the firm may be requested by a client to furnish additional copies of a previously issued report. Approval of the engagement partner is necessary to reissue a previously issued report. In such situations the engagement partner may prepare a memo stating the reasons for the reissuance and that he or she is not aware of any circumstances occurring since the original report date that would require adjustment to or disclosure in the financial statements.

.33 Use of the original report date removes any implication that records, transactions, or events after that date have been audited or reviewed. Although the auditor has no responsibility to make further investigation or inquiry as to subsequent events, the engagement partner should consider a brief discussion with the client's chief financial or executive officer before reissuing his or her report.

---

* 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-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). The full text of this rule can be found at www.pcaob.org/Rules/Rules_of_the_Board/Rule_3525.pdf.

[2] The AICPA Auditing Standards Board Auditing Interpretation of AU section 341, "Eliminating a Going-Concern Explanatory Paragraph From a Reissued Report," (AICPA, *Professional Standards*, vol. 1, AU sec. 9341.01–.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.

Subsequent Discovery of Facts Existing at Report Date

.34 Although the auditor has no obligation to make any continuing inquiries or perform other procedures after issuing his or her report, the auditor may become aware of information that affects the financial statements upon which he or she has previously reported. When becoming aware of such information, the auditor should determine the reliability of the information and whether such information existed at the date of the report. The engagement partner should make inquiries of client management in this regard.

.35 If the information is reliable and did exist at the date of the report, if the report would have been affected if the information had been known at the report date, and if there are persons relying on the financial statements who would attach importance to the information, the auditor should take action to prevent future reliance on the report. If the engagement partner concludes that action should be taken to prevent future reliance on the report, he or she should advise the client to make appropriate disclosure of the newly discovered facts and their impact on the financial statements to the persons known to be, or likely to be, relying on the financial statements and related report. Disclosures should be made in one of the following ways:

- If the effects of subsequent facts can be promptly determined, disclosure should include reissuing revised financial statements and a revised report. The reasons for the revision usually should be described in a note to the financial statements and referred to in the auditor's report.
- If the current financial statements have not been released, appropriate disclosure of the revision of the prior-period financial statements can be included therein.
- When the effects of subsequent facts cannot be readily determined, revisions of financial statements and reports may be delayed. In this case, persons known to be, or likely to be, relying on the financial statements should be notified by the client that the financial statements and related reports should not be relied on, and that revised financial statements and report will be forthcoming.

.36 If the client refuses to make the disclosures discussed above, the auditor should contact legal counsel. He or she should also notify all members of the board of directors of such refusal and that the firm will take the following steps to prevent future reliance on its report:

- Notify the client that the auditor's report must no longer be associated with the financial statements.
- Notify any applicable regulatory agencies that the report should no longer be relied upon.
- Notify each person known to be relying on the financial statements that the report should no longer be relied upon.

.37 If the auditor's investigation of the subsequently discovered information is satisfactory, and he or she has determined that the information is reliable, the notifications in AAM section 9100.36 should include a description of the effects of the information on the financial statements. If the client has not cooperated and, as a result, the auditor has been unable to conduct a satisfactory investigation, the auditor does not need to indicate the details of the information. Instead, he or she should indicate that the auditor's report must no longer be relied upon nor should the auditor be associated with the financial statements.

[*The next page is 9211.*]

AAM Section 9210
Unqualified Opinions

.010 Auditor's Standard Report—Comparative Financial Statements

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: AU section 508.08, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1)]

.020 Auditor's Standard Report—Single Year Financial Statements

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: AU section 508.08]

.030 Report on a Single Statement Audit (Balance Sheet Only Presented) [Assuming the auditor is able to satisfy himself or herself regarding the consistency of application of accounting principles]

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 20XX. This financial statement is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the balance sheet is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the balance sheet. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall balance sheet presentation. We believe that our audit of the balance sheet provides a reasonable basis for our opinion.

In our opinion, the balance sheet referred to above presents fairly, in all material respects, the financial position of X Company as of December 31, 20XX, in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: AU section 508.34]

Note: If reporting on a single statement (for example, balance sheet only) when other financial statements are also presented, the following paragraph should be added after the opinion paragraph:

> Because we were not engaged to audit the statements of income, retained earnings, and cash flows, we did not extend our auditing procedures to enable us to express an opinion on the results of operations and cash flows for the year ended December 31, 20XX. Accordingly, we express no opinion on them.

.040 Reference to Other Auditors—Successor Auditor's Report When Predecessor's Report (Unqualified) Is Not Presented

Independent Auditor's Report

Addressee:

We have audited the balance sheet of ABC Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 20X1, were audited by other auditors whose report dated March 31, 20X2, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 20X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: AU section 508.74]

Practice Tips

(1) The successor auditor should not name the predecessor auditor in his report; however, the successor auditor may name the predecessor auditor if the predecessor auditor's practice was acquired by, or merged with that of the successor auditor.

[Source: AU section 508.74]

.050 Reference to Other Auditors in Report

Independent Auditor's Report

Addressee:

We have audited the consolidated balance sheets of ABC Company and subsidiaries as of December 31, 20X2 and 20X1, and the related consolidated statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of B Company, a wholly-owned subsidiary, which statements reflect total assets of $________ and $________ as of December 31, 20X2 and 20X1, respectively, and total revenues of $________ and $________ for the years then ended. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for B Company, is based solely on the report of the other auditors.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits and the report of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the report of other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of ABC Company and subsidiaries as of December 31, 20X2 and 20X1, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: AU section 508.13]

.060 Reference to Other Auditors—Successor Auditor's Unqualified Report When Predecessor's Report That included an Explanatory Paragraph Is Not Presented

Independent Auditor's Report

Addressee:

We have audited the balance of ABC Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 20X1, were audited by other auditors whose report dated March 1, 20X2, on those statements included an explanatory paragraph that described the change in the Company's method of computing depreciation discussed in Note X to the financial statements.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the 20X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: AU section 508.74]

.070 Reference to Other Auditors—Successor Auditor's Report When Prior Year Financial Statements Have Been Restated Following Issuance of the Predecessor's Report

Independent Auditor's Report

Addressee:

We have audited the balance sheet of ABC Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 20X1, before the restatement described in Note X, were audited by other auditors whose report dated March 31, 20X2, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 20X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

We also audited the adjustments described in Note X that were applied to restate the 20X1 financial statements. In our opinion, such adjustments are appropriate and have been properly applied.[1]

[*Signature*]

[*Date*]

[Source: AU section 508.74]

[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.

.080 Reference to Other Auditors—Prior Year Financial Statements Restated Following a Pooling of Interests

Independent Auditor's Report

Addressee:

We have audited the accompanying consolidated balance sheet of XYZ Company as of December 31, 20X2, and the related consolidated statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of XYZ Company as of [at] December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

We previously audited and reported upon the consolidated statements of income and cash flows of XYZ Company and subsidiaries for the year ended December 31, 20X1, prior to their restatement for the 20X2 pooling of interests. The contribution of XYZ Company and subsidiaries to revenues and net income represented _______ percent and _______ percent of the respective restated totals. Separate financial statements of the other companies included in the 20X1 restated consolidated statements of income and cash flows were audited and reported upon separately by other auditors. We also audited the combination of the accompanying consolidated statements of income and cash flows for the year ended December 31, 20X1, after restatement for the 20X2 pooling of interests; in our opinion, such consolidated statements have been properly combined on the basis described in Note A of notes to consolidated financial statements.

[*Signature*]

[*Date*]

[Source: AU section 543.16, *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.

.083 Reference to Other Auditors—Successor Auditor Report When Prior Period Financial Statements Were Audited by a Predecessor Auditor Who Has Ceased Operations

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of ABC Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 20X1, were audited by other auditors who have ceased operations and whose report dated March 31, 20X2, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 20X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: AU section 508.74]

.084 Reference to Other Auditors—Successor Auditor Report When Prior Period Financial Statements Were Audited By a Predecessor Auditor Who Has Ceased Operations Have Been Restated

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of ABC Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 20X1, before the restatement described in Note X, were audited by other auditors who have ceased operations and whose report dated March 31, 20X2, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 20X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

We also audited the adjustments described in Note X that were applied to restate the 20X1 financial statements. In our opinion, such adjustments are appropriate and have been properly applied.[2]

[*Signature*]

[*Date*]

[Source: AU section 508.74]

[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.

.085 Reference to Other Accountants—Report on Nonpublic Entity Presented With Prior Period Financial Statements Reviewed by a Predecessor Accountant Who Has Ceased Operations

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of ABC Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We have conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 20X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The 20X1 financial statements were reviewed by other accountants who have ceased operations, and their report thereon, dated March 1, 20X2, stated they were not aware of any material modifications that should be made to those statements for them to be in conformity with generally accepted accounting principles. However, a review is substantially less in scope than an audit and does not provide a basis for the expression of an opinion on the financial statements taken as a whole.

[*Signature*]

[*Date*]

[Source: AU section 508.74]

.086 Reference to Other Accountants—Report on Nonpublic Entity Presented With Prior Period Financial Statements Compiled by a Predecessor Accountant Who Has Ceased Operations

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of ABC Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosure in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by managements, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 20X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The 20X1 financial statements were compiled by other accountants who have ceased operations, and their report thereon, dated February 1, 20X2, stated that they did not audit or review those financial statements and, accordingly, express no opinion or any other form of assurance on them.

[*Signature*]

[*Date*]

[Source: AU section 508.74]

.090 Change in Accounting Principles or Method of Accounting

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentations. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note X to the financial statements, the Company changed its method of computing depreciation in 20XX.

[*Signature*]

[*Date*]

[Source: AU section 508.17]

.100 Going Concern—Uncertainty

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency that raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

[*Signature*]

[*Date*]

[Source: AU section 341.13, *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.

.110 Liquidation Basis of Accounting—Single Year Financial Statements

Independent Auditor's Report

Addressee:

We have audited the accompanying statement of net assets in liquidation of X Company as of December 31, 20X2, and the related statement of changes in net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2. In addition, we have audited the statements of income, retained earnings, and cash flows for the period from January 1, 20X2 to April 25, 20X2. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note X to the financial statements, the stockholders of X Company approved a plan of liquidation on April 25, 20X2, and the company commenced liquidation shortly thereafter. As a result, the company has changed its basis of accounting for periods subsequent to April 25, 20X2 from the going-concern basis to a liquidation basis.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets in liquidation of X Company as of December 31, 20X2, the changes in its net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, and the results of its operations and its cash flows for the period from January 1, 20X2 to April 25, 20X2, in conformity with accounting principles generally accepted in the United States of America applied on the bases described in the following paragraph.

[*Signature*]

[*Date*]

[Source: Interpretation No. 8, "Reporting on Financial Statements Prepared on a Liquidation Basis of Accounting" of AU section 508 (AICPA, *Professional Standards*, vol. 1, AU sec. 9508.36)]

.120 Liquidation Basis of Accounting—Comparative Financial Statements

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 20X1, and the related statements of income, retained earnings, and cash flows for the year then ended, and the statements of income, retained earnings, and cash flows for the period from January 1, 20X2 to April 25, 20X2. In addition, we have audited the statement of net assets in liquidation as of December 31, 20X2, and the related statement of changes in net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note X to the financial statements, the stockholders of X Company approved a plan of liquidation on April 25, 20X2, and the company commenced liquidation shortly thereafter. As a result, the company has changed its basis of accounting for periods subsequent to April 25, 20X2 from the going-concern basis to a liquidation basis.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X1, and the results of its operations and its cash flows for the year then ended and for the period from January 1, 20X2 to April 25, 20X2, its net assets in liquidation, as of December 31, 20X2, and the changes in its net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America applied on the bases described in the following paragraph.

[*Signature*]

[*Date*]

[Source: Interpretation No. 8 of AU section 508]

.130 Comparative Financial Statements—Unqualified Opinion on the Current Year's Financial Statements With Disclaimer of Opinion on the Prior Year's Statements of Income, Retained Earnings, and Cash Flows

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as explained in the following paragraph, we conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform our audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We did not observe the taking of the physical inventory as of December 31, 20X0, since that date was prior to our appointment as auditors for the Company, and we were unable to satisfy ourselves regarding inventory quantities by means of other auditing procedures. Inventory amounts as of December 31, 20X0, enter into the determination of net income and cash flows for the year ended December 31, 20X1.

Because of the matter discussed in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the results of operations and cash flows for the year ended December 31, 20X1.

In our opinion, the balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the year ended December 31, 20X2, present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the year ended December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: AU section 508.67]

Note: This report assumes that the independent auditor has been able to satisfy himself as to the consistency of application of generally accepted accounting principles.

.140 Comparative Financial Statements—Subsequent Restatement of Prior-Period Financial Statements to Conform With Generally Accepted Accounting Principles

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our report dated March 1, 20X2, we expressed an opinion that the 20X1 financial statements did not fairly present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles because of two departures from such principles: (1) the Company carried its property, plant, and equipment at appraisal values, and provided for depreciation on the basis of such values, and (2) the Company did not provide for deferred income taxes with respect to differences between income for financial reporting purposes and taxable income. As described in Note X, the Company has changed its method of accounting for these items and restated its 20X1 financial statements to conform with accounting principles generally accepted in the United States of America. Accordingly, our present opinion on the 20X1 financial statements, as presented herein, is different from that expressed in our previous report.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: AU section 508.69]

.150 Comparative Financial Statements—Current Year's Statements Audited and Prior Year's Statements Reviewed

<u>Independent Auditor's Report</u>

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 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 504.17, *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 AAM section 9210.170.)

.160 Comparative Financial Statements—Current Year's Statements Audited and Prior Year's Statements Compiled

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The 20X1 financial statements were compiled by us (other accountants) and our (their) report thereon, dated March 1, 20X2, stated we (they) did not audit or review those financial statements and, accordingly, express no opinion or other form of assurance on them.

[*Signature*]

[*Date*]

[Source: AU section 504.17]

Note: When unaudited financial statements are presented in comparative form with audited financial statements, the unaudited financial statements should be clearly marked to indicate their status.

.170 Comparative Financial Statements—Current Year's Statements Audited and Disclaimer on Prior Year's Unaudited Statements

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The 20X1 financial statements were not audited by us and, accordingly, we do not express an opinion on them.

[*Signature*]

[*Date*]

Notes: The above report illustrates a disclaimer of opinion as described in AU section 504.17 when the financial statements are those of a public entity. For a nonpublic entity, see AAM section 9210.150 and .160.

When unaudited financial statements are presented in comparative form with audited financial statements, the unaudited financial statements should be clearly marked to indicate their status.

.180 U.S.-Style Report Modified to Report on Financial Statements Prepared in Conformity With Accounting Principles Generally Accepted in Another Country That Are Intended for Use Only Outside the United States

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of International Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended which, as described in Note X, have been prepared on the basis of accounting principles accepted in [*name of country*]. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America (and in [*name of country*]). U.S. standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of International Company as of December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in [*name of country*].

[*Signature*]

[*Date*]

Note: The above illustrates a report as described in AU section 534.10, *Reporting on Financial Statements Prepared for Use in Other Countries* (AICPA, *Professional Standards*, vol. 1).

.190 Report on Financial Statements Prepared in Conformity With the Accounting Principles Generally Accepted in Another Country That Will Have More Than Limited Distribution in the United States

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of International Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note X to the financial statements, the Company has recorded fixed assets in excess of historical cost using appraised value as the basis for adjustment in accordance with accounting principles generally accepted in [*name of country*]. If the fixed assets had been recorded at historical cost, fixed assets and retained earnings would be decreased by $XXX,XXX and $XXX,XXX respectively, as of December 31, 20XX, and net income and earnings per share would be increased by $X,XXX and $X.XX respectively for the year then ended.

In our opinion, except for the effects of recording the fixed assets in excess of historical costs, discussed in the preceding paragraph, the financial statements present fairly, in all material respects, the financial position of International Company as of December 31, 20XX, and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

(Optional Paragraph)

In our opinion, the financial statements referred to above present fairly the financial position of the International Company at December 31, 20XX, and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in [*name of country*].

[*Signature*]

[*Date*]

Note: The above illustrates a report as described in AU section 534.14–.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.

.200 Correction of an Error, Not Involving an Accounting Principle

Independent Auditor's Report

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statements presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note X to the financial statements, certain errors resulting in an understatement of previously reported expenses for the years ended December 31, 20X1 and 20X0 were discovered by the Company's management during the current year. Accordingly, the 20X1 financial statements have been restated and an adjustment has been made to retained earnings as of January 1, 20X1 to correct the errors.

[*Signature*]

[*Date*]

[Sources: AU sections 508.08 and 420.12, *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 561.06*b*, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, [AICPA, *Professional Standards*, vol. 1]).

.210 Subsequent Event Prior to Issuance of Auditor's Report

Independent Auditor's Report

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note X to the financial statements, on March 1, 20X3, the Company entered into an agreement to sell Subsidiary A. This Subsidiary represents X% of the Company's total assets and X% of its revenues.

[*Signature*]

[*Date*]

[AU section 508.08–.19]

.220 Reissued Report Due to Subsequent Discovery of Facts Existing at the Date of the Auditor's Report

Independent Auditor's Report

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 10 to the financial statements, the Company's 20X2 [*specify account corrected*] previously reported as $XX,XXX should have been $X,XXX. This discovery was made subsequent to the issuance of the financial statements. The financial statements have been restated to reflect this correction.

[*Signature*]

[*March 31, 20X3, except for Note 10, as to which the date is April 30, 20X3*]

[Sources: AU sections 561.06*a* and 508.08, respectively]

.221 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 9508.85–.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 auditeport on the effectiveness of internal control over financial reporting either voluntarily or to comply with regulatory requirements.

.222 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 9508.89–.92]

Note: This example includes the illustrative language from AU section 9508.88se the PCAOB's Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*, 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 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 508.60, *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 508.26]

---

[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 508.67, *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.

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 508.63]

.03 Scope Limitation—Inventory and GAAP Departure—Capitalized Lease Obligations

Independent Auditor's Report

Addressee:

We were engaged to audit the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management.

The Company has excluded, from property and debt in the accompanying balance sheets, certain lease obligations that, in our opinion, should be capitalized in order to conform with accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by $_____ and $_____, long-term debt by $_____ and $_____, and retained earnings by $_____ and $_____ as of December 31, 20X2 and 20X1, respectively. Additionally, net income would be increased (decreased) by $_____ and $_____ and earnings per share would be increased (decreased) by $_____ and $_____, respectively, for the years then ended.

The Company did not make a count of its physical inventory in 20X2 or 20X1, stated in the accompanying financial statements at $_____ as of December 31, 20X2, and at $_____ as of December 31, 20X1. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 20X1, is no longer available. The Company's records do not permit the application of other auditing procedures to inventories or property and equipment.

Since the Company did not take physical inventories and we were not able to apply other auditing procedures to satisfy ourselves as to inventory quantities and the cost of property and equipment, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on these financial statements.

[*Signature*]

[*Date*]

[Source: AU section 508.39 and .63]

Note: This report would be used if the GAAP departure is not so material to require an adverse opinion. See AAM section 9220.01 for an example of an adverse opinion.

[*The next page is 9371.*]

AAM Section 9240
Qualified Opinions

.010 Scope Limitation—Investment in Foreign Affiliate (Assuming Effects Are Such That Qualification Rather Than Disclaimer Is Appropriate)

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraph, we conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We were unable to obtain audited financial statements supporting the Company's investment in a foreign affiliate stated at $_____ and $_____ at December 31, 20X2 and 20X1, respectively, or its equity in earnings of that affiliate of $_____ and $_____, which is included in net income for the years then ended as described in Note X to the financial statements; nor were we able to satisfy ourselves as to the carrying value of the investment in the foreign affiliate or the equity in its earnings by other auditing procedures.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the foreign affiliate investment and earnings, the financial statements referred to in the first paragraph above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: AU section 508.26, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1)]

.020 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 508.39]

.030 Departure From GAAP—Leases Not Capitalized—Pertinent Facts Disclosed in Note

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As more fully described in Note X to the financial statements, the Company has excluded certain lease obligations from property and debt in the accompanying balance sheets. In our opinion, accounting principles generally accepted in the United States of America require that such obligations be included in the balance sheets.

In our opinion, except for the effects of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: AU section 508.40]

.040 Inadequate Disclosure—Omission of Disclosures

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The Company's financial statements do not disclose [*describe the nature of the omitted disclosures*]. In our opinion, disclosure of this information is required by accounting principles generally accepted in the United States of America.

In our opinion, except for the omission of the information discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: AU section 508.42]

Note: This report assumes the effects are such that the auditor has concluded an adverse opinion is not appropriate.

.050 Inadequate Disclosure—Omission of Statement of Cash Flows

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income and retained earnings for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The Company declined to present a statement of cash flows for the years ended December 31, 20X2 and 20X1. Presentation of such statement summarizing the Company's operating, investing, and financing activities is required by accounting principles generally accepted in the United States of America.

In our opinion, except that the omission of a statement of cash flows results in an incomplete presentation as explained in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: AU section 508.44]

.060 Change in Accounting Principle Without Reasonable Justification

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As disclosed in Note X to the financial statements, the Company adopted, in 20X2, the first-in, first-out method of accounting for its inventories, whereas it previously used the last-in, first-out method. Although use of the first-in, first-out method is in conformity with accounting principles generally accepted in the United States of America, in our opinion the Company has not provided reasonable justification for making this change as required by those principles.

In our opinion, except for the change in accounting principle discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: AU section 508.52]

Note: If the change was from an accounting principle that is not generally accepted to one that is generally accepted it would be a correction of an error and would require recognition in the auditor's report as to consistency. However, because the middle paragraph contains all of the information required in an explanatory paragraph (following the opinion paragraph) as required by AU section 508.16–.18, an explanatory paragraph is not required in this instance.

.070 Change to an Accounting Principle Not in Conformity With Generally Accepted Accounting Principles

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The company previously recorded its land at cost but adjusted the amounts to appraised values during the year, with a corresponding increase in stockholders' equity in the amount of $_____. In our opinion, the new basis on which land is recorded is not in conformity with accounting principles generally accepted in the United States of America.

In our opinion, except for the change to recording appraised values as described above, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: AU section 508.55]

.080 More than One Reason—Qualified Opinion on Prior Year's Financial Statements With the Current Year Qualified for the Same Reason and an Additional Reason

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraph, we conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We were unable to obtain audited financial statements supporting the Company's investment in a foreign affiliate stated at $_____ and $_____ at December 31, 20X2 and 20X1, respectively, or its equity in earnings of that affiliate of $_____ and $_____, which is included in net income for the years then ended as described in Note X to the financial statements; nor were we able to satisfy ourselves as to the carrying value of the investment in the foreign affiliate or the equity in its earnings by other auditing procedures.

The Company has excluded, from property and debt in the accompanying 20X2 balance sheet, certain lease obligations that were entered into in 20X2, which in our opinion, should be capitalized in order to conform with accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by $_____, long-term debt by $_____, and retained earnings by $_____, as of December 31, 20X2. Additionally, net income would be increased (decreased) by $_____ and earnings per share would be increased (decreased) by $_____ for the year then ended.

In our opinion, except for the effects on the 20X2 and 20X1 financial statements of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the foreign affiliate investment and earnings, and except for the effects of the 20X2 financial statements of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to in the first paragraph above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: AU section 508.26 and .39]

[*The next page is 9421.*]

AAM Section 9245

Information Accompanying Audited Financial Statements

.010 Omission of Supplementary Information Required by the FASB

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Company has not presented [*describe the supplementary information required by GAAP*[1]] that accounting principles generally accepted in the United States has determined is necessary to supplement, although not required to be part of, the basic financial statements.

[*Signature*]

[*Date*]

[Source: AU section 558.08, *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 in this example.

.015 Omission of 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.*][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 558.08; AICPA Audit and Accounting Guide *State and Local Governments*, updated as of May 1, 2007, paragraph 14.56]

---

[2] This optional wording may be added in accordance with Auditing Interpretation No. 17 of AU section 508, "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. 9508.85–.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 in this example.

.020 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 558.08]

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 558.11] (See AAM section 9245.060.)

---

[4] The auditor may identify the body requiring the information, such as the Financial Accounting Standards Board in this example.

.025 Material Departures From GASB Guidelines 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 558.08; AICPA Audit and Accounting Guide *State and Local Governments*, updated as of May 1, 2007 paragraph 14.79 (Appendix A, Example A-1)]

---

[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 Governmental Accounting Standards Board in this example.

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 AU section 558.11 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*, paragraph 2.59]

.030 Prescribed Procedures Not Completed Regarding Supplementary Information Required by the FASB

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The [*specifically identify the supplementary information*] on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. Further, we were unable to apply to the information certain procedures prescribed by professional standards because [*state the reasons*].

[*Signature*]

[*Date*]

[Source: AU section 558.08]

Notes: Even though the auditor is unable to complete the prescribed procedures, if, on a basis of facts known to him or her, the auditor concludes that the supplementary information has not been measured or presented within prescribed guidelines, he or she should suggest appropriate revision; failing that, he or she should describe the nature of any material departure(s) in the report. [Source: AU section 558.08]

Ordinarily, the required supplementary information should be distinct from the audited financial statements and distinguished from other information outside the financial statements that is not required by GAAP. However, management may choose not to place the required supplementary information outside of the basic financial statements. In such circumstances, unless it is audited as part of the basic financial statements, the information should be clearly marked as unaudited. If the information is not clearly marked as unaudited, the auditor's report should be expanded to include a disclaimer on the supplementary information. [Source: AU section 558.11] (See AAM section 9245.060.)

.035 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 558.08; AICPA Audit and Accounting Guide *State and Local Governments*, 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 558.08]

---

[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."

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 558.11) 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*, paragraph 2.59]

.040 Unresolved Doubts About Adherence to Guidelines Regarding Supplementary Information Required by FASB

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The [*specifically identify the supplementary information*] on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures prescribed by professional standards that raised doubts that we were unable to resolve regarding whether material modifications should be made to the information for it to conform with guidelines established by accounting principles generally accepted in the United States. [*The auditor should consider including in the report the reason(s) he or she was unable to resolve his or her substantial doubts.*]

[*Signature*]

[*Date*]

[Source: AU section 558.08]

Note: 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 558.08]

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 558.11] (See AAM section 9245.060)

.045 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 558.08; AICPA Audit and Accounting Guide *State and Local Governments*, updated as of May 1, 2007, 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

---

[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."

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 558.08]

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 the financial statements. Although SAS No. 52, paragraph 11, as amended (AU section 558.11), 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*, paragraph 2.59.]

.050 Report on Accompanying Information

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The (identify accompanying information) is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature*]

[*Date*]

[Source: AU section 551.12, *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 551.06]

.060 Disclaimer on Accompanying Information (Not Audited)

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The (identify the accompanying information) is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and, accordingly, we express no opinion on it.

[*Signature*]

[*Date*]

[Source: AU section 551.13]

Notes: The report on the accompanying information may be added to the auditor's standard report on the basic financial statements or may appear separately in the auditor-submitted document. [Source: AU section 551.06]

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.

.070 Disclaimer on Part of the Accompanying Information (Not Audited)

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information on pages XX-YY is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information, except for that portion marked "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 551.13]

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 551.06]

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.

.080 Qualification on Basic Financial Statements and Accompanying Information (Departure From GAAP)

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The Company has excluded, from property and debt in the accompanying balance sheets, certain lease obligations that, in our opinion, should be capitalized in order to conform with accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by $_____ and $_____, long-term debt by $_____ and $_____, and retained earnings by $_____ and $_____ as of December 31, 20X2 and 20X1, respectively. Additionally, net income would be increased (decreased) by $_____ and $_____ and earnings per share would be increased (decreased) by $_____ and $_____, respectively, for the years then ended.

In our opinion, except for the effects of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The schedules of property and related depreciation (page X), and long-term debt with related interest (page Y), as of December 31, 20X2, are presented for purposes of additional analysis and are not a required part of the basic financial statements. The information in such schedules has been subjected to the auditing procedures applied in the audit of the basic financial statements; and, in our opinion, except for the effects on the schedule of property of not capitalizing certain lease obligations as explained in the third paragraph of this report, such information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature*]

[*Date*]

[Sources: AU sections 551.14 and 508.39, *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 551.06]

.090 Supplementary Information Required by the FASB Included in Auditor-Submitted Document

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The [*identify the supplementary information*] on page XX is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

[*Signature*]

[*Date*]

[Source: AU section 551.15]

Notes: The report on the accompanying information may be added to the auditor's standard report on the basic financial statements or may appear separately in the auditor-submitted document. [Source: AU section 551.06]

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 551.12 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 551.15]

In certain circumstances, the auditor's report should be expanded in accordance with AU section 558.08–.09. The illustrative reports at AAM section 9245.010–.045 are assembled from illustrative reporting language in AU section 558.08.

---

[9] The auditor may identify the body requiring the information, such as the Financial Accounting Standards Board in this example.

.095 Supplementary Information Required by the GASB Included in Auditor-Submitted Documents

Independent Auditor's Report

Addressee:

We have audited the accompanying 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 551.15; AICPA Audit and Accounting Guide *State and Local Governments*, updated as of May 1, 2007, 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 551.06]

---

[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 Governmental Accounting Standards Board in this example.

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 551.12 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 558.08 and .09. The illustrative reports at AAM section 9245.010–.045 are assembled from illustrative reporting language in AU section 558.08 and the AICPA Audit and Accounting Guide *State and Local Governments*, updated as of May 1, 2007.

.100 Consolidating Information Not Separately Audited

Independent Auditor's Report

Addressee:

We have audited the accompanying consolidated balance sheets of X Company and subsidiaries as of December 31, 20X2 and 20X1, and the related consolidated statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of X Company and subsidiaries as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The consolidating information is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position, results of operations, and cash flows of the individual companies. The consolidating information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the consolidated financial statements taken as a whole.

[*Signature*]

[*Date*]

[Source: AU section 551.18]

Notes: The report on the consolidating information may be added to the auditor's standard report on the basic financial statements or may appear separately in the auditor-submitted document.

When the auditor is engaged to express an opinion only on the consolidated financial statements and consolidating information is also included, the auditor should be satisfied that the consolidating information is suitably identified. For example, when the consolidated financial statements include columns of information about the components of the consolidated group, the balance sheets might be titled, "Consolidated Balance Sheet-December 31, 20X1, with Consolidating Information," and the columns including the consolidating information might be marked, "Consolidating Information." When the consolidating information is presented in separate schedules, the schedules presenting balance sheet information of the components might be titled, for example, "Consolidating Schedule, Balance Sheet Information, December 31, 20X1."

.110 Unqualified Opinion on Selected Financial Data in a Client-Prepared Document That Includes Audited Financial Statements

Independent Auditor's Report

Addressee:

We have audited the accompanying consolidated balance sheets of X Company and subsidiaries as of December 31, 20X5 and 20X4, and the related consolidated statements of income, retained earnings, and cash flows for each of the three years in the period ended December 31, 20X5. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of X Company and subsidiaries as of December 31, 20X5 and 20X4, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 20X5 in conformity with accounting principles generally accepted in the United States of America.

We have also previously audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated balance sheets as of December 31, 20X3, 20X2, and 20X1, and the related consolidated statements of income, retained earnings, and cash flows for the years ended December 31, 20X2 and 20X1 (none of which are presented herein); and we expressed unqualified opinions on those consolidated financial statements.

In our opinion, the information set forth in the selected financial data for each of the five years in the period ended December 31, 20X5, appearing on page XX, is fairly stated, in all material respects, in relation to the consolidated financial statements from which it has been derived.

[*Signature*]

[*Date*]

[Source: AU section 552.10, *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

.010 Accountant's Report When Expressing an Opinion Directly on the Effectiveness of an Entity's Internal Control as of a Specified Date

Independent Accountant's Report

We have examined the effectiveness of W Company's internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*]. W Company's management is responsible for maintaining effective internal control over financial reporting. Our responsibility is to express an opinion on the effectiveness of internal control based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of internal control over financial reporting, testing, and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of internal control over financial reporting to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*].[1]

[Source: AT section 501.56, *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)."

.020 Accountant's Report When Expressing an Opinion on a Written Assertion About the Effectiveness of an Entity's Internal Control as of a Specified Date

Independent Accountant's Report

We have examined management's assertion, included in the accompanying [*title of management report*], that W Company maintained effective internal control over financial reporting as of December 31, 20XX based on [*identify criteria*].[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]

[Source: AT section 501.58]

Note: Nothing precludes the practitioner from examining an assertion but opining directly on the effectiveness of internal control. (See AT section 501.59.)

[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)."

.030 Modified Report With Explanatory Language, That a Practitioner Should Use When There Is a Material Weakness in an Entity's Internal Control and, Based on Its Significance and Its Effect on the Achievement of the Objectives of the Control Criteria, the Practitioner Concludes That a Qualified Opinion Is Appropriate

Independent Accountant's Report

We have examined the effectiveness of W Company's internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*]. W Company's management is responsible for maintaining effective internal control over financial reporting. Our responsibility is to express an opinion on the effectiveness of internal control based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of internal control over financial reporting, testing, and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of internal control over financial reporting to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

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*].

[Source: AT section 501.63]

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 501.63 and .66]

---

[4] The practitioner may also include the preceding sentence in situations where the two reports are not included within the same document.

.040 Adverse Opinion on When a Material Weakness in Internal Control Exists and, in the Practitioner's Judgment, the Material Weakness(es) Is (Are) So Pervasive That the Entity's Internal Control Over Financial Reporting Does Not Achieve the Control Objectives

Independent Accountant's Report

We have examined the effectiveness of W Company's internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*]. W Company's management is responsible for maintaining effective internal control over financial reporting. Our responsibility is to express an opinion on the effectiveness of internal control based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of internal control over financial reporting, testing, and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of internal control over financial reporting to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

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*].

[Source: AT section 501.64]

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 501.64 and .66]

---

[5] The practitioner may also include the preceding sentence in situations where the two reports are not included within the same document.

.050 Qualified Opinion on the Effectiveness of an Entity's Internal Control, or Written Assertion Thereon, Due to a Scope Limitation

Independent Accountant's Report

We have examined the effectiveness of W Company's internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*]. W Company's management is responsible for maintaining effective internal control over financial reporting. Our responsibility is to express an opinion on the effectiveness of internal control based on our examination.

Except as described below, our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the internal control over financial reporting, testing, and evaluating the design and operating effectiveness of the internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

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*].

[Source: AT section 501.68]

.060 Disclaimer of Opinion When Restrictions That Significantly Limit the Scope of the Examination Are Imposed by the Client or the Responsible Party

Independent Accountant's Report

We were engaged to examine the effectiveness of W Company's internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*]. W Company's management is responsible for maintaining effective internal control over financial reporting.

[*Scope paragraph should be omitted.*]

[*Explanatory paragraph.*]

[*Include paragraph to describe scope restrictions.*]

Since management [*describe scope restrictions*] and we were unable to apply other procedures to satisfy ourselves as to the entity's internal control over financial reporting, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the effectiveness of the entity's internal control over financial reporting.

[Source: AT section 501.70]

.070 Unqualified Opinion When the Practitioner Decides to Make Reference to the Report of Another Practitioner as a Basis, in Part, for the Practitioner's Opinion

[*In these circumstances, the practitioner should disclose this fact when describing the scope of the examination and should refer to the report of the other practitioner when expressing the opinion.*[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*].

[Source: AT section 501.72]

---

[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.

.080 Unqualified Opinion on the Effectiveness of Only a Segment of an Entity's Internal Control

[*For example, internal control over financial reporting of an entity's operating division or its accounts receivable*]

Independent Accountant's Report

We have examined the effectiveness of W Company's internal control over financial reporting for its retail division as of December 31, 20XX, based on [*identify criteria*]. W Company's management is responsible for maintaining effective internal control over financial reporting. Our responsibility is to express an opinion on the effectiveness of internal control based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of internal control over financial reporting, testing, and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of the inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of internal control over financial reporting to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, W Company's retail division maintained, in all material respects, effective internal control over financial reporting as of December 31, 20XX based on [*identify criteria*].

[Source: AT section 501.77]

.090 Unqualified Opinion About the Suitability of Design of the Entity's Internal Control

Independent Accountant's Report

We have examined the suitability of W Company's design of internal control over financial reporting to prevent or detect material misstatements in the financial statements on a timely basis as of December 31, 20XX, based on [*identify criteria*]. W Company's management is responsible for the suitable design of internal control over financial reporting. Our responsibility is to express an opinion on the design of internal control based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of internal control over financial reporting, evaluating the design of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of internal control over financial reporting to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, W Company's internal control over financial reporting is suitably designed, in all material respects, to prevent or detect material misstatements in the financial statements on a timely basis as of December 31, 20XX, based on [*identify criteria*].

[Source: AT section 501.79]

Notes: This report assumes that the control criteria of the regulatory agency are both suitable and available to users as discussed in AT section 101.23–.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.

.100 Unqualified Opinion Based on an Examination on the Adequacy of an Entity's Internal Control Over Financial Reporting Based on Criteria Established by a Regulatory Agency That Are Not Suitable for General Use

Independent Accountant's Report

We have examined the adequacy of W Company's internal control over financial reporting as of December 31, 20XX, based on the criteria established by __________ agency, as set forth in its audit guide dated __________. W Company's management is responsible for maintaining adequate internal control over financial reporting. Our responsibility is to express an opinion on whether the internal control is adequate to meet such criteria based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of internal control over financial reporting, testing, and evaluating the design and operating effectiveness of internal control and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of internal control over financial reporting to future periods are subject to the risk that internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

We understand that the agency considers the controls over financial reporting that meet the criteria referred to in the first paragraph of this report adequate for its purpose. In our opinion, based on this understanding and on our examination, W Company's internal control over financial reporting is adequate, in all material respects, based on the criteria established by __________ agency.

This report is intended solely for the information and use of the board of directors and management of W Company and [*agency*] and is not intended to be and should not be used by anyone other than these specified parties.

[Source: AT section 501.82]

.110 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 significant deficiencies 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 325.26 and .29, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1)]

.120 Communication of Internal Control Related Matters Noted in an Audit When One or More Reportable Conditions Were Identified, But None is Deemed to be a Material Weakness

Addressee:

In planning and performing our audit of the financial statements of 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.[7]

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 325.28–.29]

---

[7] 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].

.130 Report on Controls Placed in Operation at a Service Organization

To XYZ Service Organization:

We have examined the accompanying description of controls related to the (payroll) application of XYZ Service Organization. Our examination included procedures to obtain reasonable assurance about whether (1) the accompanying description presents fairly, in all material respects, the aspects of XYZ Service Organization's controls that may be relevant to a user organization's internal control as it relates to an audit of financial statements, (2) the controls included in the description were suitably designed to achieve the control objectives specified in the description, if those controls were complied with satisfactorily,[8] and (3) such controls had been placed in operation as of (*date*). The control objectives were specified by the (board of directors). Our examination was performed in accordance with standards established by the American Institute of Certified Public Accountants and included those procedures we considered necessary in the circumstances to obtain a reasonable basis for rendering our opinion.

We did not perform procedures to determine the operating effectiveness of controls for any period. Accordingly, we express no opinion on the operating effectiveness of any aspects of XYZ Service Organization's controls, individually or in the aggregate.

In our opinion, the accompanying description of the aforementioned application presents fairly, in all material respects, the relevant aspects of XYZ Service Organization's controls that had been placed in operation as of (*date*). Also, in our opinion, the controls, as described, are suitably designed to provide reasonable assurance that the specified control objectives would be achieved if the described controls were complied with satisfactorily.

The description of controls at XYZ Service Organization is as of (*date*) and any projection of such information to the future is subject to the risk that, because of change, the description may no longer portray the controls in existence. The potential effectiveness of specific controls at the Service Organization is subject to inherent limitations and, accordingly, errors or fraud may occur and not be detected. Furthermore, the projection of any conclusions, based on our findings, to future periods is subject to the risk that changes may alter the validity of such conclusions.

This report is intended solely for use by the management of XYZ Service Organization, its customers, and the independent auditors of its customers.

[Source:AU section 324.38, *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 324.39, 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 324.40, 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.

[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.

.140 Report on Controls Placed in Operation at a Service Organization and Tests of Operating Effectiveness

To XYZ Service Organization:

We have examined the accompanying description of controls related to the (payroll) application of XYZ Service Organization. Our examination included procedures to obtain reasonable assurance about whether (1) the accompanying description presents fairly, in all material respects, the aspects of XYZ Service Organization's controls that may be relevant to a user organization's internal control as it relates to an audit of financial statements, (2) the controls included in the description were suitably designed to achieve the control objectives specified in the description, if those controls were complied with satisfactorily,[9] and (3) such controls had been placed in operation as of (*date*). The control objectives were specified by the (board of directors). Our examination was performed in accordance with standards established by the American Institute of Certified Public Accountants and included those procedures we considered necessary in the circumstances to obtain a reasonable basis for rendering our opinion.

In our opinion, the accompanying description of the aforementioned application presents fairly, in all material respects, the relevant aspects of XYZ Service Organization's controls that had been placed in operation as of (*date*). Also, in our opinion, the controls, as described, are suitably designed to provide reasonable assurance that the specified control objectives would be achieved if the described controls were complied with satisfactorily.

In addition to the procedures we considered necessary to render our opinion as expressed in the previous paragraph, we applied tests to specific controls, listed in Schedule X, to obtain evidence about their effectiveness in meeting the control objectives, described in Schedule X, during the period from (*date*) to (*date*). The specific controls and the nature, timing, extent, and results of the tests are listed in Schedule X. This information has been provided to user organizations of XYZ Service Organization and to their auditors to be taken into consideration, along with information about the internal control at user organizations, when making assessments of control risk for user organizations. In our opinion the controls that were tested, as described in Schedule X, were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the control objectives specified in Schedule X were achieved during the period from (*date*) to (*date*). [However, the scope of our engagement did not include tests to determine whether control objectives not listed in Schedule X were achieved; accordingly, we express no opinion on the achievement of control objectives not included in Schedule X.][10]

The relative effectiveness and significance of specific controls at XYZ Service Organization and their effect on assessments of control risk at user organizations are dependent on their interaction with the controls and other factors present at individual user organizations. We have performed no procedures to evaluate the effectiveness of controls at individual user organizations.

The description of controls at XYZ Service Organization is as of (*date*), and information about tests of the operating effectiveness of specific controls covers the period from (*date*) to (*date*). Any projection of such information to the future is subject to the risk that, because of change, the description may no longer portray the system in existence. The potential effectiveness of specific controls at the Service Organization is subject to inherent limitations and, accordingly, errors or fraud may occur and not be detected. Furthermore, the projection of any conclusions, based on our findings, to future periods is subject to the risk that changes may alter the validity of such conclusions.

---

[9] 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.

[10] 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 324.54]

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 324.55, 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 324.56, for an example explanatory paragraph and modification to the opinion paragraph when the service auditor concludes that there are sufficient deficiencies in the design or operation of the service organization's controls.

.150 Reports on Internal Control Required by SEC Rule 17a-5

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

* 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*, 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 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 ("Q&As") 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," in AU sec. 9508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), which provides reporting guidance for audits of nonissuers. Interpretation No. 18 in AU sec. 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 sec. 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.

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 on a timely basis. A *significant deficiency*[11] 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.[12]

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

---

[11] 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."

[12] 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 325.29, *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, 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*.]

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.[13]

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.

[13] Whenever inadequacies are described, the last sentence of this paragraph should be modified as per footnote 1 in this illustration. The report should also describe material inadequacies that the auditor becomes aware of that existed during the period but were corrected prior to the end of the period, unless management already has reported them to the SEC.

.160 Report on Internal Control Required by SEC Rule 17a-5(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.[14]

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 on a timely

[14] 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.

basis. A *significant deficiency*[15] 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.[16]

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, 20X6, to meet the SEC's objectives.[17]

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

---

[15] 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."

[16] 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 325.29 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*.]

[17] Whenever inadequacies are described, the last sentence of this paragraph should be modified as per note 1 above. The report should also describe material inadequacies that the auditor becomes aware of that existed during the period but were corrected prior to the end of the period, unless management already has reported them to the SEC.

[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.

.170 Letter to SEC When the Broker-Dealer Has Not Made the Required Notification

Securities and Exchange Commission

Washington D.C. and Appropriate

Regional Office

Designated Examining Authority

Dear Sirs:

Our most recent audit of the [*consolidated*] financial statements of Standard Stockbrokerage Co., Inc. [*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 auditing standards generally accepted in the United States of America or (2) study the Company's practices and procedures relevant to the objectives stated in rule 17a-5(g) of the Securities and Exchange Commission as required by rule 17a-5.

The management of the Company is responsible for establishing and maintaining internal control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of controls. The objectives of internal control are to provide management with reasonable but not absolute assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in conformity with generally accepted accounting principles.

Because of inherent limitations in internal control, errors or fraud may occur and not be detected. Also, projection of any evaluation of internal control to future periods is subject to the risk that controls may become inadequate because of changes in conditions or that the effectiveness of the design and operation of controls may deteriorate.

The purpose of performing certain procedures prior to the date of the financial statements is to facilitate the expression of an opinion on the Company's financial statements. It must be understood that the procedures performed would not necessarily 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.

.180 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, 20X6, 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

* See footnote * in paragraph .150 Reports on Internal Control Required by SEC Rule 17a-5.

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*[18] 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.[19]

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

---

[18] 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."

[19] 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 325.29 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*.]

Company's practices and procedures, as described in the second and third paragraphs of this report, were adequate at December 31, 20X6, to meet the SEC's and CFTC's objectives.[20]

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 and/or Regulation 1.16 of the CFTC 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.*]

[20] Whenever inadequacies are described, the last sentence of this paragraph should be modified as per footnote 1 in this illustration. 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.

AAM Section 9260
Special Reports

.010 Cash Basis Statements

Independent Auditor's Report

Addressee:

We have audited the accompanying statements of assets and liabilities arising from cash transactions of XYZ Company as of December 31, 20X2 and 20X1, and the related statements of revenue collected and expenses paid for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note X, these financial statements were prepared on the basis of cash receipts and disbursements, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets and liabilities arising from cash transactions of XYZ Company as of December 31, 20X2 and 20X1, and its revenue collected and expenses paid during the years then ended, on the basis of accounting described in Note X.

[*Signature*]

[*Date*]

[Source: AU section 623.08, *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.

.020 Income Tax Basis Statements

Independent Auditor's Report

Addressee:

We have audited the accompanying statements of assets, liabilities, and capital—income tax basis of ABC Partnership as of December 31, 20X2 and 20X1, and the related statements of revenue and expenses—income tax basis and of changes in partners' capital accounts—income tax basis for the years then ended. These financial statements are the responsibility of the Partnership's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note X, these financial statements were prepared on the basis of accounting the Partnership uses for income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets, liabilities, and capital of ABC Partnership as of December 31, 20X2 and 20X1, and its revenue and expenses and changes in partners' capital accounts for the years then ended, on the basis of accounting described in Note X.

[*Signature*]

[*Date*]

[Source: AU section 623.08]

.030 Regulatory (Statutory) Basis Statements

Independent Auditor's Report

Addressee:

We have audited the accompanying statements of admitted assets, liabilities and surplus—statutory basis of XYZ Insurance Company as of December 31, 20X2 and 20X1, and the related statements of income and cash flows—statutory basis and changes in surplus-statutory basis for the years then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note X, these financial statements were prepared in conformity with the accounting practices prescribed or permitted by the Insurance Department of [*State*], which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities and surplus of XYZ Insurance Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in Note X.

This report is intended solely for the information and use of the board of directors and management of XYZ Insurance Company and [*name of regulatory agency*] and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

[Source: AU section 623.08]

.040 Report Relating to Amount of Sales for the Purpose of Computing Rental

(Report on one or more specified elements, accounts, or items of a financial statement)

Independent Auditor's Report

Addressee:

We have audited the accompanying schedule of gross sales (as defined in the lease agreement dated March 4, 20XX, between ABC Company, as lessor, and XYZ Stores Corporation, as lessee) of XYZ Stores Corporation at its Main Street store, [*City*], [*State*], for the year ended December 31, 20X2. This schedule is the responsibility of XYZ Stores Corporation's management. Our responsibility is to express an opinion on this schedule based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule of gross sales is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule of gross sales. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the schedule of gross sales referred to above present fairly, in all material respects, the gross sales of XYZ Stores Corporation at its Main Street store, [*City*], [*State*], for the year ended December 31, 20X2, as defined in the lease agreement referred to in the first paragraph.

This report is intended solely for the information and use of the boards of directors and managements of XYZ Stores Corporation and ABC Company and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

[Source: AU section 623.18]

.050 Royalties

(Report on one or more specified elements, accounts, or items of a financial statement)

Independent Auditor's Report

Addressee:

We have audited the accompanying schedule of royalties applicable to engine production of the Q Division of XYZ Corporation for the year ended December 31, 20X2, under the terms of a license agreement dated May 14, 20XX, between ABC Company and XYZ Corporation. This schedule is the responsibility of XYZ Corporation's management. Our responsibility is to express an opinion on this schedule based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule of royalties is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

We have been informed that, under XYZ Corporation's interpretation of the agreement referred to in the first paragraph, royalties were based on the number of engines produced after giving effect to a reduction for production retirements that were scrapped, but without a reduction for field returns that were scrapped, even though the field returns were replaced with new engines without charge to customers.

In our opinion, the schedule of royalties referred to above presents fairly, in all material respects, the number of engines produced by the Q Division of XYZ Corporation during the year ended December 31, 20X2, and the amount of royalties applicable thereto, under the license agreement referred to above.

This report is intended solely for the information and use of the boards of directors and managements of XYZ Corporation and ABC Company and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

[Source: AU section 623.18]

.060 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 these financial statements based on our audit.

We conducted our audit of the schedule in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule of profit participation is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

We have been informed that the documents that govern the determination of John Smith's profit participation are *(a)* the employment agreement between John Smith and XYZ Company dated February 1, 20X0, *(b)* the production and distribution agreement between XYZ Company and Television Network Incorporated dated March 1, 20X0, and *(c)* the studio facilities agreement between XYZ Company and QRX Studios dated April 1, 20X0, as amended November 1, 20X0.

In our opinion, the schedule of profit participation referred to above presents fairly, in all material respects, John Smith's participation in the profits of XYZ Company for the year ended December 31, 20X1, in accordance with the provisions of the agreements referred to above.

This report is intended solely for the information and use of the boards of directors and managements of XYZ Company and John Smith and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

[Source: AU section 623.18]

.070 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 623.18]

.080 Proposed Acquisition

Independent Accountant's Report on Applying Agreed-Upon Procedures

To the Board of Directors and Management of X Company:

We have performed the procedures enumerated below, which were agreed to by the Board of Directors and Management of X Company, solely to assist you in connection with the proposed acquisition of Y Company as of December 31, 20XX. Y Company is responsible for its cash and accounts receivable records. This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of the parties specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

The procedures and the associated findings are as follows:

Cash

1. We obtained confirmation of the cash on deposit from the following banks, and we agreed the confirmed balance to the amount shown on the bank reconciliations maintained by Y Company. We mathematically checked the bank reconciliations and compared the resultant cash balances per book to the respective general ledger account balances.

Bank	*General Ledger Account Balances as of December 31, 20XX*
ABC National Bank	$ 5,000
DEF State Bank	13,776
XYZ Trust Company—regular account	86,912
XYZ Trust Company—payroll account	5,000
	$110,688

We found no exceptions as a result of the procedures.

Accounts Receivable

2. We added the individual customer account balances shown in an aged trial balance of accounts receivable (identified as exhibit A) and compared the resultant total with the balance in the general ledger account.

   We found no difference.

3. We compared the individual customer account balances shown in the aged trial balance of accounts receivable (exhibit A) as of December 31, 20XX, to the balances shown in the accounts receivable subsidiary ledger.

   We found no exceptions as a result of the comparisons.

4. We traced the aging (according to invoice dates) for 50 customer account balances shown in exhibit A to the details of outstanding invoices in the accounts receivable subsidiary ledger. The balances selected for tracing were determined by starting at the eighth item and selecting every fifteenth item thereafter.

   We found no exceptions in the aging of the amounts of the 50 customer account balances selected. The sample size traced was 9.8 percent of the aggregate amount of the customer account balances.

5. We mailed confirmations directly to the customers representing the 150 largest customer account balances selected from the accounts receivable trial balance, and we received responses as indicated below. We also traced the items constituting the outstanding customer account balance to invoices and supporting shipping documents for customers from which there was no reply. As agreed, any individual differences in a customer account balance of less than $300 were to be considered minor, and no further procedures were performed.

   Of the 150 customer balances confirmed, we received responses from 140 customers; 10 customers did not reply. No exceptions were identified in 120 of the confirmations received. The differences disclosed in the remaining 20 confirmation replies were either minor in amount (as defined above) or were reconciled to the customer account balance without proposed adjustment thereto. A summary of the confirmation results according to the respective aging categories is as follows:

	Accounts Receivable December 31, 20XX		
Aging Categories	*Customer Account Balances*	*Confirmations Requested*	*Confirmation Replies Received*
Current	$156,000	$ 76,000	$ 65,000
Past due:			
Less than one month	60,000	30,000	19,000
One to three months	36,000	18,000	10,000
Over three months	48,000	48,000	8,000
	$300,000	$172,000	$102,000

We were not engaged to, and did not conduct an audit, the objective of which would be the expression of an opinion on cash and accounts receivable. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of the board of directors and management of X Company and is not intended to be and should not be used by anyone other than these specified parties.

[Source: AT section 201.48, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*, vol. 1)]

.090 Claims of Creditors

Independent Accountant's Report
on Applying Agreed-Upon Procedures

To the Trustee of XYZ Company:

We have performed the procedures described below, which were agreed to by the Trustee of XYZ Company, with respect to the claims of creditors solely to assist you in determining the validity of claims of XYZ Company as of May 31, 20XX, as set forth in accompanying Schedule A. XYZ Company is responsible for maintaining records of claims submitted by creditors of XYZ Company. This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of the party specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

The procedures and associated findings are as follows:

1. Compare the total of the trial balance of accounts payable at May 31, 20XX, prepared by XYZ Company, to the balance in the related general ledger account.

   The total of the accounts payable trial balance agreed with the balance in the related general ledger account.

2. Compare the amounts for claims received from creditors (as shown in claim documents provided by XYZ Company) to the respective amounts shown in the trial balance of accounts payable. Using the data included in the claims documents and in XYZ Company's accounts payable detail records, reconcile any differences found to the accounts payable trial balance.

   All differences noted are presented in column 3 of Schedule A. Except for those amounts shown in column 4 of Schedule A, all such differences were reconciled.

3. Obtain the documentation submitted by creditors in support of the amounts claimed and compare it to the following documentation in XYZ Company's files: invoices, receiving reports, and other evidence of receipt of goods or services.

   No exceptions were found as a result of these comparisons.

   We were not engaged to, and did not, conduct an audit, the objective of which would be the expression of an opinion on the claims of creditors set forth in the accompanying Schedule A. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

   This report is intended solely for the information and use of the Trustee of XYZ Company and is not intended to be and should not be used by anyone other than this specified party.

[Source: AT section 201.48]

.100 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. 9101.47–.55).]

---

[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.

.110 Reporting on Management's Assertions

Independent Accountants Report
on Attest Engagements on Financial Information[4]
Included in XBRL Instance Documents

We have examined managements 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, managements 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 9101.47–.55]

[4] Financial information includes data presented in audited or reviewed financial statements or other financial information (for example, Management Discussion and Analysis).

.120 Compliance With Contractual Provisions (Separate Report)

We have audited, in accordance with auditing standards generally accepted in the United States of America, the balance sheet of XYZ Company as of December 31, 20X2, and the related statement of income, retained earnings, and cash flows for the year then ended, and have issued our report thereon dated February 16, 20X3.

In connection with our audit, nothing came to our attention that caused us to believe that the Company failed to comply with the terms, covenants, provisions, or conditions of sections XX to XX, inclusive, of the Indenture dated July 21, 20X0, with ABC Bank insofar as they relate to accounting matters. However, our audit was not directed primarily toward obtaining knowledge of such noncompliance.

This report is intended solely for the information and use of the boards of directors and management of XYZ Company and ABC Bank and is not intended to be and should not be used by anyone other than these specified parties.

[Source: AU section 623.21]

Note: When this report is included in the auditor's standard report accompanying financial statements, the last two paragraphs are examples of the paragraphs that should follow the opinion paragraph of the auditor's report on the financial statements.

.130 Report on Financial Statements Prepared Pursuant to Loan Agreements That Results in a Presentation Not in Conformity With Generally Accepted Accounting Principles or an Other Comprehensive Basis of Accounting

Independent Auditor's Report

Addressee:

We have audited the accompanying special-purpose statement of assets and liabilities of ABC Company as of December 31, 20X1, and the related special-purpose statements of revenues and expenses and of cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The accompanying special-purpose financial statements were prepared for the purpose of complying with section 4 of a loan agreement between DEF Bank and the Company as described in Note X, and are not intended to be a presentation in conformity with generally accepted accounting principles.

In our opinion, the special-purpose financial statements referred to above present fairly, in all material respects, the assets and liabilities of ABC Company as of December 31, 20X1, and the revenues, expenses and cash flows for the year then ended, on the basis of accounting described in Note X.

This report is intended solely for the information and use of the boards of directors and managements of ABC Company and DEF Bank and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

[Source: AU section 623.30]

.140 Report on a Schedule of Gross Income and Certain Expenses to Meet Regulatory Requirements and to be Included in a Document Distributed to the General Public

Independent Auditor's Report

Addressee:

We have audited the accompanying Historical Summaries of Gross Income and Direct Operating Expenses of ABC Apartments, City, State (Historical Summaries), for each of the three years in the period ended December 31, 20XX. These Historical Summaries are the responsibility of the Apartments' management. Our responsibility is to express an opinion on the Historical Summaries based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Historical Summaries are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the Historical Summaries. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the Historical Summaries. We believe that our audits provide a reasonable basis for our opinion.

The accompanying Historical Summaries were prepared for the purpose of complying with the rules and regulations of the Securities and Exchange Commission (for inclusion in the registration statement on Form S-11 of DEF Company) as described in Note X, and are not intended to be a complete presentation of the Apartments' revenues and expenses.

In our opinion, the Historical Summaries referred to above present fairly, in all material respects, the gross income and direct operating expenses described in Note X of ABC Apartments for each of the three years in the period ended December 31, 20XX, in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: AU section 623.26]

.150 Report on a Statement of Assets Sold and Liabilities Transferred to Comply With a Contractual Agreement

Independent Auditor's Report

Addressee:

We have audited the accompanying statement of net assets sold of ABC Company as of June 8, 20XX. This statement of net assets sold is the responsibility of ABC Company's management. Our responsibility is to express an opinion on the statement of net assets based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the statement of net assets sold is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the statement. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the statement of net assets sold. We believe that our audit provides a reasonable basis for our opinion.

The accompanying statement was prepared to present the net assets of ABC Company sold to XYZ Corporation pursuant to the purchase agreement described in Note X, and is not intended to be a complete presentation of ABC Company's assets and liabilities.

In our opinion, the accompanying statement of net assets sold presents fairly, in all material respects, the net assets of ABC Company as of June 8, 20XX, sold pursuant to the purchase agreement referred to in Note X, in conformity with accounting principles generally accepted in the United States of America.

This report is intended solely for the information and use of the boards of directors and managements of ABC Company and XYZ Corporation and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

[Source: AU section 623.26]

.160 Report on the Application of Accounting Principles

Introduction

We have been engaged to report on the appropriate application of accounting principles generally accepted in the United States of America to the specific transaction described below. This report is being issued to ABC Company for assistance in evaluating accounting principles for the described specific transaction. Our engagement has been conducted in accordance with standards established by the American Institute of Certified Public Accountants.

Description of Transaction

The facts, circumstances, and assumptions relevant to the specific transaction as provided to us by the management of ABC Company are as follows:

[*Describe transaction*]

Appropriate Accounting Principles

[*Text discussing generally accepted accounting principles*]

Concluding Comments

The ultimate responsibility for the decision on the appropriate application of accounting principles generally accepted in the United States of America for an actual transaction rests with the preparers of financial statements, who should consult with their continuing accountants. Our judgment on the appropriate application of accounting principles generally accepted in the United States of America for the described specific transaction is based solely on the facts provided to us as described above; should these facts and circumstances differ, our conclusion may change.

Restricted Use

This report is intended solely for the information and use of the board of directors and management of ABC Company and is not intended to be and should not be used by anyone other than these specified parties.

[Source: AU section 625.11, *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 625.03]

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 625.04]

.170 Report on Financial Statements Presented in Conformity With a Prescribed Basis of Accounting (Property and Liability Insurance Company)

Independent Auditor's Report

To the Board of Directors

ABC Insurance Company

We have audited the accompanying statutory statements of admitted assets, liabilities, and surplus of ABC Insurance Company as of December 31, 20X2 and 20X1, and the related statutory statements of income and changes in surplus, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America.[5] Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described more fully in Note X to the financial statements, the Company prepared these financial statements using accounting practices prescribed or permitted by the Insurance Department of the State of [*state of domicile*], which practices differ from generally accepted accounting principles. The effects on the financial statements of the variances between statutory accounting practices and accounting principles generally accepted in the United States of America, although not reasonably determinable, are presumed to be material.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted

---

[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, 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 ("Qs&As") 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 of AU section 508, titled, "Reference to PCAOB Standards in an Audit Report of a Nonissuer" (AICPA, *Professional Standards*, vol. 1, AU sec. 9508.89–.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, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1). AU section 508 can be found in AICPA *Professional Standards* and *PCAOB Standards and Related Rules*. 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 of AU section 508, titled "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. 9508.85–.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."

in the United States of America, the financial position of ABC Insurance Company as of December 31, 20X2 and 20X1, or the results of its operations or its cash flows[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 Insurance Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in Note X.

[*Signature*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Property and Liability Insurance Companies*, updated as of September 1, 2006, paragraph 8.30]

[*The next page is 9571*.]

[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.

AAM Section 9270

Unaudited Financial Statements of a Public Entity

(When an accountant is associated with the financial statements but has not audited or reviewed such statements)

.01 Disclaimer

Addressee:

The accompanying balance sheet of X Company as of December 31, 20X1, and the related statements of income, retained earnings, and cash flows for the year then ended were not audited by us, and, accordingly, we do not express an opinion on them.

[*Signature*]

[*Date*]

[Source: AU section 504.05, *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 504.05 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, 20X1, and the related statement of revenues collected and expenses paid during the year then ended were not audited by us and, accordingly, we do not express an opinion on them.

[*Signature*]

[*Date*]

[Source: AU section 504.07]

Notes: A note to the financial statements should describe how the basis of presentation differs from generally accepted accounting principles, but the monetary effect of such differences need not be stated.

The disclaimer may accompany the unaudited financial statements or it may be placed directly on them. In addition, each page of the financial statements should be clearly and conspicuously marked as unaudited.

If the unaudited financial statements are those of a privately held (nonpublic) company, this example is not appropriate. See AAM sections 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 504.07]

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, 20X1 and the related statements of income, retained earnings, and cash flows for the year then ended were not audited by us and, accordingly, we do not express an opinion on them.

[*Signature*]

[*Date*]

[Source: AU section 504.10, *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 guidance in Statements on Standards for Accounting and Review Services (SSARS) should be followed. (See AAM section 2610.03.)

[*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 to financial data and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying interim financial information (statements) for it (them) to be in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: AU section 722.38, *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 722.02.

[*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 552.06, *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 consolidated statements of income, retained earnings, and cash flows for the year then ended, presented on pages XX-XX, are presented as a summary and therefore do not include all of the disclosures required by accounting principles generally accepted in the United States of America.

In our opinion, because of the significance of the omission of the information referred to in the preceding paragraph, the condensed consolidated financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of X Company and subsidiaries as of December 31, 20X0, or results of their operations and their cash flows for the year then ended.

[*Signature*]

[*Date*]

[Source: AU section 552.07]

.03 Review Report on Condensed Financial Statements

Independent Auditor's Report

Addressee:

We have reviewed the condensed consolidated balance sheet of ABC Company and subsidiaries as of March 31, 20X1, and the related condensed consolidated statements of income and cash flows for the three-month periods ended March 31, 20X1 and 20X0. These financial statements are the responsibility of the company's management.

We conducted our review in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures to financial data and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the condensed consolidated financial statements referred to above for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated balance sheet of ABC Company and subsidiaries as of December 31, 20X0, and the related consolidated statements of income, retained earnings, and cash flows for the year then ended (not presented herein); and in our report dated February 15, 20X1, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 20X0, is fairly stated in all material respects, in relation to the consolidated balance sheet from which it has been derived.

[*Signature*]

[*Date*]

[Source: AU section 722.39, *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*], and the related statement of changes in net worth for the [*period*] then ended. These financial statements are the responsibility of James and Jane Person. My (our) responsibility is to express an opinion on these financial statements based on my (our) audit.

I (We) conducted my (our) audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that I (we) plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by James and Jane Person, as well as evaluating the overall financial statement presentation. I (We) believe that my (our) audit provides a reasonable basis for my (our) opinion.

In my (our) opinion, the financial statements referred to above present fairly, in all material respects, the financial condition of James and Jane Person as of [*date*] and the changes in their net worth for the [*period*] then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide*, 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*] and 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, those procedures are not appropriate to determine the estimated current values of the assets in conformity with generally accepted accounting principles. The effects on the financial statements of not applying appropriate procedures to determine the estimated current values of the assets are not reasonably determinable.

In my (our) opinion, except for the effects of the valuation of assets determined by James Person as described in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial condition of James and Jane Person as of [*date*], and the changes in their net worth for the [*period*] then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide*, 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) was engaged to audit the accompanying statement of financial condition of James and Jane Person as of [*date*], and the related statement of changes in net worth for the [*period*] then ended. These financial statements are the responsibility of James and Jane Person.

James and Jane Person do not maintain accounting records sufficient to assure that all transactions are recorded. Accordingly, it was not practicable for me (us) to extend my (our) auditing procedures sufficiently to determine that all of their assets and liabilities and the changes in their net worth are recorded in the financial statements referred to above.

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 explained in the following paragraph, I (we) conducted my (our) audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that I (we) plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by James and Jane Person, as well as evaluating the overall financial statement presentation. I (We) believe that my (our) audit provides a reasonable basis for my (our) opinion.

James and Jane Person do not maintain accounting records sufficient to assure that all transactions are recorded. Accordingly, it was not practicable for me (us) to extend my (our) auditing procedures sufficiently to determine that all of their assets and liabilities and the changes in their net worth are recorded in the financial statements referred to above.

In my (our) opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had I (we) been able to determine that all assets and liabilities and changes in net worth were recorded in the financial statements, the financial statements referred to in the first paragraph above present fairly, in all material respects, the financial condition of James and Jane Person as of [*date*], and the changes in their net worth for the [*period*] then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide*, 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 assets 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 that accompanying statement of asset and liabilities—income tax basis of James and Jane Person as of [*date*], and the related statement of changes in net assets—income tax basis for the [*period*] then ended, in accordance with Statement on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide*, updated as of May 1, 2007, paragraph 5.20]

Note: When personal financial statements are prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles, the notes ordinarily would state the basis of presentation and describe how that basis differs from generally accepted accounting principles. [Source: Accounting and Review Services Interpretation No. 12 of AR section 100, "Reporting on a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.42)]

.13 Compilation Report—Financial Statements Included in a Prescribed Form

Addressee:

I (We) have compiled the [*identification of financial statements, including period covered and name of individual(s)*] included in the accompanying prescribed form, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

My (Our) compilation was limited to presenting in the form prescribed by [*name of body*] information that is the representation of the individuals whose financial statements are presented. I (We) have not audited or reviewed the financial statements referred to above and, accordingly, do not express an opinion or any other form of assurance on them.

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

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide*, 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). The PCAOB adopted as interim standards, on an initial, transitional basis, the AICPA generally accepted auditing standards in existence on April 16, 2003. In September 2004 the PCAOB issued Release 2004-008 that makes conforming amendments to the interim standards resulting from the adoption of PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Connection With an Audit of Financial Statements*. The PCAOB has issued four auditing standards that should be followed when auditing plans that are required to file Form 11-K. These standards include:

- PCAOB Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the 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*
- PCAOB Auditing Standard No. 3, *Audit Documentation*
- PCAOB Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*

Form 11-K does not require a 302 certification. Although the rule is silent regarding Rule 404 reports, the SEC staff had agreed that because Form 11-K filers are not subject to Item 308 of Regulation S-K, Form 11-K need not include a 404 report. fn # Accordingly, this Guide does not reflect PCAOB Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Connection With an Audit of Financial Statements, except to reflect certain conforming amendments found in PCAOB Release 2004-008. Certain of the provisions in Release 2004-008 are relevant to situations in which an auditor is engaged solely to audit a company's financial statements and not just when performing an integrated audit of financial statements and internal control over financial reporting. Therefore, certain of the conforming amendments are reflected in this guide as noted in the table below. For information on PCAOB auditing standards, quality control standards, and related guidance that may have been issued subsequent to the writing of this guide, please refer to the PCAOB Web site at www.pcaobus.org (audits of issuers only).

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

(continued)

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 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*]

---

[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*, as amended (AICPA, Professional Standards, vol. 1, AU sec. 9508.85–.88) issued in June 2004.

[Source: AICPA Audit and Accounting Guide *Employee Benefit Plans*, updated as of March 1, 2007, paragraph 13.05]

Note: Department of Labor Regulations, section 2520.103-1 requires the accountant's report to be dated, manually signed, indicate the city and state where issued and identify the financial statements and schedules covered by the report.

.02 Unqualified Opinion—Defined Benefit Plan Assuming Beginning-of-Year Benefit Information Date

Independent Auditor's Report

Addressee:

We have audited the accompanying statements of net assets available for benefits of XYZ Pension Plan as of December 31, 20X2 and 20X1, and the related statements of changes in net assets available for benefits for the years then ended and the statement of accumulated plan benefits as of December 31, 20X1, and the related statement of changes in accumulated plan benefits for the year then ended. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. [*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, 2007, paragraph 13.05]

---

[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, issued in June 2004.

.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, 2007, 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, issued in June 2004.

.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, 2007, 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, issued in June 2004.

.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, 2007, paragraph 13.11]

Notes: This paragraph can be shown separately in the auditor-submitted document or as a separate paragraph, after the opinion paragraph, of the auditor's standard report, when the auditor's report covers additional information and the auditor has applied auditing procedures and is expressing an opinion on the additional information.

Examples of paragraphs that should be added to the standard auditor's report when the report on the supplemental schedules is modified because of omitted information or an omitted schedule required by DOL regulations are presented in AAM section 9600.07–.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*]

---

[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, issued in June 2004.

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Employee Benefit Plans,* updated as of March 1, 2007, 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. The Interpretation, "Evaluating the Adequacy of Disclosure in Financial Statements Prepared on the Cash, Modified Cash, or Income Tax Basis of Accounting" (AICPA, *Professional Standards*, vol. 1, AU sec. 9623.90), 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, 2007, paragraph 13.23]

.07 Modified Report—Omitted Information or Omitted Schedule Required Under DOL Regulations

Following are examples of paragraphs that should be added to the auditor's report when the auditor should modify his or her report on the supplemental schedules because of omitted information or an omitted schedule which is required under DOL regulations.

Independent Auditor's Report

Addressee:

[*Same first, second, and third paragraphs as the standard report.* See AAM section 9600.01–.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, 2007, paragraph 13.16]

.08 Qualified Opinion—Omitted or Incomplete Schedule or Material Inconsistency

The following paragraphs should be added to the auditor's report when the auditor concludes that his or her opinion on the supplemental schedules should be qualified because a schedule, or information thereon, was omitted (when the schedules are not covered by a trustee's certification as to completeness and accuracy), or because information in a required schedule is materially inconsistent with the financial statements.

Independent Auditor's Report

Addressee:

[*Same first, second, and third paragraphs as the standard report*. See AAM section 9600.01–.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, 2007, paragraph 13.16]

.09 Qualified Opinion—Disclosure of Material Prohibited Transaction With Party in Interest Omitted

The following paragraphs should be added to the auditor's report on the plan's financial statements when the auditor concludes that his or her opinion on the supplemental schedules should be qualified because disclosure of a material prohibited transaction with a party in interest is omitted.

Independent Auditor's Report

Addressee:

[*Same first, second, and third paragraphs as the standard report.* See AAM section 9600.01–.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, 2007, paragraph 13.17]

.10 Adverse Opinion—Disclosure of Material Prohibited Transaction With Party in Interest Omitted

The following paragraphs should be added to the auditor's report on the plan's financial statements when the auditor decides that an adverse opinion should be expressed on the supplemental schedules because disclosure of a material prohibited transaction with a party in interest is omitted.

Independent Auditor's Report

Addressee:

[*Same first, second, and third paragraphs as the standard report.* See AAM section 9600.01–.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, 2007, paragraph 13.17]

.11 Modified Report—Disclosure of Immaterial Prohibited Transaction With Party in Interest Omitted

The following paragraphs should be added to the auditor's report on the plan's financial statements when the auditor decides to modify his or her report on the supplemental schedules because disclosure of a prohibited transaction with a party in interest that is not material to the financial statements has been omitted.

Independent Auditor's Report

Addressee:

[*Same first, second, and third paragraphs as the standard report.* See AAM section 9600.01–.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, 2007, 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, 2007, paragraph 13.18]

.13 Limited-Scope Audits Under DOL Regulations

Independent Auditor's Report

Addressee:

We were engaged to audit the financial statements and supplemental schedules of XYZ Pension Plan as of December 31, 20X1 and 20X0, and for the year ended December 31, 20X1, as listed in the accompanying index. These financial statements and supplemental schedules are the responsibility of the Plan's management.

As permitted by 29 CFR 2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, the plan administrator instructed us not to perform, and we did not perform, any auditing procedures with respect to the information summarized in Note X, which was certified by ABC Bank, the trustee (or custodian) of the Plan, except for comparing such information with the related information included in the financial statements and supplemental schedules. We have been informed by the plan administrator that the trustee (or custodian) holds the Plan's investment assets and executes investment transactions. The plan administrator has obtained a certification from the trustee (or custodian) as of December 31, 20X1 and 20X0 and for the year ended December 31, 20X1 that the information provided to the plan administrator by the trustee (or custodian) is complete and accurate.

Because of the significance of the information that we did not audit, we are unable to, and do not, express an opinion on the accompanying financial statements and supplemental schedules taken as a whole. The form and content of the information included in the financial statements and supplemental schedules, other than that derived from the information certified by the trustee or custodian, have been audited by us in accordance with auditing standards generally accepted in the United States of America and, in our opinion, are presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Employee Benefit Plans*, updated as of March 1, 2007, 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, 2007, 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.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Employee Benefit Plans,* updated as of March 1, 2007, 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, 2007, 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, 2007, 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, 2007, 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, 2007, paragraph 13.32]

.19 Modified Report—Omitted Information or Omitted Schedule Required Under DOL Regulations in a Limited Scope Engagement

<u>Independent Auditor's Report</u>

Addressee:

[*Same first and second paragraphs as the limited-scope report*. See AAM section 9600.13.]

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, 2007, 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, 2007, 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

---

[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, issued in June 2004.

statements for the year ended December 31, 20X2; and in our opinion, except for the effects of the valuation of investments, as described above, the additional information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

____
[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Employee Benefit Plans*, 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, 2007, 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 controls 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 Interpretation No. 18, "Reference to PCAOB Standards in an Audit Report on a Nonissuer," of AU section 508 (AICPA, *Professional Standards*, vol. 1, AU sec. 9508.89–.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 Interpretation 18 of AU section 508, a firm also might consider the following:

> ***The Plan has determined that it is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting.***

[This information is from the Center for Public Company Audit Firms (CPCAF)—CPCAF Alert #46—March 22, 2005.]

[*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,

---

[1] 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*, 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 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 ("Q & As") 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," in AU section 9508, *Reports on Audited Financial Statements: Auditing Interpretations of Section 508*, 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 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, *References in Auditors' Reports to the Standards of the PCAOB*. See the AICPA Web site at www.aicpa.org/members/div/auditstd/index.htm for more information.

[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 section 9508.85–.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."

evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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 opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

____

[*Signature of Firm*]

[*City and State*]

[*Date*][*]

[Source: AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*, Appendix A]

Additional Guidance When Performing Integrated Audits of Financial Statements and Internal Control Over Financial Reporting

When performing an integrated audit of financial statements and internal control over financial reporting in accordance with the standards of the PCAOB, the auditor may choose to issue a combined report or separate reports on the company's financial statements and on internal control over financial reporting. Refer to paragraphs 162–199 of 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*), for direction about reporting on internal control over financial reporting. In addition, see Appendix A, "Illustrative Reports on Internal Control Over Financial Reporting," of PCAOB Auditing Standard No. 2 for an illustrative combined audit report and examples of separate reports. (AICPA, *PCAOB Standards and Related Rules*, AU sec. 508.01)

If the auditor issues separate reports on the company's financial statements and on internal control over financial reporting, the following paragraph should be added to the auditor's report on the company's financial statements (AICPA, *PCAOB Standards and Related Rules*, AU sec. 508.08):

> "We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 31, 20X4, based on [*identify control criteria*] and our report dated [*date of report, which should be the same as the date of the report on the financial statements*] expressed [*include nature of opinions*]."

When performing an integrated audit of financial statements and internal control over financial reporting in accordance with the standards of the PCAOB, the auditor's report on the company's financial statements and on internal control over financial reporting should be dated the same date. Refer to paragraphs 171–172

[*] AU section 339.23 (AICPA, *Professional Standards*, vol. 1) has been amended for SAS No. 103, *Audit Documentation* (AICPA, Professional Standards, vol. 1, AU sec. 339), which changes the date of the auditor's report from the date of completion of fieldwork to require 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.

of PCAOB Auditing Standard No. 2 for direction about the report date in an audit of internal control over financial reporting. (AICPA, *PCAOB Standards and Related Rules*, AU sec. 530.01)

[Source: AICPA Audit and Accounting Guide *Brokers and Dealers in Securities,* 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 9250.150 and .160 contain illustrative reports on internal control required by SEC Rule 17a-5.

.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

[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.

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 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*, paragraph 11.13]

---

[3] FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Held for Resale*, amends FASB Statement No. 95, *Statement of Cash Flows*, to exempt highly liquid companies that meet specified conditions from the requirement to provide a statement of cash flows.

.03 Unqualified Opinion on the Financial Statements Presenting One of the Portfolios or Entities Constituting the Series

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] FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Held for Resale*, amends FASB Statement No. 95, *Statement of Cash Flows*, to exempt highly liquid companies that meet specified conditions from the requirement to provide a statement of cash flows.

.04 Unqualified Opinion on the Financial Statements 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] 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.

[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. AU section 9508.56–.59, "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" (AICPA, *Professional Standards*, vol. 1) 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 should rely on professional standards and their individual professional judgment in determining what may be needed in individual circumstances.

TABLE OF CONTENTS

[*The next page is 10,101.*]

AAM Section 10,100
Quality Control—General

AICPA Requirements

.01 Article VI—*Scope and Nature of Services*—of the AICPA's *Principles of Professional Conduct* (ET section 57 [AICPA, *Professional Standards*, vol. 2]), requires that "members should practice in firms that have in place internal quality-control procedures to ensure that services are competently delivered and adequately supervised." Because of the public interest in the services provided by and the reliance placed on the objectivity and integrity of CPA's, a CPA firm should have a system of quality control for its practice.

.02 The AICPA has issued statements on quality control standards to give firms improved guidance for establishing and maintaining a quality control system for their accounting and auditing practices. The statements include: Statement on Quality Control Standards (SQCS) No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, as amended by SQCS No. 6, *Amendment to Statement on Quality Control Standards No. 2* (AICPA, *Professional Standards*, vol. 2, QC sec. 20), SQCS No. 3, *Monitoring a CPA Firm's Accounting and Auditing Practice* (AICPA, *Professional Standards*, vol. 2, QC sec. 30), SQCS No. 4, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (AICPA, *Professional Standards*, vol. 2, QC sec. 20), and SQCS No. 5, *The Personnel Management Element of a Firm's System of Quality Control—Competencies Required by a Practitioner-in-Charge of an Attest Engagement* (AICPA, Professional Standards, vol. 2, QC sec. 40). SQCS No. 2 supersedes SQCS No. 1, *System of Quality Control for a CPA Firm*, issued in 1979. SQCS No. 4 amends paragraph 18 of SQCS No. 2. SQCS No. 6 amends paragraph 3 of SQCS No. 2.

.03 Presented in AAM section 10,200 is a *Practice Aid for Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice.* 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

NOTICE TO READERS

This AICPA Audit and Accounting Practice Aid supersedes *Guide for Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (guide), which was issued in 1996. This practice aid is intended to help practitioners better understand and apply the Statements on Quality Control Standards (SQCSs) issued by the American Institute of Certified Public Accountants. Those standards are included in Appendix B of this Practice Aid [AAM section 10,250]. This version of the guide, prepared by the Quality Control Standards Task Force (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 changing environment. 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 explicitly 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.

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. 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 ramifications of the Act nor does it address the quality control ramifications of PCAOB standards that must be followed by auditors of issuers. Auditors of issuers should become familiar with the provisions of 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). 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," and 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. 9508.85–.88 and .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.

As previously stated, this Practice Aid does 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: http://www.pcaobus.org and the AICPA Web site: http://www.aicpa.org/info/Sarbanes-Oxley2002.asp.

For handy paperback version of this guide call the AICPA Order Department at (888) 777-7077.

* 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."

Chapter 1

OVERVIEW OF STATEMENTS ON QUALITY CONTROL STANDARDS

.01 A system of quality control is a process that encompasses the firm's organizational structure and the policies and procedures it establishes. The nature, extent, and formality of a firm's quality control policies and procedures should be sufficiently comprehensive and suitably designed in relation to the firm's size, the number of its offices, the degree of authority allowed its personnel and its offices, the knowledge and experience of its personnel, the nature and complexity of the firm's practice, and appropriate cost-benefit considerations.

.02 The objective of a system of quality control is to provide a CPA firm with reasonable assurance[1] that its personnel comply with applicable professional standards and the firm's standards of quality. Statements on Quality Control Standards (SQCSs), which are issued by the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA), consist of the following three standards:

a. SQCS No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (AICPA, *Professional Standards*, vol. 2, QC sec. 20), as amended. This standard:

- Defines the term *quality control*
- Describes the elements of quality control
- Establishes the requirement for a CPA firm to have a system of quality control for its accounting and auditing practice
- Provides guidance on how to design, implement, and maintain a system of quality control

b. SQCS No. 3, *Monitoring a CPA Firm's Accounting and Auditing Practice* (AICPA, *Professional Standards*, vol. 2, QC sec. 30). This standard provides guidance on how a CPA firm implements the monitoring element of a quality control system.

c. SQCS No. 5, *The Personnel Management Element of a Firm's System of Quality Control—Competencies Required by a Practitioner-in-Charge of an Attest Engagement* (AICPA, *Professional Standards*, vol. 2, QC sec. 40). This standard describes the personnel management element of a system of quality control and the competencies a practitioner-in-charge should have or obtain. SQCS No. 5 defines competencies as the knowledge, skills, and abilities that enable a practitioner-in-charge[2] to be qualified to perform an accounting, auditing, or attestation engagement.

.03 A firm should establish a system of quality control that includes policies and procedures that addresses each of the following five elements of quality control identified in SQCS No. 2.

a. *Independence, Integrity, and Objectivity*

b. *Personnel Management*

c. *Acceptance and Continuance of Clients and Engagements*

---

[1] The term *reasonable assurance* is used because absolute assurance cannot be attained. Statement on Quality Control Standards (SQCS) No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (AICPA, *Professional Standards*, vol. 2, QC sec. 20.05), as amended, states, "Any system of quality control has inherent limitations that can reduce its effectiveness. Variance in an individual's performance and understanding of (*a*) professional requirements or (*b*) the firm's quality control policies and procedures affects the degree of compliance with a firm's prescribed quality control policies and procedures and, therefore, the effectiveness of the system."

[2] SQCS No. 5, *The Personnel Management Element of a Firm's System of Quality Control—Competencies Required by a Practitioner-in-Charge of an Attest Engagement* (AICPA, *Professional Standards*, vol. 2, QC sec. 40.03), defines a practitioner-in-charge as an individual who is responsible for supervising accounting, auditing, and attestation engagements and signing or authorizing an individual to sign the accountant's report on such engagements.

d. *Engagement Performance*

e. *Monitoring*

.04 The elements of quality control are interrelated. For example, for a firm to maintain independence, integrity, and objectivity, it must continually assess client relationships that affect policies and procedures related to the acceptance and continuance of clients and engagements. Similarly, the personnel management element of quality control encompasses criteria related to professional development, hiring, advancement, and assignment of firm personnel to engagements, which all 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 four elements of quality control are suitably designed and effectively applied.

.05 If a firm merges, acquires, sells, or otherwise changes a portion of its practice, the surviving firm should evaluate and, as necessary, revise, implement, and maintain firm-wide quality control policies and procedures that are appropriate for the changed circumstances.

Independence, Integrity, and Objectivity

.06 The objective of the independence, integrity, and objectivity element of a system of quality control is to provide the firm with reasonable assurance that personnel maintain independence (in fact and in appearance) in all required circumstances, perform all professional responsibilities with integrity, and maintain objectivity in discharging professional responsibilities. Establishing and maintaining policies such as the following ordinarily would satisfy this objective:

- Requiring that personnel adhere to applicable independence, integrity, and objectivity 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; formerly the General Accounting Office) and any other applicable regulators.
- Having the firm's senior management set a tone for the organization that stresses the importance of ethical values, especially as they pertain to accounting and auditing engagements, and communicating related policies and procedures to firm personnel.
- Establishing procedures to help mitigate possible threats to independence and objectivity.
- Establishing 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 and foreign firm personnel, including foreign-associated firms[3]

Personnel Management

.07 The objective of the personnel management element of a system of quality control is to provide the firm with reasonable assurance that all personnel have the competencies to perform their assigned responsibilities. Attributes or qualities that enhance the competencies of personnel who perform, supervise, or review work include integrity, objectivity, intelligence, judgment, competence, experience, and motivation. This objective ordinarily would be satisfied by establishing and maintaining policies such as the following:

- Hiring personnel who possess the characteristics that enable them to perform competently.
- Assigning personnel who have the knowledge, skills, and abilities required in the circumstances. In making assignments, the nature and extent of supervision to be provided should be considered.

---

[3] 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.

Generally, the more qualified and experienced the personnel assigned to a particular engagement, the less direct supervision needed; the less qualified and less experienced the personnel assigned to a particular engagement, the more direct supervision needed.

- Having personnel participate in general and industry-specific continuing professional education and professional development activities that should enable them to accomplish assigned responsibilities and satisfy applicable continuing professional education requirements of the AICPA, state boards of accountancy, and other regulators.
- Selecting for advancement only those individuals who have the qualifications necessary to accomplish the responsibilities they will be called on to assume.
- Compensating partners and senior-level employees in a manner that provides an incentive and reward for quality work and for maintaining independence, integrity, and objectivity.

Acceptance and Continuance of Clients and Engagements

.08 The objective of the quality control element that addresses acceptance and continuance of clients and 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, a firm should be aware 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. A firm's policies and procedures related to the acceptance and continuance of clients and engagements should provide the firm with reasonable assurance that:

- The likelihood of association with a client whose management lacks integrity is minimized.
- The firm undertakes only those engagements that can be completed with professional competence.
- The risks associated with providing professional services in particular circumstances are appropriately considered.
- An understanding is reached with the client regarding the services to be performed.

.09 These objectives ordinarily should be satisfied for the initial period in which the firm is performing a service and for subsequent periods by establishing and maintaining policies such as the following.

- Evaluating factors that have a bearing on management's integrity.
- Evaluating whether the engagement can be completed with professional competence, undertaking only those engagements that can be completed with professional competence, and appropriately considering the risk associated with providing professional services in particular circumstances.[4]
- Obtaining an understanding with the client regarding the services to be performed.

Engagement Performance

.10 The objective of the engagement performance element of quality control is to provide the firm with reasonable assurance that the work performed by engagement personnel meets applicable professional

[4] 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.

standards, regulatory requirements, and the firm's standards of quality. Policies and procedures for engagement performance should address all phases of the design and execution of the engagement. To the extent appropriate and as required by applicable professional standards, these policies and procedures should cover planning, performing, supervising, reviewing, documenting, and communicating the results of each engagement. Policies and procedures also should require personnel to refer to authoritative literature or other sources and to consult, on a timely basis, with individuals within or outside the firm, when appropriate. The objective of the engagement performance element of quality control ordinarily would be satisfied by establishing and maintaining policies such as the following:

- Requiring that all engagements be planned to meet professional, regulatory, and the firm's requirements.
- Requiring that the work performed and the reports and other communications issued meet professional, regulatory, and the firm's requirements.
- Establishing policies and procedures for the review of high-risk engagements.
- Identifying areas and specialized situations for which consultation is necessary and requiring personnel to refer to authoritative literature or other sources, or consult on a timely basis with individuals within or outside the firm, when appropriate, for example, when addressing complex, unusual, or unfamiliar issues.

Monitoring

.11 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 other elements of quality control are suitably designed and effectively applied. Monitoring involves an ongoing consideration and evaluation of a firm's quality control policies and procedures, and the firm's compliance therewith. A firm may satisfy this objective through ongoing inquiry, testing, and observation about such matters as:

- The relevancy and adequacy of the firm's quality control policies and procedures in relation to the size of the firm.
- The appropriateness of the firm's guidance materials and practice aids.
- The effectiveness of the firm's professional development activities.
- The firm's compliance with its policies and procedures, and with professional standards.

.12 Monitoring the elements of quality control related to independence, integrity, and objectivity; personnel management; and acceptance and continuance of clients and engagements; involves an ongoing consideration from a firm-wide perspective of the matters listed in AAM section 10,200.11.

.13 Monitoring of the engagement performance element of quality control may be performed through either preissuance or postissuance engagement review. A preissuance review is performed periodically on selected engagements throughout the year, prior to the firm's release of its reports and the financial statements for these engagements. A postissuance review is performed during a designated period in the year on a sample of engagements for which the firm has already released its reports and the financial statements.

.14 Both preissuance and postissuance review require a full review of the reports, financial statements, and workpapers to determine whether the firm has complied with its policies and procedures and professional standards. An example of evaluating engagement-level compliance with a firm's quality control policies and procedures would be determining whether the documentation for a review of a Yellow-Book engagement indicates that the reviewer assessed whether the engagement staff had obtained the required CPE for such engagements.

Applying the Quality Control Standards to Four Hypothetical Firms

.15 The remainder of the chapters in this Practice Aid present four different hypothetical firms and the quality control policies and procedures the firms implement to address each of the quality control elements. Following is a description of those firms and their characteristics.

- Multi-Office CPA Firm has 10 offices in 3 states and is centrally managed. It has approximately 35 partners, and 200 professionals. Its accounting and auditing practice has a concentration of financial-institution clients for which it performs audit and attest services. Multi-Office CPA Firm has no SEC 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 SEC 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)
- An alternative practice structure 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 owned and controlled by CPAs. The nonattest portion is conducted through a separate entity, which may be an issuer or nonissuer, owned and controlled by individuals who are not CPAs. (Chapter 5)

The policies and procedures described in each chapter are those that a firm of a similar size and type should consider establishing and maintaining. The policies and procedures used by an actual firm need not necessarily include all those used by the illustrative firms nor be limited to those used by the illustrative firms.

.16 Most firms will find it appropriate to communicate their policies and procedures in writing. Readers of this Practice Aid should assume that the quality control policies and procedures for the illustrative firms are in writing and distributed or made available electronically to all professional personnel.

Chapter 2

SYSTEM OF QUALITY CONTROL FOR A CPA FIRM'S ACCOUNTING AND AUDITING PRACTICE—FIRM WITH MULTIPLE OFFICES

.17 This chapter describes how a CPA firm that has multiple offices and is centrally managed (Multi-Office CPA Firm) implements each element of quality control in its accounting and auditing practice. Multi-Office CPA Firm is a hypothetical firm that has 10 offices in 3 states and is centrally managed. Multi-Office CPA Firm has 35 partners, 200 professionals, and a concentration of financial-institution clients for which it performs audit and attest services. It has no Securities and Exchange Commission (SEC) clients.[5]

Independence, Integrity, and Objectivity

.18 The objective of the independence, integrity, and objectivity element of a system of quality control is to provide the firm with reasonable assurance that personnel maintain independence (in fact and in appearance) in all required circumstances, perform all professional responsibilities with integrity, and maintain objectivity in discharging professional responsibilities. Multi-Office CPA Firm satisfies this objective by establishing and maintaining the policies and procedures described in AAM section 10,200.19–.22.

.19 Policy 1: Personnel adhere to applicable independence, integrity, and objectivity 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[6] (GAO), Department of Labor (DOL), Federal Deposit Insurance Corporation (FDIC), and any other applicable regulators. Multi-Office CPA Firm implements this policy by:

- For matters related to independence, integrity, and objectivity, designating one of its partners to be responsible for responding to questions, resolving matters, and determining the circumstances for which consultation with sources outside the firm may be required.
- 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 business relationship, and (*b*) all activities in which the firm is prohibited[7] from engaging, as defined in the firm's independence policies.
- 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 should be accompanied by the most current list of all entities with which firm personnel are prohibited from having a 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.

---

[5] If Multi-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.

[6] The U.S. Government Accountability Office was formerly known as the U.S. General Accounting Office.

[7] Examples of prohibited activities include providing certain valuation and information technology services to an audit client. Readers should refer to the rules of specific standard-setters to determine the extent and relevance of any prohibition.

- 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.
- 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 de pendent of a professional obtains a security or financial interest in an entity.

.20 Policy 2: The firm's senior management sets a tone for the organization that stresses the importance of ethical values, especially as they pertain to accounting and auditing engagements, and communicates related policies and procedures to firm personnel. Multi-Office CPA Firm implements this policy by:

- Having the managing partner (through e-mails, letters, recordings, and so on), emphasize the concepts of independence, integrity, and objectivity (including the significance of client[8] engagements) in its professional development meetings, in the acceptance and continuance of clients and engagements, and in the performance of engagements. Because Multi-Office CPA Firm has a concentration of financial-institution clients, this also would include discussing the applicability of these concepts to engagements for financial institutions, such as the prohibition against any member of the engagement team having a loan with the institution, and the types of nonattest services that could affect independence.
- Providing each of its professional personnel with access to applicable professional and regulatory literature and advising them that they are expected to be familiar with that literature.
- Requiring periodic independence and ethics training for all professional personnel. Such training covers the firm's independence and ethics policies and the independence and ethical requirements of all applicable regulators.

---

[8] 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.

- Informing personnel on a timely basis of those entities to which independence policies apply, by:
  - — Preparing and maintaining a list of entities with which firm personnel are prohibited from having a 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 on a timely basis of changes in the list.

.21 Policy 3: The firm establishes procedures to help mitigate possible threats to independence and objectivity. Multi-Office CPA Firm implements this policy by:

- 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.
- Subjecting the assignment of engagement personnel to approval by another partner or manager.
- Periodically rotating engagement partners.
- Designing and implementing compensation 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*) provide disincentives for behavior, for example, the cross-selling of certain consulting services, that might be perceived as impairing the independence or objectivity of their work.
- 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 management positions, or accept offers of employment.

.22 Policy 4: The firm establishes procedures for confirming the independence of other firms, or firm personnel in associated member firms who are performing part of an engagement. Multi-Office CPA Firm implements this policy by:

- Describing in its policies and procedures manual the form, content, and frequency of independence representations to be obtained.
- Requiring that such representations be documented.

Personnel Management

.23 The objective of the personnel management element of a system of quality control is to provide the firm with reasonable assurance that all personnel have the appropriate characteristics to perform their assigned responsibilities competently. Attributes or qualities that enhance the competency of personnel who perform, supervise, or review work include integrity, objectivity, intelligence, judgment, experience, and motivation. Multi-Office CPA Firm satisfies this objective by establishing and maintaining the policies and procedures described in AAM section 10,200.24–.28.

.24 Policy 1: Personnel who are hired possess the characteristics that enable them to perform competently. Multi-Office CPA Firm implements this policy by maintaining firm-wide hiring standards and evaluating the firm's personnel needs, including:

- 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 of all hiring decisions.

.25 Policy 2: 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. Multi-Office CPA Firm implements this policy by:

- Specifying the competencies that the practitioners-in-charge of accounting, auditing, and attest engagements (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 role of the firm's system of quality control and the Code of Professional Conduct, both of which play critical roles in assuring 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 participation or training 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.
- Designating an appropriate person(s) in each office to be responsible for assigning personnel to engagements based on such factors as:
  — 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.

- Establishing a policy for monitoring the continuation and rotation of engagement partners.

The individual who makes partner and manager assignments should be a partner, and in the case of high-risk engagements or significant client engagements, second-level approval of such assignments should be obtained, for example, from the industry partner or the quality assurance partner.

.26 Policy 3: Personnel participate in general and industry-specific continuing professional education (CPE) and professional development activities that should enable them to accomplish assigned responsibilities and satisfy applicable CPE requirements of the AICPA, state societies, state boards of accountancy, and other applicable regulators. Multi-Office CPA Firm implements this policy by:

- 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:
  - — 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.
- Encouraging professional personnel at each level in the firm to participate in external professional development activities such as:
  - — Continuing professional education courses
  - — Meetings of professional organizations
  - — Serving on professional committees
  - — Writing for professional publications
  - — Speaking to professional groups

.27 Policy 4: Only those individuals who have the qualifications necessary to accomplish the responsibilities they will be called on to assume are selected for advancement. Multi-Office CPA Firm implements this policy by:

- 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:
  - — Establishing criteria for evaluating personnel at each professional level and for advancing to the next higher level of responsibility. Such criteria give due 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:
  - — 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 by
  - — At least annually, summarizing and reviewing with personnel their performance evaluations, including assessing their progress with the firm. Considerations should include past performance, future objectives of the firm and the individual, assignment preferences, and career opportunities.
  - — Periodically evaluating partners by means of performance reviews, peer evaluations, or self-appraisals, as appropriate, to determine whether they continue to have the qualifications to accomplish their assigned responsibilities and to assume additional responsibilities.

.28 Policy 5: Partners and senior-level employees are compensated in a manner that provides an incentive and reward for quality work and for maintaining independence, integrity, and objectivity. Multi-Office CPA Firm implements this policy by:

- Establishing a compensation system that predominantly rewards accounting and auditing partners and senior-level employees for the quality of their accounting and auditing work. The compensation system:
  - — Takes into consideration firm feedback based on concurring reviews, internal inspections, and outside reviews of the work performed.
  - — Rewards partners and personnel for timely identifying significant and emerging accounting and auditing issues and for timely seeking consultation with firm experts
  - — Does not include any material rewards for the cross-selling of services.

Acceptance and Continuance of Clients and Engagements

.29 The objective of the acceptance and continuance of clients and engagements element of a system of quality control is to establish criteria for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for a client. Such policies and procedures should provide the firm with reasonable assurance that:

- The likelihood of association with a client whose management lacks integrity is minimized.
- The firm undertakes only those engagements it can reasonably expect to complete with professional competence.
- The risks associated with providing professional services in particular circumstances are appropriately considered.
- An understanding with the client regarding the services to be performed is reached.

Multi-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 AAM section 10,200.30–.32.

.30 Policy 1: The firm evaluates factors that have a bearing on management's integrity. Multi-Office CPA Firm implements this policy by:

- 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 applicable information before accepting or continuing any client. The following are examples of such information:
    - Information regarding the client and its operations from sources such as annual reports, interim financial statements, reports to regulators, enforcement actions by regulators, and income tax returns.
    - Management's understanding of the nature and purpose of the services to be provided.
    - Information obtained from inquiries of third parties about the client, its management, and principals that may have a bearing on evaluating the client. Examples of such third parties are bankers, legal counsel, 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 reportable conditions, especially those that management is unwilling to correct.
- Communicating with the predecessor accountant or auditor when required or suggested 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.

If the firm is unable to obtain sufficient information about the prospective client after completing the steps listed above, or there is an indication that management or someone affiliated with the prospective client may be less than reputable, the firm conducts a background check of the business, its officers, and the person(s) in question by using an investigative firm and evaluates the information obtained regarding management's integrity.

.31 Policy 2: The firm (*a*) evaluates whether the engagement can be completed with professional competence, (*b*) undertakes only those engagements that can be completed with professional competence, and (*c*) appropriately considers the risk associated with providing professional services in particular circumstances.[9] Multi-Office CPA Firm implements this policy by:

- Evaluating whether the practice office has obtained or can reasonably expect to obtain the knowledge and expertise necessary to perform the engagement, for example, through the resources of another practice office.

[9] 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.

- 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, for example, 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, for example, 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, for example, the inability to replace the loss of key personnel who are particularly knowledgeable about a specialized industry, or a decision by the 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, for example, 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.
- 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. The evaluation process includes the following steps:
  - — All information obtained about the client or the specific engagement is evaluated by the engagement partner, including information about the significance of the client to the firm,[10] and a recommendation is made as to 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 evaluates 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.

.32 **Policy 3: The firm establishes an understanding with the client regarding the services to be performed.** Multi-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 misunderstandings regarding the nature, scope, and limitations of the services to be performed.

---

[10] See footnote 8.

Engagement Performance

.33 The objective of the engagement performance element of a system of quality control is to provide the firm with reasonable assurance that the work performed by engagement personnel meets applicable professional standards, regulatory requirements, and the firm's standards of quality. Policies and procedures for engagement performance encompass all phases of the design and execution of the engagement. To the extent appropriate and as required by applicable professional standards, these policies and procedures should cover planning, performing, supervising, reviewing, documenting, and communicating the results of each engagement. Policies and procedures also should require that personnel refer to authoritative literature or other sources and consult, on a timely basis, with individuals within or outside the firm when appropriate (for example, when addressing complex, unusual, or unfamiliar issues). Multi-Office CPA Firm satisfies this objective by establishing and maintaining the policies and procedures described in AAM section 10,200.34–.37.

.34 Policy 1: Planning for engagements meets professional, regulatory, and the firm's requirements. Multi-Office CPA Firm implements this policy by developing, maintaining, and providing personnel with the firm's policies and procedures manual which 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:

- 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.
- For all initial audit clients designated as high risk by the firm, establishing a requirement for an independent review of planning considerations.
- Requiring planning documentation that includes:
  - — 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 its 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 a sufficient amount of 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.

.35 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. Multi-Office CPA Firm implements this policy by:

- Providing personnel with the firm's policies and procedures manual which:
  - — Prescribes the form and content of documentation of the work performed and conclusions reached, including forms, checklists, and questionnaires to be used in performing engagements.
  - — Prescribes 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.

— Specifies 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.

— Specifies the extent of review to be performed of required communications to management and the board of directors.

- Assigning responsibility for the review of all reports, financial statements, and documentation of the work performed and conclusions reached to a reviewer senior to the preparer in accordance with procedures outlined in the firm's manual to obtain reasonable assurance that:

— The nature, timing, and extent of procedures performed are consistent with risk assessments and the approach described in the planning documentation, and that 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 the most extensive review.

- Adhering to the following firm guidelines regarding review of documentation of the work performed and conclusions reached, the financial statements, and documentation of the review process:

— All reviewers should have appropriate experience, competence, and responsibility and access to the firm's reference material and other resources.

— All work performed and the reports and financial statements issued are to be complete and comply with professional standards and firm policy.

— For each engagement, there should be appropriate documentation evidencing review of the documentation of the work performed and conclusions reached, the financial statements, and the report

- Requiring that all differences of professional judgment within an engagement team be resolved by the engagement and quality control partner. The resolution of the differences should be appropriately documented. If a member of the engagement team continues to disagree with the resolution, he or she may disassociate himself or herself from the resolution of the matter and should be offered the opportunity to document that a disagreement continues to exist.

.36 Policy 3: Establishing procedures for the review of high-risk engagements. Multi-Office CPA Firm implements this policy by developing procedures with respect to:

- The qualifications of partners performing independent reviews of high-risk engagements. The firm's procedures require that an independent review partner:

— Have sufficient technical expertise and experience.

— Carry out his or her responsibilities with objectivity and due professional care without regard to the relative positions of the audit engagement partner and the independent review partner.

— 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.

- The nature, timing, and extent of the review. The firm's procedures require that the independent review partner:

— Discuss significant accounting, auditing, and financial reporting matters with the engagement partner.

— Discuss with the engagement partner the engagement team's identification and audit of high-risk transactions and account balances.

— Hold a discussion with the engagement team if there has been consultation regarding significant accounting, auditing, or financial reporting matters.

— Review documentation of the resolution of significant accounting, auditing, and financial reporting matters, including documentation of consultation with firm personnel or external sources.

— Review the summary of unadjusted audit differences, if one exists.

— Read the financial statements and auditor's report.

— Confirm with the engagement partner that there are no significant unresolved matters.

— Review the workpapers to the extent considered necessary or as required by firm policy.

— Complete his or her review before the release of the audit report or reissuance of the audit report if the performance of subsequent-events procedures is required by professional standards.

- The resolution of conflicting opinions between the engagement partner and the independent review partner regarding significant matters. The policy requires documentation of the resolution of conflicting opinions before the release of the audit report or reissuance of the audit report if the performance of subsequent-events procedures is required by professional standards.

- Documentation by the independent review partner. The firm requires:

— That the engagement files contain evidence that the firm's policies and procedures with respect to the requirement for independent partner review were complied with before issuance of the firm's report.

— Documentation that the independent review partner performed the procedures specified by the firm's policies.

— Documentation that no matters have come to the attention of the independent review partner that would cause him or her to believe that (*a*) the financial statements are not in conformity with U.S. generally accepted accounting principles in all material respects, or (*b*) the firm's audit was not performed in accordance with U.S. generally accepted auditing standards.

.37 Policy 4: The firm identifies areas and specialized situations for which consultation is necessary and requires personnel to refer to authoritative literature and practice aids and to consult, on a timely basis, with individuals within or outside the firm when appropriate, for example, when addressing complex, unusual, or unfamiliar issues. Multi-Office CPA Firm implements this policy by:

- Providing personnel with the firm's policies and procedures manual which specifies the firm's consultation policies and procedures. Areas or specialized situations that may require consultation include:

— Application of newly issued technical pronouncements.

— Industries with special accounting, auditing, or reporting requirements.

— Emerging practice problems.

— Choices among alternative generally accepted accounting principles upon initial adoption or when an accounting change is made.

— Reissuance of a report, consideration of omitted procedures after a report has been issued, or subsequent discovery of facts that existed at the 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 generally accepted accounting principles or generally accepted auditing standards 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 in each office which includes materials related to specific industries, specialties, and regulatory requirements.
- 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, 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, and, at the discretion of the consultant, entered in a retrievable database to promote consistency in the application of generally accepted accounting principles in similar circumstances.

Monitoring

.38 The objective of the monitoring element of a system of quality control is to provide the firm with reasonable assurance that the policies and procedures relating to the other elements of quality control are suitably designed and effectively applied. Monitoring is an ongoing consideration and evaluation process. Multi-Office CPA Firm satisfies this objective by establishing and maintaining the policies and procedures described in AAM section 10,200.39–.42.

.39 Policy 1: The firm considers and evaluates, on an ongoing basis, the relevance and adequacy of its quality control policies and procedures. Multi-Office CPA Firm implements this policy by designating a partner or a management-level individual with appropriate authority to be responsible for quality assurance, including:

- Assuring that the firm's quality control policies and procedures and its audit methodology remain relevant and adequate. Factors to be considered include:

— Mergers and divestitures of portions of the practice.

— Changes in professional standards 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.

— The effect that changes in technology may have on a client's method of doing business.

— Changes in a client's industry that affect its operations, for example, overcapacity in the telecom industry.

— 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:

— 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.

.40 Policy 2: The firm considers and evaluates, on an ongoing basis, the appropriateness of its guidance materials and practice aids. Multi-Office CPA Firm implements this policy by:

- 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.

.41 Policy 3: The firm considers and evaluates, on an ongoing basis, the effectiveness of its professional development programs. Multi-Office CPA Firm implements this policy by:

- 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 it relates 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.

.42 Policy 4: The firm considers and evaluates, on an ongoing basis, compliance with its policies and procedures and with professional standards. Multi-Office CPA Firm implements this policy by assigning responsibility to its quality control partner for preparing inspection checklists and guidance materials, or using materials prepared by the AICPA for performing inspection procedures. These procedures include:

- Developing and coordinating the firm's inspection program to obtain feedback about the effectiveness of the firm's policies and procedures.
- 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 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
- 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.

- Summarizing findings resulting from the inspection procedures.
- 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.
- Preparing a summary inspection report for the firm's senior management that evaluates the overall results of the inspection to determine whether:

— The firm as a whole needs to improve compliance with the firm's policies and procedures.

— Revisions to the firm's quality control policies and procedures are necessary.

- Communicating in training programs, partner-manager meetings, and firm policy correspondence the need for improved compliance with the system of quality control.
- Communicating in partner-manager meetings and firm policy correspondence the need for changes in the system of quality control.
- Periodically reviewing the process for personnel evaluation and counseling to ascertain that:

— 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.

Chapter 3

SYSTEM OF QUALITY CONTROL FOR A CPA FIRM'S ACCOUNTING AND AUDITING PRACTICE—FIRM WITH A SINGLE OFFICE

.43 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 Securities and Exchange Commission (SEC) clients.[11] 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. To enhance communications, the firm provides its personnel with a written summary of its quality control policies and procedures that contains references to the detailed policies and procedures included in its practice aids.

Independence, Integrity, and Objectivity

.44 The objective of the independence, integrity, and objectivity element of a system of quality control is to provide a firm with reasonable assurance that personnel maintain independence (in fact and in appearance) in all required circumstances, perform all professional responsibilities with integrity, and maintain objectivity in discharging professional responsibilities. Single-Office CPA Firm satisfies this objective by establishing and maintaining the policies and procedures described in AAM section 10,200.45–.48.

.45 Policy 1: Personnel adhere to applicable independence, integrity, and objectivity 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[12] (GAO), Department of Labor (DOL), Federal Deposit Insurance Corporation (FDIC), and any other applicable regulators. Single-Office CPA Firm implements this policy by:

- Designating a quality assurance partner to review relevant pronouncements relating to independence, integrity, and objectivity, answer questions, and resolve matters.
- Subscribing to the AICPA *Professional Standards* service.
- Identifying circumstances for which documentation of the resolution of matters is appropriate.
- Assigning responsibility to specified individuals for obtaining written representations from personnel, upon hire and on an annual basis, concerning whether they are familiar with and in compliance with professional standards and the firm's policies and procedures regarding independence, integrity, and objectivity.
- Assigning responsibility to specified individuals for reviewing these independence representations for completeness, and for resolving reported exceptions.
- Requiring all professional personnel assigned to an engagement to sign a step in the engagement program attesting to his or her independence.
- 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.

---

[11] 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.

[12] The U.S. Government Accountability Office was formerly known as the U.S. General Accounting Office.

- Establishing a system for identifying all services performed for each client.

.46 Policy 2: The firm's senior management sets a tone for the organization that stresses the importance of ethical values, especially as they pertain to accounting and auditing engagements, and communicates related policies and procedures to firm personnel. Single-Office CPA Firm implements this policy by:

- Having the managing partner (through e-mails, letters, recordings, and so on), emphasize the concepts of independence, integrity, and objectivity (including the significance of client[13] engagements) in its professional development meetings, in the acceptance and continuance of clients and engagements, and in the performance of engagements.
- Providing each of its professional personnel with access to applicable professional and regulatory literature and advising them that they are expected to be familiar with that literature.
- Requiring periodic independence and ethics training for all professional personnel. Such training covers the firm's independence and ethics policies and the independence and ethical requirements of all applicable regulators.
- Informing personnel on a timely basis of those entities to which independence policies apply, by:
  - — Preparing and maintaining a list of entities with which firm personnel are prohibited from having a business relationship.
  - — Making the list available to personnel so they may evaluate their independence (including personnel new to the firm).
  - — Notifying personnel on a timely basis of changes in the list.

.47 Policy 3: The firm establishes procedures to help mitigate possible threats to independence and objectivity. Single-Office CPA Firm implements this policy by:

- Assigning a second partner, who is not otherwise associated with the engagement, to perform a concurring review of all audit and attest engagements.
- Designing and implementing compensation 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*) provide disincentives for behavior that might be perceived as impairing the independence or objectivity of their work, for example, the cross-selling of certain consulting services.
- 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 management positions, or accept offers of employment.

.48 Policy 4: The firm establishes procedures for confirming the independence of other firms who are performing part of an engagement. Single-Office CPA Firm implements this policy by:

- Using practice aids that prescribe the form, content, and frequency of independence representations to be obtained.
- Requiring that such representations be documented.

---

[13] 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.

Personnel Management

.49 The objective of the *Personnel Management* element of a system of quality control is to provide the firm with reasonable assurance that all personnel have the competency to perform their assigned responsibilities. Attributes or qualities that enhance the competency of personnel who perform, supervise, or review work include integrity, objectivity, intelligence, judgment, experience, and motivation. Single-Office CPA Firm satisfies this objective by establishing and maintaining the policies and procedures in AAM section 10,200.50–.53.

.50 Policy 1: Personnel who are hired possess the characteristics that enable them to perform competently. Single-Office CPA Firm implements this policy by:

- Designating a qualified individual in the firm to be responsible for:
  - — 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.
- Establishing criteria for evaluating personal characteristics such as integrity, competence, and motivation.
- 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.

.51 Policy 2: 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 by:

- Designating an appropriate person in each office to be responsible for assigning personnel to engagements based on such factors as:
  - — 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.
- Specifying the competencies that the practitioners-in-charge 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 to accomplish their engagement responsibilities. These competencies include having an understanding of:
  - — The role of the firm's system of quality control and the AICPA's Code of Professional Conduct in assuring 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 participation or training in similar engagements.

— 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 other applicable regulators.

— 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 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.

The individual who makes partner and manager assignments should be a partner, and in the case of high-risk engagements or those performed for significant clients, second-level approval of such assignments should be obtained from the managing or other partner.

.52 **Policy 3: Personnel participate in general and industry-specific continuing professional education (CPE) and professional development activities that should 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.** Single-Office CPA Firm implements this policy by:

- Assigning responsibility to a partner to maintain an office professional development program that:
  — 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 and state boards of accountancy in establishing the firm's CPE requirements.
  — Provides course materials for and maintains records of CPE completed by 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 external professional development programs, including graduate-level and self-study courses, membership in 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, and independence requirements, and the firm's guidance with respect to these requirements.

.53 **Policy 4: Only those individuals who have the qualifications necessary to accomplish the responsibilities they will be called on to assume are selected for advancement.** Single-Office CPA Firm implements this policy by:

- Assigning responsibility to a partner for making advancement and termination decisions. Such responsibilities include:
  — Identifying criteria for evaluating personnel at each professional level and for advancement to the next higher level of responsibility. Such criteria give due 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:

— Annually summarizing and reviewing with personnel the evaluation of their performance, including an assessment of their progress with the firm. Considerations should include past performance, future objectives of the individual and the firm, the individual's assignment preferences, and career opportunities.

— Periodically evaluating partners by means of counseling, peer evaluation, or self-appraisal, as appropriate.

.54 Policy 5: Partners and senior-level employees are compensated in a manner that provides an incentive and reward for quality work and for maintaining independence, integrity, and objectivity. Single-Office CPA Firm implements this policy by:

- Establishing a compensation system that predominantly rewards accounting and auditing partners and senior-level employees for the quality of their accounting and auditing work. The compensation system:

— Takes into consideration firm feedback based on concurring reviews, internal inspections, and outside reviews of the work performed.

— Rewards partners and personnel for timely (*a*) identifying significant and emerging accounting and auditing issues and (*b*) seeking consultation with firm experts.

— Does not include any material rewards for the cross-selling of services.

Acceptance and Continuance of Clients and Engagements

.55 The objective of the acceptance and continuance of clients and engagements element of a system of quality control is to establish criteria for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for that client. Such policies and procedures should provide the firm with reasonable assurance that:

- The likelihood of association with a client whose management lacks integrity is minimized.
- The firm undertakes only those engagements that can be completed with professional competence.
- The risks associated with providing professional services in particular circumstances are appropriately considered.
- An understanding with the client regarding the services to be performed is reached.

Single-Office CPA Firm satisfies this objective, 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 AAM section 10,200.56–.58.

.56 Policy 1: The firm evaluates factors that have a bearing on management's integrity. Single-Office CPA Firm implements this policy by:

- 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 available financial information regarding the client and its operations such as annual reports, interim financial statements, reports to and from regulators, income tax returns, and credit reports before accepting or continuing a client.

- Making inquiries of client management about the nature and purpose of the services to be provided.
- Making inquiries of the client's bankers, factors, attorneys, credit services, and others who have business relationships with the entity.
- Communicating with the predecessor accountant or auditor when required or suggested by professional standards. If the contemplated engagement is an audit, the partner should ensure that AU section 315, *Communications Between Predecessor and Successor Auditors*, (AICPA, *Professional Standards*, vol. 1) is followed, specifically AU section 315.09.

If after taking the steps described above, the firm is unable to obtain sufficient information about the prospective client, or there is an indication that management or someone affiliated with the prospective client may be less than reputable, the firm conducts a background check of the business, its officers, and the person(s) in question. The firm accomplishes this by using the services of a company specializing in background checks and evaluating the information obtained regarding management's integrity.

.57 **Policy 2: The firm (*a*) evaluates whether the engagement can be completed with professional competence, (*b*) undertakes only those engagements that can be completed with professional competence, and (*c*) considers the risk associated with providing professional services in particular circumstances.** Single-Office CPA Firm implements this policy by:

- Evaluating whether the firm has obtained or can reasonably expect to obtain the knowledge and expertise necessary to perform the engagement.
- 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, for example, 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, for example, 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 has been delinquent in paying fees. (This may also affect the firm's independence.)
  — Engagements for entities operating in highly specialized or regulated industries, including financial institutions, governmental entities, and employee benefit plans.
  — Engagements that require a burdensome amount of time to complete relative to the available resources of the firm.
  — Engagements for entities in the development stage.
  — Engagements in which the client has ignored prior recommendations, for example, recommendations 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 should be made at least annually).
- Evaluating the information obtained regarding acceptance or continuance of the client or engagement by having:

— The engagement partner evaluate the information obtained about the client or the specific engagement, including information about the significance of the client to the firm,[14] and make a recommendation about whether the client or engagement should be accepted or continued.

— The engagement partner complete a client acceptance form and submit it to the managing partner for approval.

— The engagement partner sign a step in the planning program noting client continuance, and complete a form documenting client continuance if conditions exist that trigger the requirement between annual audits to reevaluate a client or engagement.

— The managing partner evaluate and approve 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.

.58 Policy 3: The firm obtains an understanding with the client regarding the services to be performed. Single-Office CPA Firm implements this policy by obtaining, for all engagements, a written and signed engagement letter thus minimizing the risk of misunderstanding regarding the nature, scope, and limitations of the services to be performed.

Engagement Performance

.59 The objective of the *Engagement Performance* element of a system of quality control is to provide the firm with reasonable assurance that the work performed by engagement personnel meets the applicable professional standards, regulatory requirements, and the firm's standards of quality. Policies and procedures for engagement performance encompass all phases of the design and execution of the engagement. To the extent appropriate and as required by applicable professional standards, these policies and procedures should cover planning, performing, supervising, reviewing, documenting, and communicating the results of each engagement. Policies and procedures also should require that personnel refer to authoritative literature or other sources and consult, on a timely basis, with individuals within or outside the firm, when appropriate. Single-Office CPA Firm satisfies this objective by establishing and maintaining the policies and procedures described in AAM section 10,200.60–.63.

.60 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 which 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, but generally include:

- Assigning responsibilities to appropriate personnel during the planning phase.
- Developing or updating background information on the client and the engagement.
- Developing a planning document that includes:
  — Proposed work programs tailored to the specific engagement.

  — Staffing requirements and the need for specialized knowledge.

  — The economic conditions affecting the client and its industry and their potential effect on the conduct of the engagement.

  — The audit risks, including fraud considerations, affecting the client and the engagement and how they may affect the procedures performed.

[14] See footnote 13.

— A budget that allocates a sufficient amount of time for the engagement to be performed in accordance with professional standards and the firm's quality control policies and procedures.

.61 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. Single-Office CPA Firm implements this policy by:

- Providing adequate supervision during the course of an engagement. 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.
- 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 documentation in the working papers in accordance with professional standards and the firm's policies.
- 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:

— All reviewers are to have appropriate experience, competence, and responsibility.

— All work performed and the reports and financial statements issued are to be complete and comply with professional standards and firm policy.

— For each engagement, there should be evidence of appropriate review of documentation of the work performed and conclusions reached, the financial statements, and the report.

— All differences of professional judgment among members of an engagement team are to be resolved by the engagement partner and the managing partner. The resolution of differences should be appropriately documented. If a member of the team continues to disagree with the resolution, he or she may disassociate himself or herself from the resolution of the matter and should be offered the opportunity to document that a disagreement continues to exist.

.62 Policy 3: Establishing procedures for the review of high-risk engagements. Single-Office CPA Firm implements this policy by developing procedures with respect to:

- The qualifications of partners performing independent reviews of high-risk engagements. The firm's procedures require that an independent review partner:

— Have sufficient technical expertise and experience.

— Carry out his or her responsibilities with objectivity and due professional care without regard to the relative positions of the audit engagement partner and the independent review partner.

— 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.

- The nature, timing, and extent of the review. The firm's procedures require that the independent review partner:

— Discuss significant accounting, auditing, and financial reporting matters with the engagement partner.

— Discuss with the engagement partner the engagement team's identification and audit of high-risk transactions and account balances.

— Hold a discussion with the engagement team if there has been consultation regarding significant accounting, auditing, or financial reporting matters.

— Review documentation of the resolution of significant accounting, auditing, and financial reporting matters, including documentation of consultation with firm personnel or external sources.

— Review the summary of unadjusted audit differences, if one exists.

— Read the financial statements and auditor's report.

— Confirm with the engagement partner that there are no significant unresolved matters.

— Review the workpapers to the extent considered necessary or as required by firm policy.

— Complete his or her review before the release of the audit report or reissuance of the audit report if the performance of subsequent-events procedures is required by professional standards.

- The resolution of conflicting opinions between the engagement partner and the independent review partner regarding significant matters. The policy requires documentation of the resolution of conflicting opinions before the release of the audit report or reissuance of the audit report if the performance of subsequent-events procedures is required by professional standards.

- Documentation by the independent review partner. The firm requires:

  — That the engagement files contain evidence that the firm's policies and procedures with respect to the requirement for independent partner review were complied with before issuance of the firm's report.

  — Documentation that the independent review partner performed the procedures specified by the firm's policies.

  — Documentation that no matters have come to the attention of the independent review partner that would cause him or her to believe that (*a*) the financial statements are not in conformity with U.S. generally accepted accounting principles in all material respects, or (*b*) the firm's audit was not performed in accordance with U.S. generally accepted auditing standards.

.63 Policy 4: The firm identifies areas and specialized situations for which consultation is necessary and requires personnel to refer to authoritative literature and practice aids, and consult, on a timely basis, with individuals within or outside the firm when appropriate, for example, when addressing complex, unusual, or unfamiliar issues. Single-Office CPA Firm implements this policy by:

- Informing personnel of the firm's consultation policies and procedures.

- 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 resolution of differences of opinion. If there is an unresolved disagreement, an outside source may be consulted to assist in determining the appropriate application of accounting principles.

Monitoring

.64 The objective of the *Monitoring* of a system of quality control is to provide the firm with reasonable assurance that the policies and procedures relating to the other elements of quality control are suitably designed and effectively applied. Monitoring is an ongoing consideration and evaluation process. Single-Office CPA Firm satisfies this objective by establishing and maintaining the policies and procedures described in AAM section 10,200.65–.68.

.65 Policy 1: The firm considers and evaluates, on an ongoing basis, the relevance and adequacy of its quality control policies and procedures. Single-Office CPA Firm implements this policy by designating a partner or a management-level individual to be responsible for quality assurance, including:

- Assuring that the firm's quality control policies and procedures and its audit methodology remain relevant and adequate. Factors to be considered include:
  - — Mergers and divestitures of portions of the practice.
  - — Changes in professional standards or other regulatory requirements applicable to the firm's practice.
  - — Results of inspections and peer reviews.
  - — Review of litigation and regulatory enforcement actions against the firm and its personnel.
  - — The effect that changes in technology may have on a client's method of doing business.
  - — Changes in a client's industry that may affect its operations.
  - — Changes in applicable AICPA membership requirements.
- Determining whether personnel have been appropriately informed of their responsibilities for maintaining the firm's standards of quality in performing their duties.
- Identifying the need to:
  - — 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.

.66 Policy 2: The firm considers and evaluates, on an ongoing basis, the appropriateness of its guidance materials and practice aids. Single-Office CPA Firm implements this policy by:

- 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.

.67 Policy 3: The firm considers and evaluates, on an ongoing basis, the effectiveness of its professional development activities. Single-Office CPA Firm implements this policy by:

- 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.
- 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.
- Soliciting information from the firm's personnel during staff meetings regarding the effectiveness of training programs.

.68 Policy 4: The firm considers and evaluates, on an ongoing basis, its compliance with firm policies and procedures and with professional standards. For purposes of illustrating policy 4, two scenarios are described: scenario 1 illustrates how Single-Office CPA Firm would satisfy the objective of policy 4 by reviewing engagements throughout the year; scenario 2 illustrates how Single-Office CPA Firm would implement policy 4 by reviewing engagements during a designated period in the year.

.69 In determining which scenario is appropriate, consideration should be given to SQCS No. 3, (See QC section 30.03–.07), which establishes guidance for determining the extent of the inspection procedures to be performed, including those related to individual engagements.

.70 ***Scenario 1: Reviewing Engagements Throughout the Year.*** Single-Office CPA Firm implements policy 4 by:

- 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 (for example, monthly, quarterly). The comprehensiveness of the review of selected engagements should be 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:
  - — 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, review, compilation, and attest).
  - — 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.

- Reviewing the selected engagements. Deficiencies identified as a result of this process are summarized and evaluated to determine whether:

  — Additional emphasis should be placed on specific areas or industries in future engagements.

  — Existing policies and procedures should be modified to prevent the deficiencies noted from recurring.

- At least annually, reviewing other engagement files 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.

- Summarizing the deficiencies noted resulting from the preissuance and postissuance reviews.

- Preparing a summary of the deficiencies noted so that the partner or management group may incorporate any recommended changes in 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.

.71 ***Scenario 2: Reviewing a Sample of Engagements During a Designated Period of the Year.*** Single-Office CPA Firm implements policy 4 by:

- 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, review, compilation, and attest).

  — 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).
- Selecting a sample of engagements for review and reevaluating that selection throughout the process.
- Selecting other engagement files to determine compliance with the firm's quality control policies and procedures and reviewing the selected engagements.
- 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.
- Summarizing findings resulting from the inspection procedures.
- 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 as to 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).

Chapter 4

SYSTEM OF QUALITY CONTROL FOR A CPA FIRM'S ACCOUNTING PRACTICE—SOLE PRACTITIONER

.72 This chapter describes how a sole practitioner (Sole Practitioner, CPA) implements each element of quality control in his or her accounting practice. Sole Practitioner, CPA is a hypothetical firm of which Sole Practitioner 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 Statements on Standards for Accounting and Review Services (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.

Independence, Integrity, and Objectivity

.73 The objective of the *Independence, Integrity, and Objectivity* element of a system of quality control is to provide a firm with reasonable assurance that personnel maintain independence (in fact and in appearance) in all required circumstances, perform all professional responsibilities with integrity, and maintain objectivity in discharging their professional responsibilities. Sole Practitioner, CPA, satisfies this objective by establishing and maintaining the policy and procedures described in AAM section 10,200.74–.75.

.74 **Policy 1: I adhere to applicable independence, integrity, and objectivity 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.** Sole Practitioner, CPA, implements this policy by:

- Subscribing to AICPA *Professional Standards*.
- 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*.
- Ensuring that per diem personnel are aware of financial, family, business, and other relationships that may be prohibited by applicable requirements.
- Signing a step on each engagement program attesting to her independence, and requiring per diem personnel to do the same.
- 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 the client to the firm.[15]

---

[15] 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.

.75 Policy 2: I establish procedures to help mitigate possible threats to my independence and objectivity. Sole Practitioner, CPA implements this policy by:

- Subjecting review engagements for significant clients (or other high-risk engagements) to preissuance review by another firm.

Personnel Management

.76 The objective of the personnel management element of a system of quality control is to provide a firm with reasonable assurance that all personnel have the competency to perform their assigned responsibilities. Attributes or qualities that enhance the competency of personnel who perform, supervise, or review work include integrity, objectivity, intelligence, judgment, experience, and motivation. Sole Practitioner, CPA, satisfies this objective by establishing and maintaining the policy and procedures described in AAM section 10,200.77.

.77 Policy 1: 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 should 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 by:

- 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, for example:
  - — 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.
- Receiving professional publications, such as state society journals, to keep abreast of changes in accounting standards and any client industry-specific pronouncements.
- Consulting the AICPA Web site for information about changes in professional standards.

Acceptance and Continuance of Clients and Engagements

.78 The objective of the acceptance and continuance of clients and engagements element of a system of quality control is to establish criteria for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for a client. Such policies and procedures should provide the firm with reasonable assurance that:

- The likelihood of association with a client whose management lacks integrity is minimized.
- The firm undertakes only those engagements that can be completed with professional competence.
- The risks associated with providing professional services in particular circumstances are appropriately considered.
- An understanding with the client regarding the services to be performed is reached.

Sole Practitioner, CPA, satisfies this objective, 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 AAM section 10,200.79–.81.

.79 Policy 1: I evaluate factors that have a bearing on management's integrity. Sole Practitioner, CPA, implements this policy by:

- Obtaining information such as the following before accepting or continuing a client:
  - — The nature and purpose of the services to be provided.
  - — Information regarding the client and its operations from sources such as prior-year reports, internally generated financial statements (if applicable), income tax returns, and credit reports.
- Inquiring of third parties such as bankers, factors, and legal counsel about management's integrity.
- Communicating with the predecessor accountant when required or suggested by professional standards.[16]
- Evaluating the information obtained regarding management's integrity.

.80 Policy 2: I accept or continue to perform only those engagements I can complete with professional competence, and appropriately consider the risk associated with providing professional services in particular circumstances. Sole Practitioner, CPA, implements this policy by:

- 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.
  - — The client has been delinquent in paying fees. (This also may affect the firm's independence.

[16] 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.

- Determining if she has the knowledge and expertise to perform the engagement or whether it reasonably can be obtained.
- 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.

.81 Policy 3: I establish an understanding with the client regarding the services to be performed. Sole Practitioner, CPA, implements this policy by:

- 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.

Engagement Performance

.82 The objective of the engagement performance element of a system of quality control is to provide the firm with reasonable assurance that the work performed by engagement personnel meets the applicable professional standards, regulatory requirements, and the firm's standards of quality. Policies and procedures for engagement performance encompass all phases of the design and execution of the engagement. To the extent appropriate and as required by applicable professional standards, these policies and procedures should cover planning, performing, supervising, reviewing, documenting, and communicating the results of each engagement. Policies and procedures also should require that personnel refer to authoritative literature or other sources and consult, on a timely basis, with individuals within or outside the firm, when appropriate, for example, when dealing with complex, unusual, or unfamiliar issues. Sole Practitioner, CPA, satisfies this objective by establishing and maintaining the policies and procedures described in AAM section 10,200.83–.85.

.83 Policy 1: I plan engagements to meet professional standards 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:

- Developing or updating client information.
- Assessing the significance of the client to her firm.
- Obtaining an engagement letter for engagements performed under AR section 100.20, *Compilation and Review of Financial Statements*, (AICPA, *Professional Standards*, vol. 1) 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.

.84 Policy 2: I perform, supervise, review, document, and report (or communicate) in accordance with the requirements of professional standards and the firm. Sole Practitioner, CPA, implements this policy by:

- Requiring the use of appropriate practice aids in all engagements.
- Maintaining the availability of current practice aids and AICPA professional standards.

- Documenting the work performed in accordance with professional standards and the firm's policy.
- Reviewing and initialing all engagement documentation prepared by per diem personnel.

.85 Policy 3: I identify areas and specialized situations for which consultation is necessary. I require personnel to refer to authoritative literature and practice aids and consult, on a timely basis, with individuals outside the firm when appropriate, for example, when addressing complex, unusual, or unfamiliar issues. Sole Practitioner, CPA, implements this policy by:

- Maintaining access to 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 all relevant facts and circumstances and references to professional literature used in the analysis of the matter and the conclusion reached. This documentation is retained with the engagement documentation.

Monitoring

.86 The objective of the monitoring element of a system of quality control is to provide the firm with reasonable assurance that the procedures relating to the other elements of quality control are suitably designed and effectively applied. Monitoring is an ongoing consideration and evaluation process. Sole Practitioner, CPA, satisfies this objective by establishing and maintaining the policies and procedures described in AAM section 10,200.87–.90.

.87 Policy 1: I consider and evaluate, on an ongoing basis, the relevance and adequacy of my quality control policies and procedures. Sole Practitioner, CPA, implements this policy by reviewing all policies and procedures and revising those affected by changes in professional standards or the nature of her practice.

.88 Policy 2: I consider and evaluate, on an ongoing basis, the appropriateness of my guidance materials and practice aids. Sole Practitioner, CPA, implements this policy by reviewing and determining that the firm's practice aids are current and reflect recent professional pronouncements and changes in her practice.

.89 Policy 3: I consider and evaluate, on an ongoing basis, the effectiveness of professional development activities. Sole Practitioner, CPA, implements this policy by:

- 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.

.90 Policy 4: I consider and evaluate, on an ongoing basis, compliance with my policies and procedures, and with professional standards. Sole Practitioner, CPA, implements this policy by:

- Performing a postissuance review of selected engagements within six months of the completion of the engagements.[17]

[17] 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 AAM section 10,200.71, "Scenario 2: Reviewing 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.

- Including in the postissuance review, engagements for which there have been complaints or allegations from clients or third parties that the work failed to comply with professional standards, regulatory requirements, or the firm's system of quality control.
- Placing additional emphasis to correct certain deficient areas in future engagements.
- Determining if existing policies and procedures should be modified so that any identified deficiencies do not recur.
- Reviewing compliance with the firm's policies and procedures related to independence, integrity, and objectivity; personnel management; acceptance and continuance of clients and engagements; and engagement performance
- Considering the results of the firm's monitoring and peer review findings to ensure that the competencies necessary to accomplish responsibilities are maintained for each of the firm's engagements.
- Responding to notification of the need for peer review, scheduling, and completion of peer review on a timely basis, in accordance with professional standards and the requirements of applicable state boards of accountancy.
- Reporting all compilation and review engagements to the firm's peer reviewer.
- Demonstrating compliance with the monitoring element of quality control by summarizing the results of the procedures in AAM section 10,200.86–.90 as they relate to the firm's quality control policies and procedures. Although the form and content of that documentation is a matter of judgment, the illustration in AAM section 10,200.91 is an example of such documentation.

.91

Table 1: Summary of Quality Control Monitoring System For the Calendar Year 200X

Element of Quality Control and Applicable Policies	*Reviewer's Initials and Date Reviewed*	*Location of Additional Documentation*
Independence, integrity, and objectivity		
Policy 1. Adhering to applicable independence, integrity, and objectivity 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 6/30/0X	Independence confirmation files
Policy 2. Establishing procedures to help mitigate possible threats to my independence and objectivity.	JB 6/30/0X	Independence confirmation files
Personnel management		
Policy 1. 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 should 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. Also, monitoring for compliance the CPE requirements of per diem employees.	JB 6/30/0X	Personnel files

Element of Quality Control and Applicable Policies	*Reviewer's Initials and Date Reviewed*	*Location of Additional Documentation*
Acceptance and continuance of clients and engagements		
Policy 1. Evaluating factors that have a bearing on management's integrity.	JB 6/30/0X	Client acceptance files and client engagement files
Policy 2. Accepting or continuing to perform only those engagements I can complete with professional competence, and appropriately considering the risk associated with providing professional services in particular circumstances.	JB 6/30/0X	Engagement files
Policy 3. Establishing an understanding with the client regarding services to be performed.	JB 6/30/0X	Engagement files
Engagement performance		
Policy 1. Planning engagements to meet professional standards and the firm's requirements.	JB 6/30/0X	Engagement files
Policy 2. Performing, supervising, reviewing, documenting, and reporting (or communicating) in accordance with the requirements of professional standards and the firm.	JB 6/30/0X	Engagement files
Policy 3. Identifying areas and specialized situations for which consultation is necessary, and requiring personnel to refer to authoritative literature and practice aids, and consult, on a timely basis, with individuals outside the firm when appropriate.	JB 6/30/0X	Engagement files
Monitoring		
Policy 1. Considering and evaluating, on an ongoing basis, the relevance and adequacy of my quality control policies and procedures.	JB 6/30/0X	Inspection/monitoring file
Policy 2. Considering and evaluating, on an ongoing basis, the appropriateness of my guidance materials and practice aids.	JB 6/30/0X	Inspection/monitoring file
Policy 3. Considering and evaluating, on an ongoing basis, the effectiveness of professional development activities.	JB 6/30/0X	Inspection/monitoring file
Policy 4. Considering and evaluating, on an ongoing basis, compliance with my policies and procedures, and with professional standards.	JB 6/30/0X	Inspection/monitoring file

Chapter 5

SYSTEM OF QUALITY CONTROL FOR AN ALTERNATIVE PRACTICE STRUCTURE

.92 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. Alternative practice structures are described in Interpretation No. 101-14, "The Effect of Alternative Practice Structures on the Applicability of Independence Rules," under Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 1, ET sec. 101.16), and is included in AAM section 10,280. The closely aligned CPA Firm has no Securities and Exchange Commission (SEC) clients.[18] This chapter describes quality control policies and procedures relevant to alternative practice structures when certain portions of the CPA firm's system of quality control:

- Reside at the non-CPA-owned entity, or
- Operate in conjunction with the system of quality control of the non-CPA-owned entity.

Elements of quality control that might reside in a non-CPA-owned entity include:

- Independence, integrity, and objectivity requirements.
- Personnel management.
- Monitoring.

This chapter describes quality control policies and procedures that should reside in the non-CPA-owned entity or its affiliated companies, and are related to:

- Independence, integrity, and objectivity
- Personnel management.
- The monitoring of independence, integrity, objectivity, and personnel management.

Independence, Integrity, and Objectivity

.93 The objective of the *Independence, Integrity, and Objectivity* element of a system of quality control is to provide the firm with reasonable assurance that personnel maintain independence (in fact and in appearance) in all required circumstances, perform all professional responsibilities with integrity, and maintain objectivity in discharging professional responsibilities. 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 section 10,200.94–.96.

.94 Policy 1: The non-CPA-owned entity adheres to applicable independence, integrity, and objectivity 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. The non-CPA-owned entity implements this policy by:

- Developing policies and procedures to ensure the independence of the CPA firm as required by the applicable aforementioned regulators. (The non-CPA 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.)

---

[18] 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.

- Designating an officer to be responsible for providing guidance, answering questions, monitoring compliance, and resolving matters concerning independence, integrity, and objectivity of the CPA firm.
- Determining when consultation with outside sources regarding independence, integrity, and objectivity matters is required.
- Reviewing written representations from direct and indirect superiors[19] 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 the CPA firm a current list of all entities with which firm personnel are prohibited from having a business relationship[20]
- Obtaining written representations from personnel of the non-CPA-owned entity, upon hire and on an annual basis, stating that they are familiar with and in compliance with the non-CPA-owned entity's policies and procedures regarding independence, integrity, and objectivity.

.95 **Policy 2: Personnel of the non-CPA-owned entity are familiar with policies and procedures regarding independence, integrity, and objectivity.** The non-CPA-owned entity implements this policy by:

- Providing all of its personnel with access to its policies and procedures and guidance materials related to independence, integrity, and objectivity, for example, manuals, memoranda, and databases containing professional and regulatory literature.
- Advising personnel of the non-CPA-owned entity that the following financial or other relationships, circumstances, or activities involving either individuals or entities may be prohibited:
  - — Business relationships with the CPA firm's clients or with non-clients that have investor or investee relationships with the CPA firm's clients.
  - — Loans to and from the CPA firm's clients, including loans from the CPA firm's financial-institution clients.
  - — Family members who are employed by the CPA firm's clients, or who serve as director, officer, manager, or in other audit-sensitive positions with clients of the CPA firm, including not-for-profit organizations.
  - — Past due fees from the CPA firm's clients.
  - — Services in which the service provider assumes some of the responsibilities of client management.
  - — Performing bookkeeping services for Securities and Exchange Commission (SEC) clients of the CPA firm.

---

[19] 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.

[20] Examples of business relationships prohibited by independence standard-setting bodies such as the AICPA, U.S. Government Accountability Office (GAO; formerly the General Accounting Office), and U.S. Department of Labor (DOL) because they might impair independence include being an investor in a joint venture with a client, or serving as a board member on the board of an audit client.

- — Client relationships with the non-CPA-owned entity in which the CPA firm leases employees, facilities, and so on.
- — Situations in which personnel of the non-CPA-owned entity act as promoters, underwriters, voting trustees, directors, or officers of the CPA firm's clients.
- — Direct and material financial interests in clients of the CPA firm.
- — Material investments by the CPA firm's clients in the non-CPA-owned entity that allow the clients to exercise significant influence over the non-CPA-owned entity.

- Advising personnel of the non-CPA-owned entity during professional development meetings, in memoranda, or in electronic communications of:
  - — All direct superiors, and all activities in which the firm is prohibited from engaging, as defined in the firm's independence policies and procedures.[21]
  - — All indirect superiors, and all activities in which the firm is prohibited from engaging, as defined by the non-CPA-owned entity's policies and procedures.
- Obtaining client lists from the CPA firm to inform all personnel, on a timely basis, of clients of the CPA firm to which independence policies apply.
- Obtaining documented representations from all non-CPA-entity personnel, including those defined as direct and indirect superiors or supervisors of affiliated issuers,[22] upon hire and on an annual basis thereafter, stating that they are familiar with and in compliance with policies and procedures regarding independence, integrity, and objectivity.
- Assigning responsibility for obtaining, maintaining, and reviewing those representations for completeness, and resolving reported exceptions with the non-CPA-owned entity's chief executive.
- Requiring the chief executive of the non-CPA-owned entity to review unpaid fees from clients of the CPA firm to ascertain whether any outstanding amounts impair the CPA firm's independence.

.96 Policy 3: The *top-tier company*[23] maintains a system of quality control to ensure that its personnel and indirect superiors[24] adhere to all applicable independence, integrity, and objectivity 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. The non-CPA-owned entity implements this policy by:

- Designating an individual to be responsible for:
  - — Designing and directing the quality control activities at the top-tier company and disseminating information to all subsidiaries and affiliated entities, all subsidiaries associated with CPA firms, and all CPA firms closely aligned with company subsidiaries.
  - — Maintaining documentation of the resolution of all independence, integrity, and objectivity questions.
  - — Identifying significant shareholders qualifying as indirect superiors, and obtaining a comprehensive list of entities with which the indirect superiors are associated.

---

[21] Examples of business relationships prohibited by independence standard-setting bodies such as the AICPA, GAO, and DOL because they might impair independence include being an investor in a joint venture with a client that is material to the client, or serving as a board member on the board of an audit client. Examples of prohibited activities include providing certain valuation and information technology services to an audit client. Readers should refer to the rules of specific standard-setters to determine the extent and relevance of any prohibition.

[22] 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.

[23] The top-tier company is the parent company of the non-CPA-owned entity, which may be an issuer.

[24] Indirect superiors generally are involved in regional management of direct superiors; thus, they need to adhere to requirements.

— Comparing the names of the indirect superiors and their associated entities with the list of attest clients of CPA firms closely aligned with company subsidiaries to ensure that such individuals or associated companies are not receiving attest services from associated CPA firms.

— Ensuring that indirect superiors review lists of all attest clients of CPA firms closely aligned with company subsidiaries, and represent their independence.

— Reviewing all independence representations and resolving conflicts noted on those representations.

- Providing all company personnel and indirect superiors with access to the company's policies and procedures with respect to independence, integrity, and objectivity.
- Maintaining a database, accessible to all company personnel including direct and indirect superiors, of affiliated issuers and clients of CPA firms that are issuers and are closely aligned with the company or its subsidiaries.
- Obtaining written representations from all leased or per diem personnel[25] and indirect superiors of companies that provide leased or per diem personnel, upon hire and on an annual basis, stating that they are familiar with and in compliance with the non-CPA-owned entity's policies and procedures regarding independence, integrity, and objectivity and that they are independent with respect to the associated CPA firm's attest clients.
- Providing the CPA firm with a representation that all leased or per diem personnel and indirect superiors are independent with respect to the CPA firm's attest clients.

Personnel Management

.97 The objective of the *Personnel Management* element of a system of quality control is to provide the non-CPA-owned entity with reasonable assurance that leased or per diem personnel have the characteristics that will enable them to competently perform their assigned responsibilities for the CPA firm. Attributes or qualities that enhance the capability of personnel who perform, supervise, or review work include integrity, objectivity, intelligence, judgment, competence, experience, and motivation. A CPA firm 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 AAM section 10,200.98–.100 with regard to its leased or per diem personnel.

.98 **Policy 1: Leased or per diem personnel possess characteristics that enable them to competently perform and review engagements.** The non-CPA-owned entity implements this policy by:

- Designating an individual to be responsible for hiring and managing human resources on behalf of the CPA firm.
- Reviewing the CPA firm's personnel requirements for attest engagements to ensure that sufficient and capable staff persons are available to perform those engagements.
- Establishing criteria for hiring professionals on behalf of the CPA firm that include the attributes, achievements, and experiences desired in entry-level and experienced personnel. Such criteria should assist in evaluating (*a*) the personal characteristics of professionals, such as, integrity, competence, and motivation, and (*b*) whether professionals can competently perform responsibilities within the CPA firm. Guidelines should be established for the additional procedures to be performed when hiring experienced personnel, such as performing background checks and inquiring about any outstanding regulatory actions.

[25] Leased or per diem personnel are professional personnel who devote at least 25 percent of their time to performing attest engagements, or who have partner- or manager-level responsibility for the overall supervision or review of such engagements.

- Establishing criteria for determining which individuals will be involved in interviewing and hiring personnel on behalf of the CPA firm.

.99 **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.** The non-CPA-owned entity implements this policy by:

- Designating an individual to be responsible for CPE and professional development activities, including maintaining CPE records and course material for leased and per diem personnel.
- Establishing policies that require individuals performing audits, reviews, compilations, or attestation engagements for the 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 devote at least 25 percent of their time to performing audits, reviews, compilations, or attestation engagements for the 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 the 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.

.100 **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 the CPA firm.** The non-CPA-owned entity implements this policy by:

- Establishing a system for providing information to the 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:
  - — 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 the CPA firm and the individual, and discussing assignment preferences.
  - — Periodically evaluating owners of the 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 the CPA firm in which a supervisory-level individual of the CPA firm is responsible for assisting the 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

.101 The objective of the monitoring element of a system of quality control is to provide the firm with reasonable assurance that the policies and procedures relating to the other elements of quality control are suitably designed and effectively applied. Monitoring is an ongoing consideration and evaluation process. A CPA firm 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 AAM section 10,200.102–.103.

.102 **Policy 1: The non-CPA-owned entity considers and evaluates, on an ongoing basis, the relevance and adequacy of its policies and procedures related to independence, integrity, and objectivity which are applicable to all its personnel, and its personnel management policies and procedures applicable to leased or per diem personnel.** The non-CPA-owned entity implements this policy by designating qualified individuals to be responsible for monitoring quality assurance, including:

- Ensuring that the 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 by:
  - — 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 the non-CPA-owned entity and compliance with those policies and procedures.
  - — Ensuring, on an ongoing basis, that guidance materials and any practice aids the non-CPA-owned entity provides to the CPA firm are appropriately designed to assist the 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 the non-CPA-owned entity are updated to reflect current professional standards and regulatory requirements, and are relevant to and effective for the CPA firm's practice.
  - — Ensuring that the 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 CPA firm policies or practice aids.

.103 **Policy 2: The non-CPA-owned entity considers and evaluates, on an ongoing basis, compliance with its policies and procedures related to independence, integrity, and objectivity which are applicable to all of its personnel, as well as personnel management policies and procedures applicable to leased or per diem personnel.** The non-CPA-owned entity implements this policy by having the designated qualified individuals responsible for monitoring:

- Consider and evaluate, on an ongoing basis, compliance with policies and procedures related to independence, integrity, and objectivity, as applicable to all of its personnel, by:
  - — Performing timely monitoring of policies and procedures, on an on-going basis, relating 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 the non-CPA-owned entity.
- — Correcting noted deficiencies based on the results of the monitoring to ensure compliance with policies and procedures.

- Engage an independent CPA to report on whether the top-tier company complied with its system of quality control with respect to its policies and procedures for independence, integrity, and objectivity. This engagement should be an attestation engagement performed annually under Statement on Standards for Attestation Engagements , (AICPA, *Professional Standards*, vol. 1, AT section 101). See Policy 3 in AAM section 10,200.96 for information about quality control policies and procedures at the top-tier firm.

.104

Glossary of Selected Terms

Accounting and auditing practice (attest practice). A practice that performs audit, attest, 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 (AICPA, *Professional Standards*, vol., ET secs. 201.01 and 202.01). 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.

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. Except for purposes of applying Rule 101: *Independence*, (AICPA, *Professional Standards*, vol. 2, ET sec. 101) the firm includes the individual partners thereof.

Foreign-associated firm. 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.

Issuer. 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."

Partner. A proprietor, shareholder, equity, or non-equity partner or any individual who assumes the risks and benefits of firm ownership or who is otherwise held out by the firm to be the equivalent of any of the aforementioned.

Personnel. All individuals who perform professional services for which the firm is responsible, whether or not they are CPAs.

Policy. A definite course or method of action to guide and determine present and future decisions. It is a guide to decision making under a given set of circumstances within the framework of a firm's objectives, goals, and management philosophies.

Practitioner-in-charge. An individual who is responsible for supervising accounting, auditing, and attestation engagements and signing or authorizing an individual to sign the accountant's report on such engagements.

Procedure. A particular way of accomplishing something, an established way of doing things, a series of steps followed in a definite regular order. It provides for a consistent and repetitive approach to actions.

Terms Related to Alternative Practice Structures

For additional information about these terms, see Interpretation No. 101-14 of Rule 101, Independence, *"The Effect of Alternative Practice Structures on the Applicability of Independence Rules" (AICPA, Professional Standards, vol. 1, ET sec. 101.16), reprinted in AAM section 10,280.*

Alternative practice structure. 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 owned and controlled by CPAs. The nonattest portion is conducted through a separate issuer or nonissuer firm owned and controlled by individuals who are not CPAs.

Direct superiors. Those persons so closely associated with a partner or manager who is a covered member,[26] 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. 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.

Leased or per diem personnel. Professional personnel who devote at least 25 percent of their time to attest functions, or who have partner- or manager-level responsibility for the overall supervision or review of attest engagements.

Nonattest portion of the practice. All services other than audit, attest, compilation, review, and other services performed under standards established by the AICPA Auditing Standards Board or the AICPA Accounting and Review Services Committee pursuant to Rules 201 or 202 of the AICPA Code of Professional Conduct.

Non-CPA-owned entity. An entity with which a CPA firm is closely aligned through common employment, leasing of employees, equipment, facilities, or other similar arrangements.

Top-tier company. The parent company of a non-CPA-owned entity, which may be an issuer.

[*The next page is 10,261.*]

[26] The term *covered member* is defined in AICPA Code of Professional Conduct, *Definitions* (AICPA, *Professional Standards*, vol. 1, ET sec. 92.06). A covered member is:

a. An individual on the attest engagement team;

b. An individual in a position to influence the attest engagement;

c. A partner or manager who provides nonattest services to the attest client beginning once he or she provides ten hours of nonattest services to the client within any fiscal year and ending on the later of the date (i) the firm signs the report on the financial statements for the fiscal year during which those services were provided or (ii) he or she no longer expects to provide ten or more hours of nonattest services to the attest client on a recurring basis;

d. A partner in the office in which the lead attest engagement partner primarily practices in connection with the attest engagement;

e. The firm, including the firm's employee benefit plans; or

f. 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 (*a*) through (*e*) or by two or more such individuals or entities if they act together.

AAM Section 10,250
Statements on Quality Control Standards

Statements on Quality Control Standards 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.

Statement on Quality Control Standards No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (QC Section 20), as Amended

.01

(Supersedes Statement on Quality Control Standards No. 1 and its interpretations)

Introduction and Applicability

.01 This Statement provides that a CPA firm shall have a system of quality control for its accounting and auditing practice and describes elements of quality control and other matters essential to the effective design, implementation, and maintenance of the system.

.02 The AICPA Principles of Professional Conduct provide, among other things, that "members should practice in firms that have in place internal quality-control procedures to ensure that services are competently delivered and adequately supervised."[1] Because of the public interest in the services provided by and the reliance placed on the objectivity and integrity of CPAs, this section provides that a CPA firm shall have a system of quality control for its accounting and auditing practice.[2]

[1] AICPA Code of Professional Conduct, "Article VI—Scope and Nature of Services" (AICPA, *Professional Standards*, vol. 1, ET sec. 57.03).

[2] *Accounting and auditing practice* refers to all audit, attest, accounting and review, and other services for which standards have been established by the AICPA Auditing Standards Board or the AICPA Accounting and Review Services Committee under rule 201 or 202 of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 1, ET secs. 201 and 202). Standards may also be established by other AICPA senior technical committees; engagements that are performed in accordance with those standards are not encompassed in the definition of an accounting and auditing practice.

System of Quality Control

.03 A firm[3] as a responsibility to ensure that its personnel[4] comply with the professional standards applicable to its accounting and auditing practice. A system of quality control is broadly defined as a process to provide the firm with reasonable assurance that its personnel comply with applicable professional standards and the firm's standards of quality.[5] The policies and procedures designed to implement the system in one segment of a firm's practice may be the same as, different from, or interrelated with the policies and procedures designed for another segment, but the purpose of the system is the same for all segments of a firm's practice.

[3] A *firm* is defined in the AICPA Code of Professional Conduct as "a form of organization permitted by state law or regulation whose characteristics conform to resolutions of Council that is engaged in the practice of public accounting, including the individual owners thereof" (AICPA, *Professional Standards*, vol. 1, ET sec. 92.05).

[4] The term *personnel* refers to all individuals who perform professional services for which the firm is responsible, whether or not they are CPAs.

[5] Deficiencies in individual audit, attest, review, and compilation engagements do not, in and of themselves, indicate that the firm's system of quality control is insufficient to provide it with reasonable assurance that its personnel comply with applicable professional standards.

.04 A firm's system of quality control encompasses the firm's organizational structure and the policies adopted and procedures established to provide the firm with reasonable assurance of complying with professional standards. The nature, extent, and formality of a firm's quality control policies and procedures should be appropriately comprehensive and suitably designed in relation to the firm's size, the number of its offices, the degree of authority allowed its personnel and its offices, the knowledge and experience of its personnel, the nature and complexity of the firm's practice, and appropriate cost-benefit considerations.

.05 Any system of quality control has inherent limitations that can reduce its effectiveness. Variance in an individual's performance and understanding of (*a*) professional requirements or (*b*) the firm's quality control policies and procedures affects the degree of compliance with a firm's prescribed quality control policies and procedures and, therefore, the effectiveness of the system.

.06 The system of quality control should provide the firm with reasonable assurance that the segments of the firm's engagements performed by its foreign offices or by its domestic or foreign affiliates or correspondents are performed in accordance with professional standards in the United States when such standards are applicable.

Quality Control Policies and Procedure

Elements of Quality Control

.07 The quality control policies and procedures applicable to a firm's accounting and auditing practice should encompass the following elements:

a. Independence, Integrity, and Objectivity

b. Personnel Management

c. Acceptance and Continuance of Clients and Engagements

d. Engagement Performance

e. Monitoring

.08 The elements of quality control are interrelated. For example, the maintenance of *Integrity, Objectivity*, and, where required, *Independence* requires a continuing assessment of client relationships. Similarly, the element of *Personnel Management* encompasses criteria for professional development, hiring, advancement, and assignment of the firm's personnel to engagements, which affect policies and procedures developed to meet the objectives of the quality control element of *Engagement Performance*. Similarly, policies and procedures for the quality control element of *Monitoring* are established to provide the firm with reasonable assurance that the policies and procedures related to each of the other elements of quality control are suitably designed and are being effectively applied.

Independence, Integrity, and Objectivity

.09 Policies and procedures should be established to provide the firm with reasonable assurance that personnel maintain independence (in fact and in appearance) in all required circumstances,[6] perform all professional responsibilities with integrity, and maintain objectivity in discharging professional responsibilities.

[6] Independence requirements are set forth in Rule 101 of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 101) and the rules of applicable regulatory agencies such as state boards of accountancy, the Securities and Exchange Commission, the U.S. General Accounting Office, and the U.S. Department of Labor.

.10 *Independence, Integrity,* and *Objectivity* are defined and more fully described in the AICPA Code of Professional Conduct (the Code) and AU section 220, *Independence* (AICPA, *Professional Standards*, vol. 1). Rules 101 and 102 of the Code, and the related Interpretations and Rulings (ET sections 101, 102, *Integrity and Objectivity*, and 191, *Ethics Rulings on Independence, Integrity, and Objectivity*) contain examples of instances wherein a member's independence, integrity, and objectivity will be considered to be impaired. *Independence* encompasses an impartiality that recognizes an obligation for fairness not only to management and owners of a business but also to those who may otherwise use the firm's report. The firm and its personnel must be free from any obligation to or interest in the client, its management, or its owners.[7] Integrity requires personnel to be honest and candid within the constraints of client confidentiality. Service and the public trust should not be subordinated to personal gain and advantage. *Objectivity* is a state of mind and a quality that lends value to a firm's services. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest.

[7] See AU section 220.02, *Independence* (AICPA, *Professional Standards*, vol. 1).

Personnel Management

.11 A firm's quality control system depends heavily on the proficiency of its personnel. In making assignments, the nature and extent of supervision to be provided should be considered. Generally, the more able and experienced the personnel assigned to a particular engagement, the less direct supervision is needed.

.12 The quality of a firm's work ultimately depends on the integrity, objectivity, intelligence, competence, experience, and motivation of personnel who perform, supervise, and review the work. Thus, a firm's personnel management policies and procedures factor into maintaining such quality.

.13 *Personnel Management* encompasses hiring, assigning personnel to engagements, professional development, and advancement activities. Accordingly, policies and procedures should be established to provide the firm with reasonable assurance that—

a. Those hired possess the appropriate characteristics to enable them to perform competently.

b. Work is assigned to personnel having the degree of technical training and proficiency required in the circumstances.

c. Personnel participate in general and industry-specific continuing professional education and other professional development activities that enable them to fulfill responsibilities assigned, and satisfy applicable continuing professional education requirements of the AICPA and regulatory agencies.[8]

d. Personnel selected for advancement have the qualifications necessary for fulfillment of the responsibilities they will be called on to assume.

[8] Regulatory agencies that have established continuing education requirements include state boards of accountancy and the U.S. General Accounting Office. [*now the U.S. Government Accountability Office*].

Acceptance and Continuance of Clients and Engagements

.14 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 firm with reasonable assurance that the likelihood of association with a client whose management lacks integrity is minimized. Establishing such policies and procedures does not imply that a firm vouches for the integrity or reliability of a client, nor does it imply that a firm has a duty to any person or entity but itself with respect to the acceptance, rejection, or retention of clients. However, prudence suggests that a firm be selective in determining its client relationships and the professional services it will provide.

.15 Such policies and procedures should also provide reasonable assurance that the firm—

a. Undertakes only those engagements that the firm can reasonably expect to be completed with professional competence.

b. Appropriately considers the risks associated with providing professional services in the particular circumstances.

.16 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.

Engagement Performance

.17 Policies and procedures should be established to provide the firm with reasonable assurance that the work performed by engagement personnel meets applicable professional standards, regulatory requirements, and the firm's standards of quality.

.18 Policies and procedures for *Engagement Performance* encompass all phases of the design and execution of the engagement. To the extent appropriate and as required by applicable professional standards, these policies and procedures should cover planning, performing, supervising, reviewing, documenting, and communicating the results of each engagement. Where applicable, these policies and procedures should also address the concurring partner review requirements applicable to SEC engagements as set forth in membership requirements of the SEC Practice Section of the AICPA.

.19 Policies and procedures should also be established to provide reasonable assurance that personnel refer to authoritative literature or other sources and consult, on a timely basis, with individuals within or outside the firm, when appropriate (for example, when dealing with complex, unusual, or unfamiliar issues). Individuals consulted should have appropriate levels of knowledge, competence, judgment, and authority. The nature of the arrangements for consultation depends on a number of factors, including the size of the firm and the levels of knowledge, competence, and judgment possessed by the persons performing the work.

Monitoring

.20 Policies and procedures should be established to provide the firm with reasonable assurance that the policies and procedures established by the firm for each of the other elements of quality control described in paragraphs .07–.19 are suitably designed and are being effectively applied.[9] *Monitoring* involves an ongoing consideration and evaluation of the—

a. Relevance and adequacy of the firm's policies and procedures.

b. Appropriateness of the firm's guidance materials and any practice aids.

c. Effectiveness of professional development activities.

d. Compliance with the firm's policies and procedures. When monitoring, the effects of the firm's management philosophy and the environment in which the firm practices and its clients operate should be considered.

---

[9] See section 30.

Administration of a Quality Control System

.21 To provide reasonable assurance that the firm's quality control system achieves its objectives, appropriate consideration should be given to the assignment of quality control responsibilities within the firm, the means by which quality control policies and procedures are communicated, and the extent to which the policies and procedures and compliance therewith should be documented.

Assignment of Responsibilities

.22 Responsibility for the *design* and *maintenance* of the various quality control policies and procedures should be assigned to an appropriate individual or individuals in the firm. In making that assignment, consideration should be given to the proficiency of the individuals, the authority to be delegated to them, and the extent of supervision to be provided. However, all of the firm's personnel are responsible for *complying* with the firm's quality control policies and procedures.

Communication

.23 A firm should communicate its quality control policies and procedures to its personnel in a manner that provides reasonable assurance that those policies and procedures are understood and complied with. The form and extent of such communications should be sufficiently comprehensive to provide the firm's personnel with an understanding of the quality control policies and procedures applicable to them. In addition, a firm should establish a means of communicating its established quality control policies and procedures, and the changes thereto, to appropriate personnel on a timely basis.

Documentation of Quality Control Policies and Procedures

.24 The size, structure, and nature of the practice of the firm should be considered in determining whether documentation of established quality control policies and procedures is required for effective communication and, if so, the extent of such documentation. 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. Although communication ordinarily is enhanced if it is in writing, the effectiveness of a firm's system of quality control is not necessarily impaired by the absence of documentation of established quality control policies and procedures.

Documentation of Compliance With Quality Control Policies and Procedures

.25 A firm should prepare appropriate documentation to demonstrate *compliance* with its policies and procedures for the quality control system discussed herein. The form and content of such documentation is a matter of judgment and depends on a number of factors, such as the size of a firm, the number of offices, the degree of authority allowed its personnel and its offices, the nature and complexity of the firm's practice, its organization, and appropriate cost-benefit considerations. Documentation should be retained for a period of time sufficient to enable those performing monitoring procedures and a peer review to evaluate the extent of the firm's compliance with its quality control policies and procedures.

Effective Date

.26 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, 1997.

Statement on Quality Control Standards No. 3, *Monitoring a CPA Firm's Accounting and Auditing Practice* (QC Section 30)

.02

Introduction

.01 This section provides guidance on how a CPA firm implements the monitoring element of a quality control system in its accounting and auditing practice.[1]

[1] *Accounting and auditing practice* refers to all audit, attest, accounting and review, and other services for which standards have been established by the AICPA Auditing Standards Board or the AICPA Accounting and Review Services Committee under rule 201 or 202 of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 1, ET sections 201 and 202). Standards may also be established by other AICPA senior technical committees; engagements that are performed in accordance with those standards are not encompassed in the definition of an accounting and auditing practice.

.02 Statement on Quality Control Standards No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (AICPA, *Professional Standards*, vol. 2, QC sec. 20), describes *Monitoring* as one of the five elements of quality control. It provides that a CPA firm[2] should establish policies and procedures to provide the firm with reasonable assurance that the policies and procedures relating to each of the other elements of quality control are suitably designed and are being effectively applied. Monitoring involves an ongoing consideration and evaluation of the—

a. Relevance and adequacy of the firm's policies and procedures.

b. Appropriateness of the firm's guidance materials and any practice aids.

c. Effectiveness of professional development activities.

d. Compliance with the firm's policies and procedures.

When monitoring, the effects of the firm's management philosophy and the environment in which the firm practices and its clients operate should be considered.

[2] A *firm* is defined in the AICPA Code of Professional Conduct as "a form of organization permitted by state law or regulation whose characteristics conform to resolutions of Council that is engaged in the practice of public accounting, including the individual owners thereof" (ET section 92.05).

Monitoring Procedures

.03 Monitoring procedures taken as a whole should enable the firm to obtain reasonable assurance that its system of quality control is effective. Procedures that provide the firm with a means of identifying and communicating circumstances that may necessitate changes to or the need to improve compliance with the firm's policies and procedures contribute to the monitoring element. A firm's monitoring procedures may include—

- Inspection procedures. (See paragraphs .04–.07.)
- Preissuance or postissuance review of selected engagements. (See paragraphs .08 and .09.)
- Analysis and assessment of—
  - — New professional pronouncements.
  - — Results of independence confirmations.
  - — Continuing professional education and other professional development activities undertaken by firm personnel.[3]
  - — Decisions related to acceptance and continuance of client relationships and engagements.
  - — Interviews of firm personnel.
- Determination of any corrective actions to be taken and improvements to be made in the quality control system.
- Communication to appropriate firm personnel of any weaknesses identified in the quality control system or in the level of understanding or compliance therewith.
- Follow-up by appropriate firm personnel to ensure that any necessary modifications are made to the quality control policies and procedures on a timely basis.

[3] The term *personnel* refers to all individuals who perform professional services for which the firm is responsible, whether or not they are CPAs.

.04 Inspection procedures evaluate 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 its quality control policies and procedures. Inspection procedures contribute to the monitoring function because findings are evaluated and changes in or clarifications of quality control policies and procedures are considered.

.05 The need for and extent of inspection procedures depends in part on the existence and effectiveness of the other monitoring procedures. Factors to be considered in determining the need for and extent of inspection procedures include, but are not limited to—

- The nature, complexity, and diversity of, and the risks associated with, the firm's practice.
- The firm's size, number of offices, degree of authority allowed its personnel and its offices, and organizational structure.
- The results of recent practice reviews[4] and previous inspection procedures.
- Appropriate cost-benefit considerations.[5]

---

[4] Practice reviews include, but are not limited to, peer reviews performed under standards established by the AICPA and reviews conducted by regulatory agencies.

[5] Although appropriate cost-benefit considerations may be considered in determining the need for and extent of inspection procedures, a firm must still effectively *monitor* its practice.

.06 The nature of inspection procedures will vary based on the firm's quality control policies and procedures and the effectiveness and results of other monitoring procedures. The adequacy of and compliance with a firm's quality control system are evaluated by performing such inspection procedures as—

- Review of selected administrative and personnel records pertaining to the quality control elements.
- Review of engagement working papers, reports, and clients' financial statements. (See also paragraphs .08–.09)
- Discussions with the firm's personnel.
- Summarization of the findings from the inspection 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 inspection 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.

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[6] responsible for the conduct of its accounting and auditing practice.

---

[6] The term *management-level individual* refers to all owners of a firm and other individuals within the firm with a managerial position as described in Interpretation 101-9 of the Code of Professional Conduct.

.07 Inspection procedures may be performed at a fixed time(s) during the year covering a specified period(s) of time or as part of ongoing quality control procedures, or a combination thereof.

.08 Procedures for carrying out preissuance or postissuance review of engagement working papers, reports, and clients' financial statements by a qualified management-level individual (or by a qualified individual under his or her supervision) may be considered part of the firm's monitoring procedures provided that those performing or supervising such preissuance or postissuance reviews are *not directly associated with the performance of the engagement*. Such preissuance or postissuance review procedures may constitute inspection procedures provided—

a. The review is sufficiently comprehensive to enable the firm to assess compliance with all applicable professional standards and the firm's quality control policies and procedures.

b. Findings of such reviews that may indicate the need to improve compliance with or modify the firm's quality control policies and procedures are periodically summarized, documented, and communicated to the firm's management personnel having the responsibility and authority to make changes in those policies and procedures.

c. The firm's management personnel consider on a timely basis the systemic causes of findings that indicate improvements are needed and determine appropriate actions to be taken.

d. The firm implements on a timely basis such planned actions, communicates changes to personnel who might be affected, and follows up to determine that the planned actions were taken.

A preissuance and, except as described in paragraph .09, a postissuance review of engagement working papers, reports, and clients' financial statements by the person with final responsibility for the engagement does not constitute a monitoring procedure.

.09 In small firms with a limited number of qualified management-level individuals, postissuance review of engagement working papers, reports, and clients' financial statements by the person with final responsibility for the engagement may constitute inspection procedures, provided the provisions in paragraph .08*a–d* are followed. (See also paragraph .11.)

Monitoring in Small Firms With a Limited Number of Management-Level Individuals

.10 In small firms with a limited number of management-level individuals, 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. To effectively monitor one's own compliance with the firm's policies and procedures, an individual must 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.

.11 The performance of inspection procedures in firms with a limited number of management-level individuals can assist the firm in the monitoring process. An individual inspecting his or her own compliance with a quality control system may be inherently less effective than having such compliance inspected by another qualified individual. When one individual inspects his or her own compliance, the firm may have a higher risk that noncompliance with policies and procedures will not be detected. Accordingly, a firm in this circumstance may find it beneficial to engage a qualified individual from outside the firm to perform inspection procedures.

The Relationship of Peer Review to Monitoring

.12 A peer review does not substitute for 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 some or all of its inspection procedures for the period covered by the peer review.

Effective Date

.13 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, 1997.

Statement on Quality Control Standards No. 5, *The Personnel Management Element of a Firm's System of Quality Control—Competencies Required By a Practitioner-in-Charge of an Attest Engagement* (QC Section 40)

.03

Introduction

.01 Statement on Quality Control Standards No. 2, provides that a CPA firm shall have a system of quality control for its accounting and auditing practice[1] that should encompass the following elements:

a. Independence, integrity, and objectivity

b. Personnel management

c. Acceptance and continuance of clients and engagements

d. Engagement performance

e. Monitoring

---

[1] *Accounting and auditing practice* refers to all accounting, audit, and attestation services for which standards have been established by the AICPA Auditing Standards Board or the AICPA Accounting and Review Services Committee under Rule 201 or 202 of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 1, ET sections 201 and 202). Standards may also be established by other AICPA senior technical committees; engagements that are performed in accordance with those standards are not encompassed in the definition of an accounting, auditing, and attestation practice.

The Personnel Management Element of Quality Control

.02 *Personnel Management* encompasses hiring, assigning personnel to engagements, professional development, and advancement activities. Accordingly, policies and procedures should be established to provide the firm with reasonable assurance that—

a. Those hired 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.

b. Work is assigned to personnel having the degree of technical training and proficiency required in the circumstances.

c. Personnel participate in general and industry-specific continuing professional education and other professional development activities that enable them to fulfill responsibilities assigned, and satisfy applicable continuing professional education requirements of the AICPA, and regulatory agencies.[2]

d. Personnel selected for advancement have the qualifications necessary for fulfillment of the responsibilities they will be called on to assume.

---

[2] Regulatory agencies that have established continuing education requirements include state boards of accountancy and the U.S. General Accounting Office. [*now the U.S. Government Accountability Office*].

.03 This section clarifies the requirements of the personnel management element of a firm's system of quality control. In light of the significant responsibilities during the planning and performance of accounting, auditing, and attestation engagements of individuals who are responsible for supervising accounting, auditing, and attestation engagements and signing or authorizing an individual to sign the accountants report on such engagements, a firm's policies and procedures related to the items noted in paragraph .02 above should be designed to provide a firm with reasonable assurance that such individuals possess the kinds of competencies that are appropriate given the circumstances of individual client engagements. For purposes of this standard, such an individual is referred to as the practitioner-in-charge of the engagement.

Competencies

.04 Competencies are the knowledge, skills, and abilities that enable a practitioner-in-charge to be qualified to perform an accounting, auditing, or attestation engagement. A firm is expected to determine the kinds of competencies that are necessary in the individual circumstances. Competencies are not measured by periods of time because such a quantitative measurement may not accurately reflect the kinds of experiences gained by a practitioner in any given time period. Accordingly, for purposes of this section, a measure of overall competency is qualitative rather than quantitative.

Gaining Competencies

.05 A firm's policies and procedures would ordinarily require a practitioner-in-charge of an engagement to gain the necessary competencies through recent experience in accounting, auditing, and attestation engagements. In some cases, however, a practitioner-in-charge will have obtained the necessary competencies through disciplines other than the practice of public accounting, such as in relevant industry, governmental, and academic positions. If necessary, the experience of the practitioner-in-charge should be supplemented by continuing professional education (CPE) and consultation. The following are examples.

- A practitioner-in-charge of an engagement 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.
- A practitioner-in-charge of an engagement who did not have any experience in auditing the financial statements of a public company and only possessed recent prior experience in auditing the financial statements of nonpublic entities may develop the necessary competencies by obtaining relevant CPE related to SEC rules and regulations and consulting with other practitioners who possess relevant knowledge related to SEC rules and regulations.
- A practitioner-in-charge of an engagement who did not have any experience in auditing the financial statements of a public company but possessed prior public accounting practice experience auditing financial statements of nonpublic entities and who also has relevant experience as the controller of a public company may have the necessary competencies in the circumstances.
- A practitioner-in-charge of an engagement whose actual 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 continuing professional education relating to auditing, and/or using consulting sources during the course of performing the audit engagement.
- A person in academia might obtain the necessary competencies to perform accounting, auditing or attestation engagements by (*a*) obtaining specialized knowledge through teaching or authorship of research projects or similar papers, and (*b*) a rigorous self-study program or by engaging a consultant to assist on such engagements.

.06 Regardless of the manner in which a particular competency is gained, a firm's quality control policies and procedures should be adequate to provide reasonable assurance that a practitioner-in-charge of an engagement possesses the competencies necessary to fulfill his or her engagement responsibilities.

.07 The nature and extent of competencies established by a firm that are expected of the practitioner-in-charge of an engagement should be based on the characteristics of a particular client, industry, and the kind of service being provided. For example, the following should be considered.

- The competencies expected of a practitioner-in-charge of 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 what would be expected in performing attest services for clients in other industries.
- The practitioner-in-charge of an engagement to audit the financial statements of a public company would be expected to have certain technical proficiency in SEC reporting requirements, while a practitioner-in-charge who is not assigned to the audits of public companies would not need to be proficient in this area. This would include, for example, experience in the industry and appropriate knowledge of SEC and ISB rules and regulations, including accounting and independence standards.
- The practitioner-in-charge of 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 certain technical proficiency in understanding and evaluating the effectiveness of controls, while a practitioner-in-charge of 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.

Competencies Expected in Performing Accounting, Auditing, and Attestation Engagements

.08 In practice, the kinds of competency requirements that a firm should establish for the practitioner-in-charge of an engagement are necessarily broad and varied in both their nature and number. However, the firm's quality control policies and procedures should ordinarily address the following competencies for the practitioner-in-charge of an engagement. Firms policies and procedures should also address other competencies as necessary in the circumstances.

a. *Understanding of the Role of a System of Quality Control and the Code of Professional Conduct*—Practitioners-in-charge of an engagement should possess 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 accountant's reports.

b. *Understanding of the Service to Be Performed*—Practitioners-in-charge of an engagement should possess an understanding of the performance, supervision, and reporting aspects of the engagement, which is normally gained through actual participation in that kind of engagement under appropriate supervision.

c. *Technical Proficiency*—Practitioners-in-charge of an engagement should possess an understanding of the applicable accounting, auditing, and attest 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.

d. *Familiarity With the Industry*—To the extent required by professional standards applicable to the kind of service being performed, practitioners-in-charge of an engagement should possess an understanding of the industry in which a client operates. 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.

e. Professional Judgment—Practitioners-in-charge of an engagement should possess skills that indicate sound professional judgment. In performing an audit or review of financial statements, 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 necessary in the circumstances.

f. Understanding the Organization's Information Technology Systems—Practitioners-in-charge of an audit engagement should have an understanding of how the organization is dependent on or enabled by information technologies; and the manner in which information systems are used to record and maintain financial information.

Interrelationship of Competencies and Other Elements of a Firm's System of Quality Control

.09 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.

.10 In establishing policies and procedures related to the nature of competencies needed by the practitioner-in-charge of an engagement, a firm may need to consider the requirements of policies and procedures established for other elements of quality control. For example, a firm would consider its requirements related to engagement performance in determining the nature of any competency requirements that assess 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 Personnel Management Element of Quality Control

.11 The Uniform Accountancy Act (UAA) is a model legislative statute and related administrative rules that the AICPA and the National Association of State Boards of Accountancy (NASBA) designed to provide a uniform approach to the regulation of the accounting profession. CPAs are not required to follow the provisions of the UAA itself but rather the accountancy laws of the individual licensing jurisdictions in the United States governing the practice of public accounting, which may have adopted the UAA in whole or in part. 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 this competency requirement; however, this section's applicability is broader than what is required by the UAA since the definition of an accounting and auditing practice in quality control standards encompasses a wider range of attest engagements.

Effective Date

.12 The provisions of this section are applicable to a CPA firm's system of quality control for its accounting and auditing practice as of June 30, 2000. Earlier implementation is encouraged.

[*The next page is 10,281.*]

AAM Section 10,280

Interpretation No. 101-14 of Rule 101, Independence

Interpretation No. 101-14 of Rule 101, *Independence*: "The Effect of Alternative Practice Structures on the Applicability of Independence Rules" (ET Section 101.16)

.01

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* (AICPA, *Professional Standards*, vol. 1, ET sec. 505.01). In complying with laws, regulations, and Rule 505 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 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 (for example, 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 (AICPA, *Professional Standards*, vol. 1, ET sec. 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.

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 (for example, through another entity over which the Direct Superior can exercise significant influence)[22] 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* [23] *are subject to Rule 101 and its interpretations and rulings in their entirety.*

[22] 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 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.

[23] 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 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. *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.

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 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 (for example, investments, loans or both) 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 [24] 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 and its interpretations and rulings in their entirety.

---

[24] 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 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.

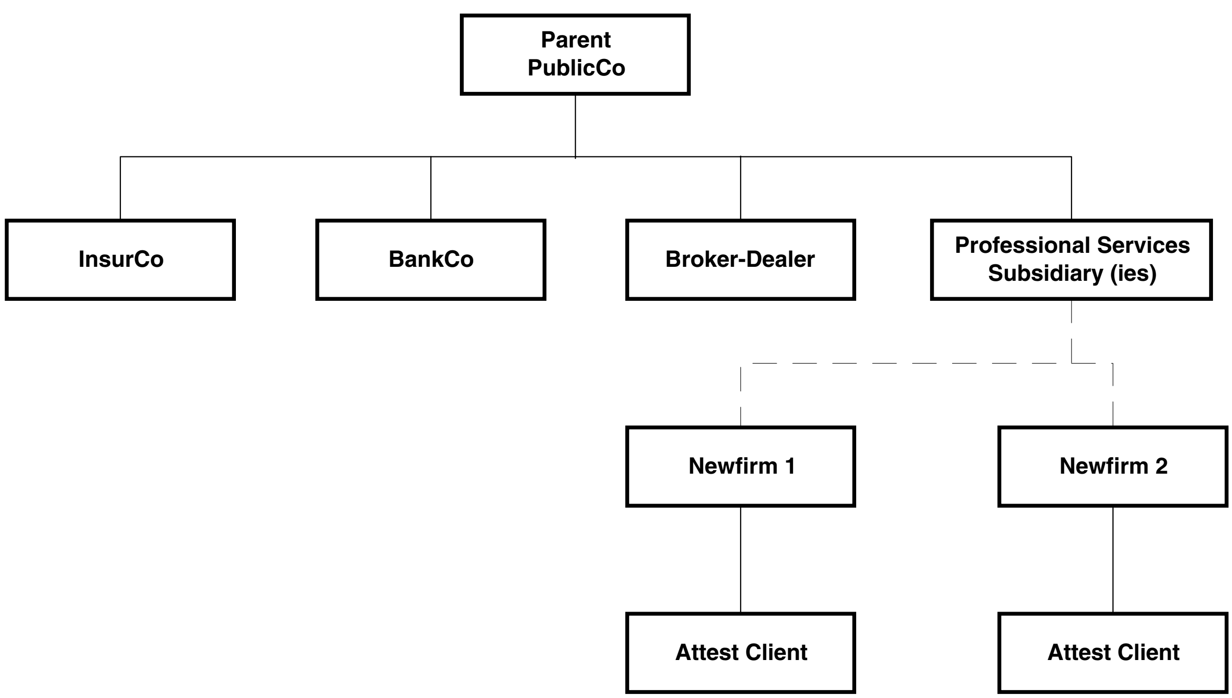
Other Matters

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[25] over PublicCo.

[25] 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 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* (AICPA, *Professional Standards*, vol. 1, ET sec. 102.03).

Alternative Practice Structure (APS) Model



[*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, e.g., year*] then ended.	_____	_____
2. We are aware that [*Name of primary auditor*] plans to rely on our audit of the financial statements of [*Name of subsidiary or component*] as of [*Date*] and for the [*period, e.g., year*] then ended.	_____	_____
3. [We are aware that the primary auditor will refer to our report in their report.]	_____	_____
4. We are independent with respect to [*Name of both the parent and subsidiary or component*.]	_____	_____

____ ____

Partner of other audit firm Date

Reviewed by:

____

Partner of primary audit firm

.03 Scheduling Request

Client ______________________ Engagement No. __________ Year End __________

Partner ______________________ Manager ______________ Tax Ptr/Mgr ________

Personnel Requested	Experience Level	Interim			Year End			Total Hours
		From	Thru	Hours	From	Thru	Hours	

Audited? Yes______ No ______

SEC? Yes______ No ______

Reviewed? Yes______ No ______

Compiled? Yes______ No ______

Attestation? Yes______ No ______

Industry ______________________

Estimated total hours:

Partner ______________

Manager ______________

Staff ______________

Total

Can dates be adjusted? Yes _____ No ______ Explain ______________

Can personnel be changed? Yes _____ No ______ Explain ______________

Comments ____

Requested by ______________ Date __________ Scheduled __________ Date _______

Assignment Manager

.04 History of Staff Assignments

NAME ____________________________

	DATES			ASSIGNMENT DESCRIPTION				
CLIENT/ LOCATION	INTERIM	YEAR END	RESPONSIBILITY LEVEL	TOTAL HOURS	INDUSTRY	SEC	AUDIT AREAS PERFORMED	REPORTED TO

.05 Client History of Personnel Assigned

CLIENT ______________________________ LOCATION ______________

YEAR ENDING ______________ AUDITED? YES_______ NO _______ SEC? YES_________ NO __________

FISCAL YEAR	HOURS		ENTER NAMES AND CHARGEABLE HOURS FOR THE YEAR							
	INTERIM	YEAR END	PARTNER	MANAGER	SENIOR	IN-CHARGE	STAFF	STAFF	STAFF	STAFF

.06 Scheduling Master Plan

MONTH OF ______

			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 ____________ ☐ Agency ____________ ☐ Friend ____________ ☐ Other ____________
NAME NAME NAME NAME

EDUCATIONAL BACKGROUND — ☐ See Below ☐ See Attached Resume

	NAME & LOCATION OF SCHOOL	MAJOR COURSE	YEARS ATTENDED		YEAR GRAD.
			FROM	TO	
Elementary					
High or Vocational					
Business or Technical					
College					
Graduate					

ADDITIONAL SKILLS OR MACHINE KNOWLEDGE ☐ See Below ☐ See Attached Resume

Note: See 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 forty hours or more.]

Name ______________________________ Classification ______________

Client ______________________________ From ________ To __________

Describe work assigned: ____

____

____

In your opinion based on the staff member's classification, should this assignment be considered:

Demanding ☐ Routine ☐

This individual is ☐ is not ☐ ready for increased responsibility. Explain ____________________

____

Rating: Enter comments which describe the staff member's performance on this engagement. Rate the staff member on each of the items below as Outstanding (O), Very High (VH), Good (G), Below Normal (BN), or Not Applicable (NA).

[Support each caption with specific incidents or remarks.]

Technical Knowledge: Did the staff member possess adequate knowledge to function effectively at the level assigned? Did this knowledge encompass accounting principles, auditing standards, and tax accounting? Has the staff member kept current on recent developments and new pronouncements on professional practice matters as they affected this engagement?

	O	VH	G	BN	NA
Rating:	☐	☐	☐	☐	☐

____

____

____

Analytical Ability and Judgment: How well did the staff member recognize problems, develop relevant facts, formulate alternative solutions, and decide on appropriate conclusions? Did the staff member distinguish between material and immaterial items? Was the staff member practical in adapting theory and experience to the individual circumstances of this client?

	O	VH	G	BN	NA
Rating:	☐	☐	☐	☐	☐

____

____

____

Written and Oral Expression: Evaluate the effectiveness of the staff member's letters, memoranda, and other forms of written communication. In conversation, did the staff member communicate intentions effectively? Were instructions understood the first time? Did the staff member sell ideas, obtain acceptance and action?

	O	VH	G	BN	NA
Rating:	☐	☐	☐	☐	☐

____

____

____

Note: See the AICPA MAP Handbook for alternatives.

Performance: Can you depend on the staff member for sustained, productive work? Were assignments organized and completed accurately in a reasonable amount of time? Did the staff member readily assume responsibility? Did the staff member meet time estimates and document work papers properly?

O VH G BN NA
Rating: ☐ ☐ ☐ ☐ ☐

____
____
____

Development of Personnel: In assigning work, did the in-charge member make the most effective use of available talent in terms of getting the work done and in terms of developing staff members performing the work? Did the in-charge staff member tend to make assignments which were either too easy or too hard for his subordinates? Was the staff member readily accepted as a leader? Was the staff member effective in on-the-job coaching?

O VH G BN NA
Rating: ☐ ☐ ☐ ☐ ☐

____
____
____

Client Relations: How well did the staff member relate to this client and gain his acceptance? How well did the staff member recognize and take advantage of practice development opportunities, through extension of services to this client?

O VH G BN NA
Rating: ☐ ☐ ☐ ☐ ☐

____
____
____

Attitude: Did the staff member demonstrate a positive and professional approach to the assignment? Was this demonstrated by sustained effort in completing work? Was the assignment undertaken with enthusiasm and zest? Did the staff member respond in a positive way to suggestions and guidance from superiors? To what degree did the staff member make personal sacrifices to meet client requirements? Was the staff member a helpful member of the team? Did the staff member go out of his way to help an associate?

O VH G BN NA
Rating: ☐ ☐ ☐ ☐ ☐

____
____
____

Personal Characteristics: Did the staff member possess self-confidence and was this confidence projected in an acceptable way? Were positive impressions created with this client and with associates? Did the staff member have a keen sense of what to do or say (tact)? Were clothes appropriate to professional work? Was the staff member well groomed?

O VH G BN NA
Rating: ☐ ☐ ☐ ☐ ☐

____
____
____

Strong points which were evident: ____

____

____

____

____

Recommendations for improvement: ____

____

____

____

____

Comments of Staff Member Being Evaluated: ____

____

____

____

____

Signatures:

Evaluated staff member ____ Date __________

Evaluator ____ Title ______________ Date __________

Engagement manager ____ Date __________

Partner ____ Date __________

.15

JOB EVALUATION REPORT
[For Assignments of Thirty (30) Hours or More]

Name ____
Location ____
Engagement ____
Assistant ____________________ In-Charge ________________

	Compared to Others in Peer Group							
	A	A-	B+	B	B-	C+	C	
	SUPERIOR	EXCELLENT	ABOVE AVERAGE	SATISFACTORY	IMPROVEMENT DESIRED	IMPROVEMENT REQUIRED	UNSATISFACTORY	NOT APPLICABLE
A. PERFORMANCE ON THE JOB								
1. *Technical Ability Demonstrated*								
a) The purpose of the audit procedures planned was understood								
b) Materiality was neither underestimated nor overestimated								
c) Accounting theory and current releases of the profession were applied correctly								
d) Federal and state income tax regulations were applied correctly								
2. *Working Paper Evidence*								
a) Documentation of work performance, including adequate indexing and cross referencing								
b) Sound explanations and conclusions								
c) Use of standard work papers								
d) Legibility								
e) Accuracy — absence of mathematical errors								
3. *Completing This Job*								
a) Meeting planned time estimates								
b) Completing reports and tax returns								
c) Following up the reviewer's comments and making the necessary changes								
4. *Client Reaction on This Job*								
a) Getting along with the client's employees								
b) Interest in the client's business								
B. ENGAGEMENT ADMINISTRATION — (For In-Charge Accountants Only)								
1. *Effectiveness of Proper Planning*								
a) Extent that the scope of the work related to internal control								
b) Developing the work program								
2. *Utilizing Staff Effectively and Efficiently*								
a) Advance planning to minimize crises								
b) Efficient use of staff on the job								
c) On-the-job training of assistants								
3. *Meeting Deadlines*								
a) Completing the engagement in the planned time								
b) Delivering completed pencil copies of the report and tax returns to the supervisor as agreed								
4. *The Product*								
a) Quality of report preparation, including adequate and informative disclosures								
b) Quality of the management advice recommendations								
5. *Practice Management*								
a) Extending service								
b) Ease of collecting for services performed								

.16

Knowledge and Skill Form

(and Profile of Management Role Performance)

________________________________ Staff member evaluated

________________________________ Date

________________________________ Evaluator

Indicate most effective and least effective roles by placing a check in the far left or right hand column (maximum of two each). For the other five traits, indicate relative strength of staff member by placing a check in columns 2, 3, or 4.

(Circle at least two but not more than four in each section and indicate the effectiveness of each trait.)

			If you wish, add your own words.	Effectiveness: Least 1	2	3	4	Most 5
Planner								
Careful	Sloppy	Thorough						
Imaginative	Foresighted	Infrequent						
Routine	Erratic	Last-minute						
Constant	Cautious	Meticulous						
Problem solver								
Analytical	Consistent	Superficial						
Critical	Faulty	Routine						
Hasty	Creative	Reliable						
Slow	Quick	Successful						
Communicator								
Warm	Sloppy	Cold						
Inhibited	Weak	Unstructured						
Thorough	Receptive	Patient						
Expressive	Efficient	Precise						
Leader								
Dominating	Excitable	Partial						
Uncertain	Permissive	Energetic						
Weak	Fair	Heavy-handed						
Loose	Amiable	Sure						
Decision maker								
Decisive	Lone	Delayer						
Slow	Avoider	Reliable						
Quick	Seldom	Participative						
Frequent	Rash	Dependent						
Trainer								
Systematic	Unprepared	Conscientious						
Patient	Efficient	Knowledgeable						
Sloppy	Diligent	Disinterested						
Off-on	Slow	Enthusiastic						
Team member								
Cooperative	Unreliable	Independent						
Influential	Divisive	Undisciplined						
Conformist	Reliable	Contributing						
Forceful	Reluctant	Welcome						
Innovator								
Original	Appropriate	Consistent						
Infrequent	Clever	Sensible						
Unnecessary	Creative	Unimaginative						
Constant	Disruptive	Rash						
Job expertise								
Amateur	Improving	Too technical						
Obsolete	Mediocre	Disinterested						
Masterful	Balanced	Lagging						
Versatile	Up-to-date	Thorough						

(Complete Annually)

.17 Employee Annual Performance Appraisal

Time Period Involved			
From	To		☐ EXEMPT
			☐ NON-EXEMPT

Name	Position Title	Number

Hire Date	Present Position Date	Days Absent From: ____________ To: _______ Charged To Sick Time: ______________ Disability: ______________

Strengths	Development Needs
	Suggested Plan for Performance Improvement

Summary

Overall Rating on Having Met Job Requirements	
Non-Exempt - Circle One	Exempt - Circle One
1 2 3	1 2 3 4 5
1 = Did Not Meet Job Requirements	1 = Did Not Meet Job Requirements 2 = Met Most
2 = Met All 3 = Exceeded	3 = Met All 4 = Exceeded 5 = Far Exceeded

Review the following questions before answering them, using the following criteria:

- A "yes" answer should be considered for possible mention as a "strength". If so, refer to it on the first page of this evaluation.
- A "no" answer should be considered for possible mention as a "development need". If so, refer to it on the first page of this evaluation.

All answers should be considered in arriving at an overall rating on having met job requirements.

	CHECK AS APPROPRIATE				
	Strength	Yes	N/A	No	Development Need
Quality of Work					
Is work accurate, neat and clearly presented?	( )	( )	( )	( )	( )
Carefully planned, well organized and thorough?	( )	( )	( )	( )	( )
Productivity					
Is a good level of production maintained?	( )	( )	( )	( )	( )
Are deadlines met?	( )	( )	( )	( )	( )
Are pressure situations handled effectively?	( )	( )	( )	( )	( )
Knowledge of Job					
Does the individual know where to get information?	( )	( )	( )	( )	( )
Is the individual used as a source of information by others?	( )	( )	( )	( )	( )
Communication					
Does the individual ask for clarification when necessary?	( )	( )	( )	( )	( )
Does the individual respond to others in a manner that indicates understanding?	( )	( )	( )	( )	( )
Are ideas expressed so that others are able to understand them?	( )	( )	( )	( )	( )
Human Relations					
Does the individual cooperate with others to get the job done?	( )	( )	( )	( )	( )
Does the individual demonstrate tact and courtesy in dealing with others?	( )	( )	( )	( )	( )
Does the individual maintain a good working relationship with all others?	( )	( )	( )	( )	( )
Are questions and requests dealt with in a helpful manner?	( )	( )	( )	( )	( )
Need for Supervision					
Can the individual be relied upon to get work done without close supervision?	( )	( )	( )	( )	( )
Does the individual take the initiative when appropriate?	( )	( )	( )	( )	( )
Problem Solving					
Does the individual collect the data needed to solve problems?	( )	( )	( )	( )	( )
Are problems solved quickly?	( )	( )	( )	( )	( )
Are solutions reasonable and accurate?	( )	( )	( )	( )	( )

	CHECK AS APPROPRIATE				
	Strength	Yes	N/A	No	Development Need
Problem Solving—cont'd					
Does the individual know when to ask for advice and whom to ask?	( )	( )	( )	( )	( )
Does the individual seek out methods to do work more efficiently?	( )	( )	( )	( )	( )
Are alternate solutions generated when appropriate?	( )	( )	( )	( )	( )
Work Habits					
Does the individual comply with the Institute's established work hours?	( )	( )	( )	( )	( )
Does the individual provide proper notification when absent from work?	( )	( )	( )	( )	( )
Personal Development					
Does the individual try to expand on required knowledge and skills?	( )	( )	( )	( )	( )
Does the individual readily grasp and master the new job requirements?	( )	( )	( )	( )	( )
Does the individual show ambition by building on strengths and working on deficiencies?	( )	( )	( )	( )	( )
Is the individual a good candidate for promotion?	( )	( )	( )	( )	( )
Is the individual ready for promotion at this time?	( )	( )	( )	( )	( )
Supervisory Capabilities					
Does the individual demonstrate the ability to direct and be responsible for the performance of others?	( )	( )	( )	( )	( )
Does the individual effectively evaluate and develop subordinates?	( )	( )	( )	( )	( )
Are subordinates properly motivated?	( )	( )	( )	( )	( )
Are subordinates given reasonable goals and aided in meeting them?	( )	( )	( )	( )	( )
Does the individual comply with administrative and policy guidelines of ________?	( )	( )	( )	( )	( )
Is good judgment exercised in observing budget constraints?	( )	( )	( )	( )	( )
Does the individual maintain adequate discipline in regard to subordinates attendance and punctuality?	( )	( )	( )	( )	( )
Does the individual provide a good example for peers and subordinates to follow?	( )	( )	( )	( )	( )

INCUMBENT REVIEW COMMENTS & ACKNOWLEDGEMENT
I acknowledge that: (1) I have reviewed and discussed this performance appraisal with the preparer. My signature means that I have been advised of my performance evaluation but does not necessarily imply that I agree with it; (2) I have received a copy of the goals/duties that will be used to evaluate my performance during the coming year; and (3) I have reviewed my job description and do ☐ do not ☐ feel it should be revised. My signature and the date I discussed this with the preparer appears below.

Employee	Date

Evaluator/Title	Date

.18 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 ______________________			
	Reviewed		
Monitoring Procedure	By	**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").

.21

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						

Reprinted from *Journal of Accountancy*, Copyright © 1997 by AICPA (updated to reflect the issuance of recent authoritative literature, June 1998).

[*The next page is 20,001*.]

AAM TOPICAL INDEX

References are to section and paragraph numbers.

[*Reserved*.]