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Technical Practice Aids

As of June 1, 2014

- > Technical Questions and Answers (Nonauthoritative)
- > PCAOB Staff Questions and Answers and Other Implementation Guidance
- > Trust Services Principles, Criteria, and Illustrations
- > Principles and Criteria for XBRL-Formatted Information
- > Statement of Position — Accounting
- > Issues Papers Listing of the Accounting Standards Division
- > Statements of Position — Auditing and Attestation



Technical Practice Aids

As of June 1, 2014



Technical Practice Aids

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PCAOB Staff Questions and Answers and Other Implementation Guidance
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CHANGES AFFECTING TECHNICAL PRACTICE AIDS

TECHNICAL QUESTIONS AND ANSWERS (NONAUTHORITATIVE)

<u>Section</u>	<u>Title</u>	<u>Status</u>
LIABILITIES AND DEFERRED CREDITS		
Contingent Liabilities		
3400.02	Disclosure of Agreement Between Corporation and Its Shareholders	Deleted
CAPITAL		
Stock Dividends and Stock Splits		
4150.01	Stock Dividends of Closely-Held Corporation	Deleted
REVENUE AND EXPENSE		
Revenue Recognition		
5100.38	Subsequent Event Related to Vendor-Specific Objective Evidence for Software Revenue Recognition	Deleted
5100.39	Software Revenue Recognition for Multiple-Element Arrangements	Deleted
5100.40	Software Revenue Recognition Related to Year 2000 Compliant Software	Deleted
5100.41	Effect of Prepayments on Software Revenue Recognition	Deleted
5100.42	Extended Payment Terms and Software Revenue Recognition	Deleted
5100.43	Corrections of Errors in Computer Software (Bug Fixes)	Deleted
5100.44	Postcontract Customer Support During the Deployment Phase of Computer Software	Deleted
5100.45	Effect of Change in License Mix on Software Revenue Recognition	Deleted
5100.46	Nonmonetary Exchanges of Software (Part I)	Deleted
5100.47	Nonmonetary Exchanges of Software (Part II)	Deleted
5100.48	Application of Contract Accounting in Software Arrangements (Part I)	Deleted

Changes Affecting *Technical Practice Aids*

<u>Section</u>	<u>Title</u>	<u>Status</u>
5100.49	Application of Contract Accounting in Software Arrangements (Part II)	Deleted
5100.50	Definition of More-Than-Insignificant Discount and Software Revenue Recognition	Deleted
5100.51	Accounting for Significant Incremental Discounts in Software Revenue Recognition	Deleted
5100.52	Fair Value of PCS in a Perpetual License and Software Revenue Recognition	Deleted
5100.53	Fair Value of PCS in a Short-Term Time-Based License and Software Revenue Recognition	Deleted
5100.54	Fair Value of PCS in a Multi-Year Time-Based License and Software Revenue Recognition	Deleted
5100.55	Fair Value of PCS With a Consistent Renewal Percentage (But Varying Renewal Dollar Amounts) and Software Revenue Recognition	Deleted
5100.56	Concessions and Software Revenue Recognition	Deleted
5100.57	Overcoming Presumption of Concessions in Extended Payment Term Arrangements and Software Revenue Recognition	Deleted
5100.58	Effect of Prepayments on Software Revenue Recognition (Part II)	Deleted
5100.59	Subsequent Cash Receipt in an Extended Payment Term Arrangement for Software Revenue Recognition	Deleted
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5100.62	Indicators of Incremental Risk and Their Effect on the Evaluation of Whether a Fee is Fixed or Determinable and Software Revenue Recognition	Deleted

Changes Affecting *Technical Practice Aids*

<u>Section</u>	<u>Title</u>	<u>Status</u>
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5100.64	Indicators of Vendor Participation in Customer Financing That Do Not Result in Incremental Risk and Software Revenue Recognition	Deleted
5100.65	Software Vendor Interest Rate Buy Downs on Customer Financing and Software Revenue Recognition	Deleted
5100.66	Consideration of Other TPAs on Customer Borrowing When Customer is a Reseller and Software Revenue Recognition	Deleted
5100.67	Customer Acceptance and Software Revenue Recognition	Deleted
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5100.74	Effect of Discounts on Future Products on the Residual Method and Software Revenue Recognition	Deleted

Changes Affecting *Technical Practice Aids*

<u>Section</u>	<u>Title</u>	<u>Status</u>
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AUDIT FIELD WORK

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8100.03	Using Current Auditing Standards for Audits of Prior Periods	Added
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Compilation and Review Engagements

9150.32	Modification to the Accountant's Compilation or Review Report When a Client Adopts a Private Company Council Accounting Alternative	Added
9150.33	Compilation or Review Report in Which Management Refuses to Include Disclosure Related to Adoption of a PCC Accounting Alternative	Added
9150.34	Modification to the Accountant's Compilation or Review Report When a Client Adopts a Private Company Council Accounting Alternative That Results in a Change to a Previously Issued Report	Added

Other Reporting Issues

9160.29	Modification to the Auditor's Report When a Client Adopts a PCC Accounting Alternative	Added
9160.30	Modification to the Auditor's Report When a Client Adopts a PCC Accounting Alternative That Results in a Change to a Previously Issued Report	Added

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Section 400—Staff Audit Practice Alerts

<u>Topic</u>	<u>Date</u>	<u>PC Section</u>
Staff Audit Practice Alert No. 11, <i>Considerations for Audits of Internal Control Over Financial Reporting</i>	October 24, 2013	400.11

STATEMENTS OF POSITION—AUDITING AND ATTESTATION
**Statements of Position—Auditing and Attestation,
Recently Added**

<u>Statement</u>	<u>Title</u>	<u>Addition Date</u>	<u>Section</u>
SOP 13-2	Performing Agreed-Upon Procedures Engagements That Address the Completeness, Mapping, Consistency, or Structure of XBRL-Formatted Information	September 2013	14,470

**Statements of Position—Auditing and Attestation,
Recently Removed**

<u>Statement</u>	<u>Title</u>	<u>Addition Date</u>	<u>Section</u>
SOP 09-1	Performing Agreed-Upon Procedures Engagements That Address the Completeness, Accuracy, or Consistency of XBRL- Tagged Data	April 2009	14,440

ADDITIONAL CHANGES

Technical Questions and Answers (Nonauthoritative)

Sections throughout Technical Questions and Answers have been revised to reflect conforming changes necessary due revisions to the FASB *Accounting Standards Codification*[®].

Trust Services Principles, Criteria, and Illustrations

A new section, TSP section 100, *Trust Services Principles and Criteria for Security, Availability, Processing Integrity, Confidentiality, and Privacy*, has been added. TSP section 100 replaces the 2009 version, which is now archived in new TSP section 100A, *Trust Services Principles, Criteria, and Illustrations for Security, Availability, Processing Integrity, Confidentiality, and Privacy—2009*.

The criteria in TSP section 100 are effective for periods ending on or after December 15, 2014, with earlier implementation permitted. TSP section 100A will retain the superseded material until March 31, 2016. The practitioner should identify which set of criteria was used for the report and assertion.

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HOW *TECHNICAL PRACTICE AIDS* IS ORGANIZED

Scope of *Technical Practice Aids*

Technical Practice Aids brings together the following:

- Selected AICPA Technical Questions and Answers (nonauthoritative)
- Public Company Accounting Oversight Board (PCAOB) Staff Guidance
- Trust Services Principles, Criteria, and Illustrations of the AICPA Assurance Services Executive Committee (ASEC)
- Principles and Criteria for XBRL-Formatted Information established by ASEC
- A listing of issues papers of the AICPA Accounting Standards Division
- Statements of Position of the AICPA Audit and Attest Standards Division

Special Note About Financial Accounting Standards Board *Accounting Standards Codification*[®]

The Financial Accounting Standards Board (FASB) released the FASB *Accounting Standards Codification* (ASC) on July 1, 2009. On its effective date, FASB ASC became the source of authoritative U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the Securities and Exchange Commission (SEC). FASB ASC significantly changes the way financial statement preparers, auditors, and academics perform accounting research.

FASB ASC flattens the U.S. generally accepted accounting principles (GAAP) hierarchy to two levels: one that is authoritative (in FASB ASC) and one that is nonauthoritative (not in FASB ASC). Exceptions include all rules and interpretive releases of the SEC under the authority of federal securities laws, which are sources of authoritative U.S. GAAP for SEC registrants, and certain grandfathered guidance having an effective date before March 15, 1992. The codification creates FASB ASC 105, *Generally Accepted Accounting Principles*.

Amendments to FASB ASC are now issued by FASB through Accounting Standards Updates (ASUs) and serve only to update FASB ASC. FASB does not consider the ASUs authoritative in their own right; such amendments become authoritative when they are incorporated into FASB ASC. The ASUs issued include the amendments to the codification and an appendix of FASB ASC update instructions. ASUs also provide background information about the amendments, and explain the basis for FASB's decisions. This method of updating the accounting guidance means that there will no longer be, for example, accounting standards in the form of statements, staff positions, Emerging Issues Task Force (EITF) abstracts, or AICPA Accounting Statements of Position (SOPs). ASUs are issued in the form of ASU No. 20YY-XX, in which "YY" is the last two digits of the year and "XX" is the sequential number for each update. For example, ASU No. 2011-01 is the first update in the year 2011. FASB organizes the contents of each ASU using the same section headings as those used in FASB ASC.

FASB ASC is a major restructuring of accounting and reporting standards designed to simplify user access to all authoritative U.S. GAAP by providing the

authoritative literature in a topically organized structure. FASB ASC disassembled thousands of nongovernmental accounting pronouncements (including those of FASB, the EITF, and the AICPA) and reassembled them under approximately 90 topics and included all accounting standards issued by a standard setter within levels A–D of the current U.S. GAAP hierarchy. FASB ASC also includes relevant portions of authoritative content issued by the SEC, as well as selected SEC staff interpretations and administrative guidance issued by the SEC; however, FASB ASC is not the official source of SEC guidance and does not contain the entire population of SEC rules, regulations, interpretive releases, and staff guidance. Moreover, FASB ASC does not include governmental accounting standards. FASB ASC is not intended to change U.S. GAAP or any requirements of the SEC.

FASB ASC uses a topical structure in which guidance is organized into *areas*, *topics*, *subtopics*, *sections*, and *subsections*. These terms are defined as follows:

Areas. The broadest category in FASB ASC and represent a grouping of topics.

Topics. The broadest categorization of related content and correlate with the International Accounting Standards (IASs) and International Financial Reporting Standards (IFRSs).

Subtopics. Represent subsets of a topic and are generally distinguished by type or scope.

Sections. Indicate the nature of the content such as recognition, measurement, or disclosure. The sections' structure correlates with the IASs and IFRSs.

Subsections. Allow further segregation and navigation of content.

Topics, subtopics, and sections are numerically referenced. This effectively organizes the content without regard to the original standard setter or standard from which the content was derived. An example of the numerical referencing is FASB ASC 305-10-05, in which 305 is the *Cash and Cash Equivalents* topic, 10 represents the "Overall" subtopic, and 05 represents the "Overview and Background" section.

FASB ASC represents a major shift in the organization and presentation of U.S. GAAP. Users are encouraged to read the notice to constituents, which explains the scope, structure, and usage of consistent terminology in FASB ASC. This document is available on the FASB website at <http://asc.fasb.org>. In addition to the notice, this link contains information on the options available for users to access the codification. FASB ASC is offered by FASB at no charge in a Basic View and for an annual fee in a Professional View. FASB ASC and the notice to constituents are also offered by certain third party licensees, including the AICPA.

To read more about FASB ASC, including recent developments and updates, see the AICPA's dedicated FASB ASC website at www.aicpa.org/InterestAreas/FRC/AccountingFinancialReporting/Pages/FASBAccountingStandardsCodification.aspx.

FASB ASC Effect on AICPA Literature Included in Technical Practice Aids

As noted previously, FASB ASC disassembled and reassembled thousands of nongovernmental accounting pronouncements (including those of FASB, the EITF, and the AICPA) and codified them under approximately 90 topics. FASB ASC reduces the U.S. GAAP hierarchy to two levels: one that is authoritative (in FASB ASC) and one that is not (not in FASB ASC). Those standards you have come to memorize through FASB Statement Nos., FASB Interpretation

Nos., accounting SOPs, and the like now reside in FASB ASC and have a FASB ASC reference for accountants to use. FASB ASC codifies all AICPA accounting SOPs and Practice Bulletins and also sections .38–.76 of TIS section 5100, *Revenue Recognition*.

Arrangement of Material in *Technical Practice Aids*

The material in *Technical Practice Aids* is arranged as follows:

Technical Questions and Answers (Nonauthoritative)

- Financial Statement Presentation

 - Assets

 - Liabilities and Deferred Credits

 - Capital

 - Revenue and Expense

 - Specialized Industry Problems

 - Specialized Organizational Problems

 - Audit Field Work

 - Auditors' Reports

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PCAOB Staff Guidance

- Select PCAOB Staff Questions and Answers

 - Staff Views

 - Staff Audit Practice Alerts

- Trust Services Principles, Criteria, and Illustrations

- Principles and Criteria for XBRL-Formatted Information

- Statement of Position—Accounting

- Issues Papers Listing of the Accounting Standards Division

- Statements of Position—Auditing and Attestation

Description of Content

The major divisions are divided into sections, each with its own section number. Each paragraph or equivalent is decimally numbered for reference purposes. With respect to Technical Questions and Answers, within each section, each question and answer is decimally numbered. For example, TIS section 9100.02 is the second question and answer in TIS section 9100, *Signing and Dating of Reports*. When a question and answer is deleted, its number is reserved. Reserved sections are deleted permanently if no future questions and answers are expected for a particular topic.

Authoritative pronouncements are referenced in the questions and answers, whenever possible, to support the guidance provided. The following list explains the references and cites the publications containing the authoritative literature:

- AR Accounting and Review Services standard or interpretation contained in AICPA *Professional Standards*

- AT Attestation standard or interpretation contained in *AICPA Professional Standards*
- AU-C¹ Clarified auditing standard or interpretation contained in *AICPA Professional Standards*
- AUD Statements of Position—Auditing and Attestation contained in *AICPA Technical Practice Aids*
- ET Section from the Code of Professional Conduct of the AICPA contained in *AICPA Professional Standards*
- TSP Trust Services Principles, Criteria, and Illustrations of ASEC contained in *AICPA Technical Practice Aids*

Note: Generally, abbreviations are not used to reference AICPA Audit and Accounting Guides. Each guide is published separately and is also included in the AICPA Audit and Accounting Guides subscription service.

The TIS Topical Index for Technical Information Service Questions and Answers uses the key word method to facilitate reference to the inquiries. This index is arranged alphabetically by subject, with references to section numbers.

PCAOB Staff Guidance sections are assigned section and decimal numbers in chronological order as they are issued. However, the format and any numbering assigned by the PCAOB has been retained.

The PC Topical Index for PCAOB Staff Guidance facilitates reference to the guidance. This index is arranged alphabetically by subject, with references to section, paragraph, and question numbers.

The Trust Services Principles, Criteria, and Illustrations are assigned section numbers in chronological order as they are issued. Each paragraph or equivalent is decimally numbered for reference purposes.

Statements of Position—Auditing and Attestation are assigned section numbers in chronological order as they are issued. Each paragraph or equivalent is decimally numbered for reference purposes.

[The next page is 11.]

¹ The “AU-C” identifier was established to avoid confusion with references to existing “AU” sections, which have been superseded and deleted from *Professional Standards* as of December 2013. The AU-C identifier was scheduled to revert back to the AU identifier at the end of 2013, by which time the previous AU sections would be superseded for all engagements. However, in response to user requests, the AU-C identifier will be retained indefinitely.

TECHNICAL QUESTIONS AND ANSWERS (NONAUTHORITATIVE)

Notice to Readers

The questions and answers in this section of *Technical Practice Aids* are not sources of established authoritative accounting principles as described in Financial Accounting Standards Board *Accounting Standards Codification*[™] and Governmental Accounting Standards Board Statement No. 55, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*, the authoritative sources of generally accepted accounting principles for nongovernmental and governmental entities, respectively. This material is based on selected practice matters identified by the staff of the AICPA's Technical Hotline and various other bodies within the AICPA and has not been approved, disapproved, or otherwise acted upon by any senior committee of the AICPA.

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TIS Section 1000

FINANCIAL STATEMENT PRESENTATION

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Section 1100

Statement of Financial Position

[.01] Reserved

[.02] Reserved

.03 Unclassified Balance Sheet for Venture With Limited Life

Inquiry—A corporation has recently been organized with the sole purpose of constructing a shopping center which will take several years to complete, after which the company will be liquidated. The company uses the completed contract method to recognize income, and will have only one operating cycle. Would an unclassified balance sheet be appropriate?

Reply—An unclassified balance sheet would be more appropriate than a classified one in this situation. The sole purpose of the corporation is to construct the shopping center, and the appropriate time frame for reporting purposes, by definition, becomes the time required to complete the project, rather than an arbitrary one-year period.

[.04] Reserved

[.05] Reserved

[.06] Reserved

.07 Comparative Statement Disclosures

Inquiry—When financial statements of the prior period are presented on a comparative basis with financial statements of the current period, should the notes to the comparative financial statements disclose details for the prior year?

Reply—Generally, in practice notes to comparative financial statements are also comparative if they present details of items on the financial statements or are otherwise pertinent. For example, details of notes payable outstanding at the end of each period are normally disclosed, but the future maturities disclosure need only be disclosed for the current year.

[Amended, June 1995.]

.08 Classification of Outstanding Checks

Inquiry—Should the amount of checks that have been issued and are out of the control of the payor but which have not cleared the bank by the balance sheet date be reported as a reduction of cash?

Reply—Yes. A check is out of the payor's control after it has been mailed or delivered to the payee. The balance sheet caption "cash" should represent an amount that is within the control of the reporting enterprise, namely, the amount of cash in banks plus the amount of cash and checks on hand and deposits in transit minus the amount of outstanding checks. Cash is misrepresented if outstanding checks are classified as liabilities rather than a reduction of cash.

[.09] Reserved

[.10] Reserved

[.11] Reserved

[.12] Reserved

[.13] Reserved

.14 Classification of Convertible Debt

Inquiry—A company has debt that is convertible into common stock of the company at the option of the company. The debt by its terms is considered long-term debt in the classified balance sheet. The company intends to call the debt and issue the common stock within one year of the balance sheet date. Should this debt be classified as a current liability?

Reply—No. The expected call of the debt securities will not consume current assets or increase current liabilities, and accordingly should continue to be classified as a long-term obligation.

The general principle underlying the classification of debt in a debtor's principal balance sheet should be based on facts existing at the date of the balance sheet rather than on expectations. According to Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary, the term *current liabilities* "is used principally to designate obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current liabilities."

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.15 Liquidity Restrictions

Inquiry—Entities may invest in assets such as money market funds or other short term investment vehicles from which they generally may withdraw funds at any time without prior notice or penalty, but for which the fund (or its trustee) may restrict the ability of an entity to withdraw its balance in the fund or other short term investment vehicle. In some circumstances, with little or no notice, the fund (or its trustee) may impose such withdrawal restrictions. For example, the fund (or its trustee), in accordance with the terms of the fund, may, with little or no notice, stipulate that up to 20 percent of the fund balance can be withdrawn immediately, an additional 30 percent can be withdrawn in 6 months, and the remaining balance can be withdrawn in 2 years.

What are the potential accounting and auditing implications of such an event for a nongovernmental entity (the event being restrictions on the ability of an entity to withdraw its balance in the money market fund or other short term investment vehicle)?

Reply—The following are examples of potential accounting and auditing issues that may be relevant if such an event exists. Each situation is different and should be evaluated based on its specific facts and circumstances:

Balance Sheet Classification. Such withdrawal restrictions should be considered in determining whether such assets meet the definition of *cash equivalents*. (This technical question and answer does not address whether such assets met the definition of *cash equivalents* prior to the imposition of such withdrawal restrictions.)

Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary provides a definition of *cash equivalents* for the purposes of applying FASB ASC 230, *Statement of Cash Flows*.

Such withdrawal restrictions should be considered in determining whether such assets meet the definition of *current assets*.

FASB ASC glossary defines *current assets* for balance sheet classification purposes.

For entities that do not prepare a classified balance sheet, such withdrawal restrictions should be considered in determining the sequencing of assets on the balance sheet or disclosures in the notes to financial statements providing relevant information about the liquidity or maturity of assets.

Disclosures. The entity may be required to provide financial statement disclosures about such events. For example, such events may create or lead to risks and uncertainties pertaining to certain significant estimates, such as measurement, liquidity, and violation of debt covenants, and vulnerability from concentrations of investments in volatile markets. Entities should consider whether they should make disclosures in their financial statements (beyond those required or generally made in financial statements) about the risks and uncertainties resulting from such events and existing as of the date of the financial statements. In addition, auditors should consider whether such disclosures include forward-looking statements that are not required by generally accepted accounting principles and therefore may not be audited.

FASB ASC 275, *Risks and Uncertainties*, provides guidance pertaining to disclosures about risks and uncertainties.

Debt Covenants. Such events may result in balance sheet classifications (balance sheet classifications are previously discussed) and other events that may trigger violations of debt covenants. If a covenant violation occurs, issuers of debt should consider whether that covenant violation triggers classification of the debt liability as current (or otherwise affects reported information about liquidity) or cross covenant violations in other arrangements.

FASB ASC glossary defines *current assets* and *current liabilities* for balance sheet classification purposes. FASB ASC 470-10-45-11 clarifies how the debtor should present obligations that are callable by the creditor in a balance sheet in which liabilities are classified as current or noncurrent.

Paragraphs 12A–12B of FASB ASC 470-10-45 provide guidance for the classification of short-term obligations that are expected to be refinanced on a long-term basis.

FASB ASC 470-10-45 and FASB ASC 470-10-55 address the classification of obligations at the balance sheet date that are not callable at the balance sheet date, but that become callable by violation of a debt agreement provision after the balance sheet date but before the financial statements are issued.

FASB ASC 470-10-45-2 and FASB ASC 470-10-50-3 provide guidance pertaining to balance sheet classification in circumstances in which debt agreements include subjective acceleration clauses.

Events Occurring Subsequent to the Balance Sheet Date. Events occurring subsequent to the balance sheet date, but prior to the issuance of the financial statements, such as significant changes in fair value or changes in liquidity leading to violation of debt covenants, may need to be reflected in the financial statements (either through adjustment to or disclosure in the financial statements).

AU-C section 560, *Subsequent Events and Subsequently Discovered Facts* (AICPA, *Professional Standards*), addresses the auditor's responsibilities relating to subsequent events and subsequently discovered facts in an audit of financial statements.

Going Concern. Certain events (some interrelated) could call into question the entity's ability to continue as a going concern. For example:

- The inability to withdraw funds can pose significant challenges to the entity's liquidity.
- As discussed earlier, balance sheet reclassifications or other events may trigger violations of debt covenants.

AU-C section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*), addresses the auditor's responsibilities in an audit of financial statements with respect to evaluating whether there is substantial doubt about the entity's ability to continue as a going concern.

AU-C section 260, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*), addresses the auditor's responsibility to communicate with those charged with governance.

Paragraph .06 of AU-C section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report* (AICPA, *Professional Standards*), requires that if the auditor considers it necessary to draw users' attention to a matter appropriately presented or disclosed in the financial statements that, in the auditor's professional judgment, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor should include an emphasis-of-matter paragraph in the auditor's report, provided that the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements. For example, the auditor may wish to refer, in the auditor's report, to financial statement disclosures about restrictions on liquidity pertaining to such events.

[Issue Date: October 2008; Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[The next page is 161.]

Section 1200

Income Statement

.01 Disclosure of Revenues of an Agent

Inquiry—Company A is in the business of arranging sales of used cars for which service it receives a commission based on an established fee schedule. Company A receives title to the cars sold but simultaneously transfers title to the car buyer. Company A warrants main engine components for thirty days after date of sale.

The following presentations of revenue in the income statement are being considered:

Commission Earned	<u>\$20,000</u>
or	
Sales	\$300,000
Cost of Sales	<u>(280,000)</u>
Gross Profit (or Net Commisions)	\$20,000

What is the proper presentation of revenue?

Reply—Since Company A is operating as a broker, Company A should report Commissions Earned rather than Sales. However, Company A could disclose above the Commissions Earned figure, without showing a deduction, the amount of sale, as follows:

Sales Arranged	<u>\$300,000</u>
Commissions Earned	\$20,000
Expenses, etc.	XXX

Company A should also make proper provision for the cost of warranties.

[.02] Reserved

[.03] Reserved

.04 Statement Title When There Is a Net Loss

Inquiry—What title is suggested for the “Statement of Income” when a “net loss” exists in one or more years?

Reply—Companies included in the annual survey entitled *Accounting Trends & Techniques* (“Trends”) file with the Securities and Exchange Commission. Accordingly, their annual reports include a three year statement of income. If a current year net loss is shown in the income statement, the “Trends” companies usually describe the statement of income as the “Statement of Operations.” They occasionally use the title “Statement of Income (Loss)” and very rarely use the title “Statement of Loss.”

Some companies always use “Statement of Operations” since the heading will be the same whether there is a “net loss” or “net income.”

.05 Presentation of Reimbursed Payroll Expense

Inquiry—One company of a controlled group, in addition to its own operations, acts as a “paymaster” for the entire group. This company records the entire payroll of all members in the group on its general ledger to facilitate reconciliation with state and federal payroll tax returns. Each member of the group reimburses the “paymaster” for its share of payroll and payroll taxes and records management fee expense while the paymaster records it as management fee income.

Should the reimbursement be classified as other income in the separate income statement of the “paymaster” company?

Reply—No. The reimbursement should be allocated as a reduction of payroll and payroll tax expense because this approach would more accurately present the “paymaster” company’s expenses for its own operations.

.06 Note to TIS Section 1200.07 to 1200.16—Accounting by Noninsurance Enterprises for Property and Casualty Insurance Arrangements That Limit Insurance Risk

Insurance enables a company (the insured) to transfer insurance risk to an insurer for a specified premium. Insurance may be purchased for a number of economic reasons generally with the underlying goal of transferring insurance risk, including property damage, injury to others, and business interruption.

The following series of questions and answers (Sections 1200.07–.16) focus on certain aspects of finite insurance products that are utilized by noninsurance enterprises. Due to the diverse nature of contracts in the marketplace, the guidance in these questions and answers is designed to assist practitioners in identifying the relevant literature to consider in addressing their specific facts and circumstances. The TPAs contain many excerpts of applicable guidance, but readers should be familiar with all the guidance contained in that literature not only the specific paragraphs listed.

GAAP guidance for an insurance enterprise’s purchase of reinsurance is more extensive than guidance on accounting by noninsurance enterprises for insurance contracts. The accounting guidance for reinsurance addresses transactions between an insurer (the contract holder) and a reinsurer (the issuer of the contract). TIS sections 1200.07–.16 address property and casualty insurance contracts between a policyholder and an insurance enterprise, which is similar to the relationship between an insurer and a reinsurer.

.07 Finite Insurance

Inquiry—What are “finite” insurance transactions?

Reply—Finite insurance contracts are contracts that transfer a clearly defined and restricted amount of insurance risk from the policyholder to the insurance company, and the policyholder retains a substantial portion of the related risks under most scenarios. Nevertheless, under certain finite contracts there may be a reasonable possibility that the insurance company will incur a loss on the contract.

.08 Insurance Risk Limiting Features

Inquiry—What types of insurance risk limiting features do finite insurance contracts normally contain?

Reply—Contractual features that serve to limit insurance risk transfer are found in both traditional and finite insurance contracts; however, the degree to which these features limit risk is relatively higher in finite insurance. All contractual provisions that limit risk transfer need to be considered when reviewing insurance contracts. Common features that may limit the transfer of insurance risk include:

- *Sliding scale fees and profit sharing formulae.* These features adjust cash flows between the policyholder and insurance company based on loss experience (for example, increasing payments from the insured enterprise as losses increase and decreasing payments as losses decrease, subject to maximum and minimum limits).
- *Experience refunds.* These arrangements allow the policyholder to share in the favorable experience of the underlying contracts by reference to an “experience account” that typically tracks premiums paid, less fees, less losses incurred, plus interest. Experience provisions also can require the policyholder to share in unfavorable experience by requiring additional payments to the insurer in the event that the experience account is negative.
- *Caps.* Caps are used to limit the insurer’s aggregate exposure by imposing a dollar limit, or a limit expressed as a percentage of premiums paid, on the amount of claims to be paid by the insurer. For example, the insurer will not be responsible for losses beyond 150 percent of the premiums paid. While commercial insurance policies usually have limits on the amount of coverage provided, there may be significant risk mitigation for the insurer if the premium paid is a substantial percentage of the maximum coverage provided.
- *Loss Corridors.* This feature, which may exist in various forms, serves to eliminate or limit the risk of loss for a specified percentage or dollar amount of claims within the contract coverage. For example, in a contract providing coverage for a policyholder’s first \$3,000,000 of losses, the insurer will pay the first million and last million of losses but will exclude the corridor from \$1,000,000 to \$2,000,000.
- *Dual-triggers.* This feature requires the occurrence of both an insurable event and changes in a separate pre-identified variable to trigger payment of a benefit/claim. An example is a policy entered into by a trucking company that insures costs associated with rerouting trucks over a certain time period if snowfall exceeds a specified level during that time period.
- *Retrospectively-Rated Premiums.* Such premiums are determined after the inception of the policy based on the loss experience under the policy.
- *Reinstatement Premiums.* To the extent the coverage provided by a contract is absorbed by losses incurred, the contract provides for the policyholder to reinstate coverage for the balance of the contract period for a stated additional premium. To the extent reinstatement is required rather than optional, the additional premium may mitigate risk to the insurer.
- *Termination Provisions.* These provisions can be structured to reduce the risk of the insurer, for example, by allowing for termination by the insurer at a discounted amount under certain circumstances.
- *Payment Schedules.* Features that delay timely reimbursement of losses by the insurer prevent the transfer of insurance risk.

There may be other features and provisions, in addition to the list of common insurance risk transfer limiting features above, that exist in a contract. Determining the appropriate accounting requires a full understanding of all of the features and provisions of the contract.

.09 Transfer of Insurance Risk

Inquiry—Why is transfer of insurance risk important under GAAP?

Reply—If a contract does not provide for the indemnification of the insured by the insurer, it is accounted for as a deposit (financing) rather than as insurance as noted in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 720-20-25-1.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.10 Accounting Guidance for Transfer of Insurance Risk

Inquiry—What GAAP accounting literature provides guidance related to transfer of insurance risk?

Reply—The assessment of transfer of insurance risk requires significant judgment and a complete understanding of the insurance contract and other related contracts between the parties. The greater the number and/or degree of insurance risk limiting features that exist in a contract, the more difficult it becomes to assess whether or not the insurance risk transferred is sufficient to permit the contract to be accounted for as insurance rather than as a deposit.

Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 720-20-25-1 provides the following guidance on insurance contracts that do not provide for indemnification of the insured by the insurer against loss or liability:

To the extent that an insurance contract or reinsurance contract does not, despite its form, provide for indemnification of the insured or the ceding entity by the insurer or reinsurer against loss or liability, the premium paid less the amount of the premium to be retained by the insurer or reinsurer shall be accounted for as a deposit by the insured or the ceding entity. Those contracts may be structured in various ways, but if, regardless of form, their substance is that all or part of the premium paid by the insured or the ceding entity is a deposit, it shall be accounted for as such.

FASB ASC 944, *Financial Services—Insurance*, establishes the conditions required for a contract between an insurer and a reinsurer to be accounted for as reinsurance and prescribes accounting and reporting standards for those contracts. FASB ASC 944-20-15-41 notes:

Unless the condition in paragraph 944-20-15-53 is met, indemnification of the ceding entity against loss or liability relating to insurance risk in reinsurance of short-duration contracts exists under paragraph 944-20-15-37(a) only if both of the following conditions are met:

- a. Significant insurance risk. The reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance contracts. Implicit in this condition is the requirement that both the amount and timing of the reinsurer's payments depend on and directly vary with the amount and timing of claims settled under the reinsured contracts.
- b. Significant loss. It is reasonably possible that the reinsurer may realize a significant loss from the transaction.

FASB ASC 944 looks to the present value of all cash flows between the parties, however characterized, under reasonably possible outcomes in determining whether it is reasonably possible that the reinsurer may realize a significant loss from the contract.

FASB ASC 720-20-25-2 suggests that noninsurance entities look to the risk transfer guidance in FASB ASC 944 and states, in part:

Entities may find the conditions in Section 944-20-15 useful in assessing whether an insurance contract transfers risk.

FASB ASC 944-20-25-1 states that a multiple-year retrospectively rated insurance contract must indemnify the insured as required by FASB ASC 944-20-15-36 to be accounted for as insurance. FASB ASC 944-20 also indicates that there may be certain situations in which the guarantee accounting in accordance with FASB ASC 460, *Guarantees*, is applicable.

FASB ASC 815, *Derivatives and Hedging*, addresses scenarios where there are dual-triggers and includes a number of relevant examples.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.11 Differences Between Retroactive and Prospective Insurance

Inquiry—What are the differences between retroactive and prospective insurance?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 944-605-05-7 states that for property and casualty insurance: The distinction between prospective and retroactive reinsurance contracts is based on whether the contract reinsures future or past insured events covered by the underlying contracts.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.12 Accounting for Prospective Insurance

Inquiry—How does a noninsurance enterprise account for prospective insurance contracts that qualify for insurance accounting?

Reply—A noninsurance enterprise amortizes the premiums over the contract period in proportion to the amount of insurance protection provided. If an insured loss occurs, and if it is probable that the policy will provide reimbursement for the loss and the amount of the loss can be reasonably estimated, the noninsurance enterprise records a receivable from the insurance enterprise and a recovery of the incurred loss in the income statement. If it is not probable¹ that the policy will provide reimbursement, then the receivable and recovery are not recorded.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.13 Accounting for Retroactive Insurance

Inquiry—How does a noninsurance enterprise account for retroactive insurance contracts that qualify for insurance accounting?

Reply—Paragraphs 3–4 of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 720-20-25 state:

¹ According to the Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary, *probable* means that the future event or events are likely to occur.

Notwithstanding that Topic 944 applies only to insurance entities, purchased retroactive insurance contracts that indemnify the insured shall be accounted for in a manner similar to the manner in which retroactive reinsurance contracts are accounted for under Subtopic 944-605. The guidance in that Subtopic shall be applied, as appropriate, based on the facts and circumstances of the particular transaction. That is, amounts paid for retroactive insurance shall be expensed immediately. Simultaneously, a receivable shall be established for the expected recoveries related to the underlying insured event.

If the receivable established exceeds the amounts paid for the insurance, the resulting gain is deferred. Immediate gain recognition and liability derecognition are not appropriate because the liability has not been extinguished (the entity is not entirely relieved of its obligation). Additionally, the liability incurred as a result of a past insurable event and amounts receivable under the insurance contract do not meet the criteria for offsetting under paragraph 210-20-45-1.

FASB ASC 720-20-35-2 further states:

If the amounts and timing of the insurance recoveries can be reasonably estimated, the deferred gain shall be amortized using the interest method over the estimated period over which the entity expects to recover substantially all amounts due under the terms of the insurance contract. If the amounts and timing of the insurance recoveries cannot be reasonably estimated, then the proportion of actual recoveries to total estimated recoveries shall be used to determine the amount of the amortization.

Paragraphs 22–23 of FASB ASC 944-605-25 state:

Amounts paid for retroactive reinsurance of short-duration contracts that meets the conditions for reinsurance accounting shall be reported as reinsurance receivables to the extent those amounts do not exceed the recorded liabilities relating to the underlying reinsured contracts. If the recorded liabilities exceed the amounts paid, reinsurance receivables shall be increased to reflect the difference and the resulting gain deferred.

If the amounts paid for retroactive reinsurance for short-duration contracts exceed the re-corded liabilities relating to the underlying reinsured short-duration contracts, the ceding entity shall increase the related liabilities or reduce the reinsurance receivable or both at the time the reinsurance contract is entered into, so that the excess is charged to earnings.

FASB ASC 944-605-35-9 further states:

Any gain deferred under paragraph 944-605-25-22 shall be amortized over the estimated remaining settlement period. If the amounts and timing of the reinsurance recoveries can be reasonably estimated, the deferred gain shall be amortized using the effective interest rate inherent in the amount paid to the reinsurer and the estimated timing and amounts of recoveries from the reinsurer (the interest method). Otherwise, the proportion of actual recoveries (the recovery method) shall determine the amount of amortization.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.14 Accounting for Multiple-Year Retrospectively Rated Insurance

Inquiry—How does a noninsurance enterprise account for a multiple-year retrospectively rated insurance contract?

Reply—As noted in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 720-20-05-10, multiple-year retrospectively rated contracts:

include a retrospective rating provision that provides for any of the following based on contract experience:

- a. Changes in the amount or timing of future contractual cash flows, including premium adjustments, settlement adjustments, or refunds to the noninsurance entity
- b. Changes in the contract's future coverage.

FASB ASC 720-20-05-9 also states, in part:

A critical feature of these contracts is that part or all of the retrospective rating provision is obligatory such that the retrospective rating provision creates for each party to the contract future rights and obligations as a result of past events.

FASB ASC 944-20-25-2 also discusses the accounting for retrospective adjustments and states:

For a multiple-year retrospectively rated insurance contract accounted for as insurance, the insurer shall both:

- a. Recognize an asset to the extent that the insured has an obligation to pay cash (or other consideration) to the insurer that would not have been required absent experience under the contract.
- b. Recognize a liability to the extent that any cash (or other consideration) would be payable by the insurer to the insured based on experience to date under the contract.

Paragraphs 3–4 of FASB ASC 944-20-35 further state:

The amount recognized under paragraph 944-20-25-4 in the current period shall be computed, using a with-and-without method, as the difference between the ceding entity's total contract costs before and after the experience under the contract as of the reporting date, including costs such as premium adjustments, settlement adjustments, and impairments of coverage.

The amount of premium expense related to impairments of coverage shall be measured in relation to the original contract terms. Future experience under the contract (that is, future losses and future premiums that would be paid regardless of past experience) shall not be considered in measuring the amount to be recognized.

FASB ASC 944-20-25-4 also further states:

For contracts that meet all of the conditions described in paragraph 944-20-15-55:

- a. The ceding entity shall recognize a liability and the assuming entity shall recognize an asset to the extent that the ceding entity has an obligation to pay cash (or other consideration) to the reinsurer that would not have been required absent

experience under the contract (for example, payments that would not have been required if losses had not been experienced).

- b. The ceding entity shall recognize an asset and the assuming entity shall recognize a liability to the extent that any cash (or other consideration) would be payable from the assuming entity to the ceding entity based on experience to date under the contract.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.15 Deposit Accounting

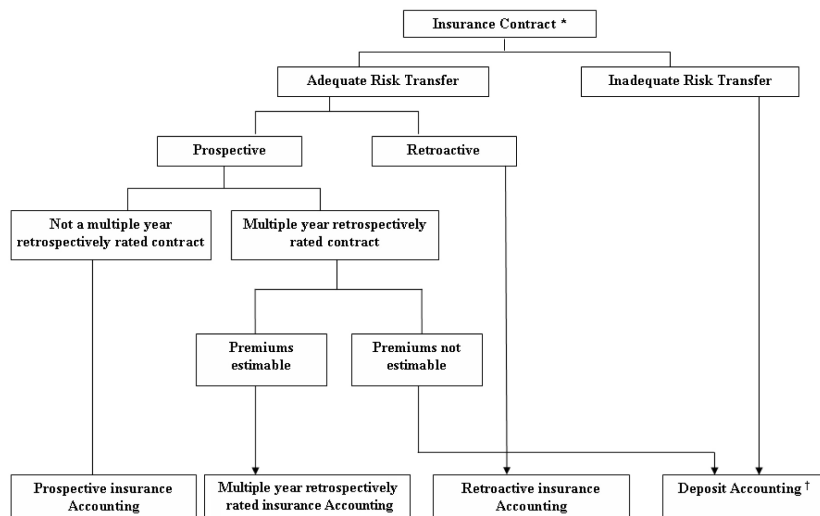
Inquiry—What is deposit accounting?

Reply—Deposit accounting essentially treats the contract as a financing transaction similar to a loan taking into account the time value of money. Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 340, *Other Assets and Deferred Costs*, provides guidance on how to account for insurance and reinsurance contracts that do not transfer insurance risk.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.16 Identifying Accounting Model for Insurance Transactions

The accompanying chart depicts the basic decision process in identifying the appropriate accounting model for insurance transactions.



* The insurance model discussed in this series of technical practice aids is based on property and casualty and other short-duration contracts, as defined in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 944, *Financial Services—Insurance*.

† FASB ASC 944-20 should also be considered in determining the accounting for multiple-year retrospectively rated contracts that do not transfer risk.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[The next page is 201.]

Section 1300

Statement of Cash Flows

[.01] **Reserved**

[.02] **Reserved**

.03 Comparative Statements of Cash Flows

Inquiry—Is it necessary to provide a statement of cash flows for both the current and prior periods if comparative income statements are presented, but only the current balance sheet is presented?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 230-10-15-3 states:

A business entity or not-for-profit entity that provides a set of financial statements that reports both financial position and results of operations shall also provide a statement of cash flows for each period for which results of operations are provided.

Therefore, if a balance sheet is presented, a statement of cash flows should be presented for both current and prior periods if income statements are presented for such periods.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.04] **Reserved**

.05 Statement of Cash Flows for Annual Report With Balance Sheet Only

Inquiry—When only a statement of financial position is presented, is it necessary that the auditor's opinion be qualified relative to the omission of the statement of cash flows?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 230-10-15-3 states:

A business entity or not-for-profit entity that provides a set of financial statements that reports both financial position and results of operations shall also provide a statement of cash flows for each period for which results of operations are provided.

Therefore, when a statement of financial position is not accompanied by a statement of operations, there is no need for presentation of a statement of cash flows, and no comment on the absence of such a statement is necessary.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.06] **Reserved**

[.07] **Reserved**

[.08] **Reserved**

[.09] **Reserved**

[.10] Special Purpose Frameworks

Inquiry—When an entity prepares its financial statements in accordance with a special purpose framework, is a statement of cash flows required?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 230-10-15-3 states:

A business entity or not-for-profit entity that provides a set of financial statements that reports both financial position and results of operations shall also provide a statement of cash flows for each period for which results of operations are provided.

Paragraph .A17 of AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* (AICPA, *Professional Standards*), states, in part:

Terms such as *balance sheet*, *statement of financial position*, *statement of income*, *statement of operations*, and *statement of cash flows*, or similar unmodified titles, are generally understood to be applicable only to financial statements that are intended to present financial position, results of operations, or cash flows in accordance with GAAP.

Paragraph .A34 of AU-C section 800 states, in part:

Special purpose financial statements may not include a statement of cash flows. 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 would either conform to the requirements for a GAAP presentation or communicate their substance. As an example, the statement of cash flows might disclose noncash acquisitions through captions on its face.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.11 The Effect of an Error Correction on the Statement of Cash Flows When Single Period Statements Are Presented

Inquiry—How would an error correction be presented in the statement of cash flows if single period statements are presented?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 250-10-45-24 states that “error corrections shall, in single period statements, be reflected as adjustments of the opening balance of retained earnings.” A corresponding error correction will normally result in a change in the beginning balance of an asset or liability account. FASB ASC 230-10-50-3 states, in part:

Information about all investing and financing activities of an entity during a period that affect recognized assets or liabilities but that do not result in cash receipts or cash payments in the period shall be disclosed.

Therefore, the difference in an account between the current balance sheet and that same account in the restated beginning balance sheet (even if not presented) that resulted from the error correction, should be reflected in the related footnote disclosures and clearly referenced to the statement of cash flows.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.12] Reserved**.13 Classification of Increase in Cash Value of Officers' Life Insurance in Statement of Cash Flows**

Inquiry—How should the increase in cash surrender value of officers' life insurance be classified in the statement of cash flows?

Reply—An increase in the cash surrender value of officers' life insurance would normally be presented as an investing outflow if the increase in cash value is less than the related premium paid. If the increase in cash value exceeds the premium paid, the premium paid is an investing outflow and the remainder of the increase in cash value would be presented as a reconciling item on the reconciliation of net income to net cash provided by operating activities.

[.14] Reserved**.15 Presentation of Cash Overdraft on Statement of Cash Flows**

Inquiry—A company has accounts at three separate banks. One of the bank accounts is in an overdraft position at year end, thus it is shown as a liability on the balance sheet. Does the company show as cash and cash equivalents on the statement of cash flows only the two accounts with the positive balances or does it show the net cash (the three accounts combined) at the end of the year as its cash and cash equivalents?

Reply—The amount that will be shown on the statement of cash flows is the two accounts with the positive balances. Per Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) ASC 230-10-45-4, "The total amounts of cash and cash equivalents at the beginning and end of the period shall be the same amounts as similarly titled line items or subtotals shown in the statements of financial position . . ." The net change in overdrafts during the period is a financing activity.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.16 Purchase of Inventory Through Direct Financing

Inquiry—An automobile dealer purchases its inventory from a manufacturer which finances purchases through a finance subsidiary. The finance subsidiary pays the manufacturer directly on behalf of the dealer. Cash is not disbursed by the dealer until the automobiles are sold.

Under the provisions of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 230, *Statement of Cash Flows*, how should the purchases of inventory be reported by the automobile dealer in the statement of cash flows?

Reply—A statement of cash flows reports an enterprise's cash receipts and cash payments during the period. Transactions that do not involve cash receipts and cash payments should be excluded from the statement of cash flows. Noncash investing and financing transactions should be reported in separate disclosures.

The purchases of inventory described above do not involve a cash flow by the automobile dealer until the automobiles are sold and the dealer pays the finance subsidiary under the financing arrangement. Therefore, only the cash outflows from payments to the finance subsidiary should be included in the body of the statement of cash flows.

Payments made to the finance subsidiary of the manufacturer should be classified as operating cash outflows in accordance with FASB ASC 230-10-45-17, which defines operating cash outflows to include principal payments on accounts and notes payable to suppliers for goods acquired for resale.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.17 Omission of Reconciliation of Net Income to Cash Flow From Operations

Inquiry—When an accountant is requested to compile financial statements that omit substantially all of the disclosures required by accounting principles generally accepted in the United States of America in accordance with paragraph .20 of AR section 80, *Compilation of Financial Statements* (AICPA, *Professional Standards*), would the omission of the schedule, “reconciliation of net income to net cash flow from operating activities” required by the direct method of reporting cash flows under FASB ASC 230 be considered a departure from accounting principles generally accepted in the United States of America?

Reply—Yes. Under the direct method of reporting net cash flows from operating activities, the separate schedule reconciling net income to net cash flow from operating activities is a required part of the cash flow statement. If the schedule is omitted, the accountant should modify his compilation report to disclose a departure from accounting principles generally accepted in the United States of America in accordance with paragraphs .27–.29 of AR section 80.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC; Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

.18 Presentation on the Statement of Cash Flows of Distributions From Investees With Operating Losses

Inquiry—An entity carries an investment in a limited partnership interest under the equity method of accounting. The partnership had operating losses during the year, but a positive cash flow allowed the partnership to distribute funds to its investors. Would receipt of that distribution by the entity be classified on the statement of cash flows as cash inflows from investing activities or as cash inflows from operating activities?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 230, *Statement of Cash Flows*, requires dividends received (returns on investments) to be classified as cash inflows from operating activities. Receipts from returns of investments are classified as cash inflows from investing activities.

Distributions to investors from investees should be presumed to be returns on investments and be classified by the investor as cash inflows from operating activities, similar to the receipt of dividends. That presumption can be overcome based on the specific facts and circumstances. For example, if the partnership sells assets, the distribution to investors of the proceeds of that sale would be considered a return of investment and be classified by the investor as cash inflows from investing activities.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.19 Classification of Payments on Equipment Finance Note

Inquiry—Under the provisions of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 230-10-50-3, noncash investing and financing transactions are to be disclosed in related narrative form or summarized in a schedule. An example of a transaction of this type would be an acquisition of equipment in a transaction in which an enterprise borrows money from a financial institution for the purchase of equipment and the financial institution remits the money directly to the vendor. In a transaction of this nature, should the payments of principal be presented as an outflow in the financing or investing section of the cash flow statement?

Reply—Payments on the aforementioned notes would be recorded as financing outflows per FASB ASC 230-10-45-15(b).

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.20 Direct vs. Indirect Method for Statement of Cash Flows

Inquiry—A company has decided to present its statement of cash flows using the direct method for the current year although the indirect method was used in the prior year. Would this change require an emphasis-of-matter paragraph noting a lack of consistency in the financial statements?

Reply—No. A change in the presentation for the statement of cash flows from the indirect to direct method (or vice versa) is considered a change in classification rather than a consistency problem. If the statement of cash flows is presented for the prior period, it should be restated using the direct method approach for comparative purposes. In addition, disclosure should be made indicating the prior period restatement.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.21 Presentation of Financing Transaction on Statement of Cash Flows

Inquiry—A buyer contracts to purchase real estate. The lender gives the buyer a check made payable to the buyer for a loan to purchase the property. The buyer in turn endorses the check over to the seller. How should this financing transaction be presented on the buyer's statement of cash flows?

Reply—This transaction should be treated as a cash receipt by the buyer since the buyer was named as payee on the check. The amount of the check should be reported on the statement of cash flows even though the buyer did not convert the check to currency or deposit it in his or her bank account. The cash receipt belongs to the payee named on the check. The buyer should present the amount of the check as "Proceeds From Borrowings" as a cash inflow from financing transactions and "Purchase of Real Estate" as a cash outflow from investing activities.

.22 Negative Amortization of Long-Term Debt in Cash Flows Statement

Inquiry—The cash repayments on a long-term loan are less than the interest expense for the period. The amount of the interest expense not paid becomes part of the principal balance (negative amortization). How should the negative amortization be shown on the cash flows statement?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 230-10-45-28(a) indicates:

Adjustments to [reconcile] net income to determine net cash flow from operating activities shall reflect accruals for interest earned but not received and interest incurred but not paid.

The negative amortization should therefore be treated as an adjustment to net income to remove the effect of this noncash expense. Disclosure should also be considered.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[The next page is 261.]

Section 1400

Consolidated Financial Statements

[.01] Reserved

.02 Consolidation of Corporation and Proprietorship

Inquiry—How should the financial statements of a corporation and a proprietorship be consolidated?

Reply—This answer assumes that 100 percent of the corporation capital stock is owned by the proprietorship.

As in any consolidation, the stockholders' equity of the subsidiary corporation should be eliminated against the investment of the parent (the proprietorship). Any net earnings of the subsidiary corporation subsequent to its acquisition and not recorded on the books of the parent should be reflected in the consolidated net equity, which, because the parent is a sole proprietorship, will be a single figure. As income taxes are assessed against the owner as an individual rather than against the proprietorship, no provision is made for income taxes beyond those payable by the corporation. However, a footnote should disclose such omission, and if it is anticipated that funds will have to be withdrawn from the proprietorship to meet future taxes on income earned to date, this too should be disclosed, with an estimate of the amount thereof if practicable. Of course, provision should be made for elimination of profits to the extent that they may be reflected in consolidated inventories or in other consolidated assets.

[Revised, April 2010.]

[.03] Reserved

[.04] Reserved

[.05] Reserved

.06 Combined and Separate Financial Statements

Inquiry—Company A and Company B are new car dealers with A selling an American made car and B selling a foreign made car. One individual owns 100 percent of the outstanding stock of both companies.

Both companies A and B are at the same location with separate buildings for sales staffs. Company A maintains the parts and service departments for both companies with the parts inventory, warranty and service receivables of Company B on Company A's books. In return, Company B pays Company A a per car fee for services to be performed on each new car sold by B.

Company A maintains the only used car inventory on the lot adjacent to Company B's building. Each time B receives a used car in trade, it is sold to Company A at the wholesale fair market value.

Although there is a differentiation in sales staffs, management, accounting, secretarial, and other related services are performed by the same staff out of both buildings, and Company B pays a monthly fee for services performed.

Company A has income for the year, but Company B has a loss for the period. Combined financial statements will be prepared, but is it also necessary to provide combining statements for the individual companies?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 810-10-55-1B states, in part:

There are circumstances, however, in which combined financial statements (as distinguished from consolidated statements) of commonly controlled entities are likely to be more meaningful than their separate statements. For example, combined financial statements would be useful if one individual owns a controlling interest in several entities that are related in their operations.

Combined financial statements of the companies would be appropriate, and there is no necessity for presenting separate statements for the companies.

Unfortunately, FASB ASC 810, *Consolidation*, makes no statement as to appropriate presentation of the stockholder's equity section of a combined balance sheet. Appropriate disclosure, therefore, may depend upon the circumstances. Either on the statement of financial position, or in a note, there should be disclosure for each company of their number of shares of stock that are authorized and outstanding, and the par value. While under some circumstances it might not be necessary to disclose the allocation of retained earnings between the two companies, other circumstances may exist under which such disclosure would be required—for example, if the losses of either company have been so severe that an insolvent condition might be anticipated.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.07 Reporting on Company Where Option to Acquire Control Exists

Inquiry—Corporation A acquired debentures from Corporation B convertible into common voting stock within ten years at \$1 per share. Corporation A also has an option to purchase additional shares at \$1 per share upon conversion to bring A's holdings in B up to 51 percent of the total outstanding shares. Corporation A also has the right to appoint a majority of Corporation B's Board of Directors and has done so. Other intercompany transactions are negligible.

May each company issue separate financial statements, or are consolidated statements required? What disclosures would be necessary?

Reply—At present there is no ownership of one company by the other, and consolidation would not be proper. Further, since intercompany transactions (other than interest on the debentures) are negligible, combined statements would probably not be particularly useful.

Corporation A should disclose in its financial statements the terms under which it may obtain controlling stock ownership of Corporation B, the amount of interest received, that no other intercompany transactions are significant, and that it presently has the right to and does appoint a majority to Corporation B's Board of Directors. It should also present summarized information as to the assets, liabilities, and operating results of Corporation B, or include B's financial statements with its report.

Corporation B, in addition to disclosing the interest rate and maturity of the convertible debentures, should disclose Corporation A's conversion and option privileges and should disclose that Corporation A has the right to and has appointed a majority to Corporation B's Board of Directors.

[.08] **Reserved**

[.09] **Reserved**

- [.10] Reserved
- [.11] Reserved
- [.12] Reserved
- [.13] Reserved
- [.14] Reserved
- [.15] Reserved
- [.16] Reserved
- [.17] Reserved
- [.18] Reserved
- [.19] Reserved
- [.20] Reserved
- [.21] Reserved

.22 Intervening Intercompany Transactions Between Subsidiary's and Parent's Year-End

Inquiry—A parent company has a December 31 year-end and its wholly owned subsidiary has a November 30 year-end. The two companies generally have substantial intercompany sales and purchases which are recorded by each company as they occur. The parent uses the subsidiary's November 30 year-end statement to prepare the consolidated financial statements.

The intervening intercompany transactions, which occur between December 1 and December 31, create intercompany account balances which do not eliminate upon consolidation due to the difference in year-ends of the parent and its subsidiary. How should these intervening transactions be accounted for in the consolidated financial statements?

Reply—In discussing differences in fiscal periods, Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 810-10-45-12 states, “if the difference is not more than about three months, it usually is acceptable to use, for consolidation purposes, the subsidiary's financial statements for its fiscal period; if this is done, recognition should be given by disclosure or otherwise to the effect of intervening events that materially affect the financial position or results of operations.”

When a subsidiary's fiscal year differs from that of the parent, intercompany accounts may not agree. Transactions in the interval between the subsidiary's year-end and the parent's year-end must be analyzed and appropriate consolidation entries prepared.

A practical approach to preparing these consolidation entries would be to reverse the intervening intercompany transactions in the parent company's accounts but not in the subsidiary's accounts. A summary of these intervening transactions could then be disclosed in a note to the consolidated financial statements.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.23 Conforming Subsidiary's Inventory Pricing Method to Its Parent Company's Method

Inquiry—A parent company uses the first-in, first-out (FIFO) cost assumption to price its inventory, while its subsidiary uses the last-in, first-out (LIFO) cost assumption to price its inventory. Must the subsidiary's inventory method be changed to conform to the FIFO method used by its parent company in consolidated financial statements?

Reply—There is no requirement under generally accepted accounting principles for the subsidiary to conform its inventory pricing method with the parent company's method. Consolidated statements may be presented with the subsidiary using LIFO and the parent using FIFO. Also, separate subsidiary only statements may be presented on the LIFO basis.

[.24] Reserved**.25 Issuance of Parent Company Only Financial Statements**

Inquiry—Generally accepted accounting principles preclude preparation of parent company financial statements for issuance to stockholders as the financial statements of the primary reporting entity. Are there any circumstances under which parent company financial statements may still be prepared?

Reply—Yes. Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 810-10-45-11 states: "In some cases parent entity statements may be needed, in addition to consolidated statements, to indicate adequately the position of bondholders and other creditors or preferred stockholders of the parent. Consolidating statements, in which one column is used for the parent entity and other columns for particular subsidiaries or groups of subsidiaries often are an effective means of presenting the pertinent information."

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.26 Consolidated Versus Combined Financial Statements

Inquiry—S Corporation has 2000 common shares and 1000 preferred shares outstanding. The preferred shareholders have the same rights as the common shareholders, except the right to vote. Of the 2000 common shares outstanding, 1000 shares are owned by P Corporation and 1000 shares are owned by I (an individual) who also owns all of the outstanding common shares of P Corporation. The preferred shares of S Corporation are owned by an outside party. Should P Corporation consolidate S Corporation for financial reporting purposes?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 810-10-05-6 states that to "justify the preparation of consolidated financial statements, the controlling financial interest shall rest directly or indirectly in one of the entities included in the consolidation." In this situation P does not control S directly or indirectly and therefore consolidation is not appropriate. Combined financial statements could be presented if the circumstances are such that combined financial statements of S Corporation and P Corporation are more meaningful than separate financial statements.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.27 Subsidiary Financial Statements

Inquiry—Generally accepted accounting principles indicate that “consolidated rather than parent-company financial statements are the appropriate general-purpose financial statements.” May subsidiary-only financial statements be issued without consolidated financial statements?

Reply—Yes. Generally accepted accounting principles do not preclude issuance of subsidiary-only statements. Care should be taken to include all disclosures required by Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) SC 740-10-50-17, FASB ASC 850, *Related Party Disclosures*, and other relevant pronouncements.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.28] Reserved**.29 Consolidated Versus Combined Financial Statements Under FASB ASC 810, Consolidation**

Inquiry—If a reporting entity is the primary beneficiary of a variable interest entity (VIE) under Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 810, *Consolidation*, would it be appropriate to issue combined financial statements rather than consolidated financial statements?

Reply—No. FASB ASC 810-10-05-6 permits combined financial statements in certain situations in which consolidated financial statements are not required. However, FASB ASC 810-10-25-38 states that “an entity shall consolidate a variable interest entity if that entity has a variable interest (or combination of variable interests) that will absorb a majority of the variable interest entity’s expected losses, receive a majority of the variable interest 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 GAAP; in the case of a primary beneficiary of a VIE, financial statements prepared in accordance with GAAP would be consolidated financial statements.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.30 Stand-Alone Financial Statements of a Variable Interest Entity

Inquiry—Regarding Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 810, *Consolidation*, is it appropriate to present stand-alone financial statements of a variable interest entity (VIE)?

Reply—FASB ASC 810 does not specifically address this issue. Subsidiary-only financial statements are appropriate under generally accepted accounting principles. By extension, it may be appropriate to present stand-alone financial statements of a VIE.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.31 GAAP Departure for FASB ASC 810

Inquiry—If a reporting entity is the primary beneficiary of a variable interest entity under Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 810, *Consolidation*, what are the implications for the auditors’ report if the reporting entity does not consolidate the variable interest entity?

Reply—AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report* (AICPA, *Professional Standards*), addresses the auditor's responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, *Professional Standards*), the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary. Paragraph .07a of AU-C section 705 states that when the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are materially misstated, the auditor should modify the opinion in the auditor's report.

As paragraph .02 of AU-C section 705 explains, the decision regarding which type of modified opinion (a qualified opinion, an adverse opinion, and a disclaimer of opinion) is appropriate depends upon the following:

- a. The nature of the matter giving rise to the modification (that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated)
- b. The auditor's professional judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements

If an auditor concludes that a qualified opinion is appropriate, he or she should disclose the GAAP departure in a separate paragraph headed "Basis for Qualified Opinion" 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 basis for qualified opinion paragraph. The basis for modification paragraph should include a description and quantification of the financial effects of the misstatement, unless impracticable. If it is not practicable to quantify the financial effects, the auditor should so state in the basis for modification paragraph. If such disclosures are made in a note to the financial statements, the basis for modified opinion paragraph may be shortened by referring to it.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.32 Parent-Only Financial Statements and Relationship to GAAP

Inquiry—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 810, *Consolidation*, addresses parent company financial statements. If consolidation is required under generally accepted accounting principles (GAAP), are there any circumstances in which an entity may prepare parent company-only financial statements without preparing related consolidated financial statements and say that the parent company-only financial statements are in accordance with GAAP?

Reply—No. FASB ASC 810-10-10-1 notes the presumption in GAAP that consolidated financial statements are more meaningful than parent entity-only financial statements. FASB ASC 810-10-15-10 states that all majority-owned subsidiaries shall be consolidated, with few exceptions. FASB ASC 810-10-45-11 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.

For example, if, as a condition of a legal or regulatory agreement, an entity is required to submit “restricted” or “special use” parent-only financial statements without related consolidated financial statements, the restricted or special use parent-only financial statements are not in accordance with GAAP.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.33] Reserved

[The next page is 301.]

Section 1500

Financial Statements Prepared in Accordance With a Special Purpose Framework

For nonauthoritative guidance regarding financial statements prepared in accordance with the cash- or tax-basis of accounting, consult the AICPA publication *Accounting and Financial Reporting Guidelines for Cash- and Tax-Basis Financial Statements*. That practice aid alerts the reader to some of the most frequently-encountered issues faced by accounting professionals in dealing with cash- and tax-basis financial statements and provides suggestions and insight into how these issues are resolved in practice. In addition, the AICPA has published a separate practice aid, *Applying OCBOA in State and Local Government Financial Statements*. To order these publications, call the AICPA at 1.888.777.7077 or visit www.cpa2biz.com.

[.01] Reserved

[.02] Reserved

[.03] Reserved

.04 Terminology for Special Purpose Financial Statements

The Clarification and Convergence project of the AICPA Accounting and Review Services Committee is currently underway. Upon the completion of this project, this Inquiry and Reply will be conformed to include references to the pertinent clarified AICPA Statements on Standards for Accounting and Review Services that are expected to be issued as a result of the project.

Inquiry—(1) If an entity prepares financial statements in accordance with a special purpose framework, may GAAP financial statement titles be used?

(2) What should be the caption for “net income” or “net loss,” and may the corporation use “retained earnings”?

Reply—(1) No. Paragraph .A17 of AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* (AICPA, *Professional Standards*), explains that unmodified GAAP financial statement titles are not acceptable for use in special purpose financial statements. The paragraph contains a few examples of appropriate financial statement titles (for example, *Statement of Assets and Liabilities Arising from Cash Transactions* and *Statement of Income—Regulatory Basis*). However, the examples presented in the authoritative literature were not meant to be all-inclusive and are not the only acceptable titles. Equally acceptable titles would be *Balance Sheet—Cash Basis* or *Statement of Operations—Income Tax Basis*. The selection of specific financial statement titles is a matter of judgment; any modified title would fulfill the requirements

of AU-C section 800 as long as it is clear that the financial statements are not prepared in accordance with GAAP.

(2) The authoritative literature is silent regarding the captions to be used within special purpose financial statements. Therefore, there is no requirement to modify standard GAAP financial statement captions in special purpose financial statements. If modifications are desired, common examples for cash basis financial statements are *Excess of revenue collected over expenses paid*, *Excess of expenses paid over revenue collected*, and *Accumulated excess of revenue over expenses paid*. For tax-basis financial statements, acceptable modifications include *Retained earnings—income tax basis* and *Net income—tax basis*.

[Amended, February 1995; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[.05] **Reserved**

[.06] **Reserved**

.07 Disclosure Concerning Subsequent Events in Special Purpose Financial Statements

Inquiry—FASB *Accounting Standards Codification (ASC) 855, Subsequent Events*, sets forth general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. FASB ASC 855 also requires disclosure of the date through which an entity has evaluated subsequent events and the basis for that date, that is, whether that date represents the date on which the financial statements were issued or were available to be issued. Should full disclosure financial statements prepared in accordance with a special purpose framework contain the disclosures set forth in FASB ASC 855?

Reply—Paragraph .19 of AR section 80, *Compilation of Financial Statements (AICPA, Professional Standards)*, and paragraph .32 of AR section 90, *Review of Financial Statements (AICPA, Professional Standards)*, state, in part, “financial statements prepared in accordance with an OCBOA¹ are not considered appropriate in form unless the financial statements include informative disclosures similar to those required by GAAP if the financial statements contain items that are the same as, or are similar to, those in financial statements prepared in accordance with GAAP.” Paragraph .A20 of AU-C section 800 states, in part, “when the special purpose financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP, informative disclosures similar to those required by GAAP are necessary to achieve fair presentation.”

Therefore, the date through which an entity has evaluated subsequent events and the basis for that date should be disclosed. Furthermore, some nonrecognized subsequent events are of such a nature that disclosure is required to keep the financial statements prepared from being misleading. Such events should be disclosed following the guidance in FASB ASC 855.

[Issue Date: June 2009; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[The next page is 451.]

¹ The cash, tax, and regulatory bases of accounting are commonly referred to as *other comprehensive bases of accounting* (OCBOA). [Footnote added, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

Section 1600

Personal Financial Statements

[.01] Reserved

[.02] Reserved

.03 Social Security Benefits—Personal Financial Statements

Inquiry—Do social security benefits to be received based on the future life expectancy of an individual qualify as an asset in personal financial statements?

Reply—No. Financial Accounting Standards Board (FASB) *Accounting Standards Codification (ASC) 274, Personal Financial Statements*, indicates that nonforfeitable rights to receive future sums must meet certain criteria to be accounted for as assets. One of these criteria is that the rights must not be contingent on the individual's life expectancy or the occurrence of a particular event, such as disability or death. In this example, because the social security benefits are contingent on the individual's life expectancy, they do not qualify as a recognizable asset for the personal financial statements.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.04 Presentation of Assets at Current Values and Liabilities at Current Amounts in Personal Financial Statements

Inquiry—Financial Accounting Standards Board (FASB) *Accounting Standards Codification (ASC) 274, Personal Financial Statements*, states that personal financial statements should present assets at their estimated current values and liabilities at their estimated current amounts at the date of the financial statements. FASB ASC 274 also defines estimated current values and current amounts.

Are the definitions of *current values* (assets) and *current amounts* (liabilities) for personal financial statements meant to be the same as *fair value*, as defined in FASB ASC 820, *Fair Value Measurements and Disclosures*?

Reply—No. FASB ASC 820 did not contemplate the reporting of personal financial statements, and FASB did not amend the definitions of estimated current values and current amounts for personal financial statements as part of its codification process.

[Issue Date: June 2009.]

[The next page is 541.]

Section 1700

Prospective Financial Statements

[.01] Reserved

[The next page is 551.]

Section 1800

Notes to Financial Statements

[.01] Reserved

[.02] Reserved

.03 Disclosure of Change in Fiscal Year

Inquiry—What disclosure in the financial statements is necessary when a company changes its fiscal year?

Reply—Generally accepted accounting principles (GAAP) do not specifically require disclosure of a change in the fiscal year. However, disclosure of such a change is generally considered necessary to make the financial statements meaningful to users.

[.04] Reserved

.05 Applicability of Fair Value Disclosure Requirements and Measurement Principles in Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 820, Fair Value Measurements and Disclosures, to Certain Financial Instruments

Inquiry—Do the fair value measurement principles and disclosure requirements in Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 820, *Fair Value Measurements and Disclosures*, apply to financial instruments that are not recognized at fair value in the statement of financial position, but for which fair value is required to be disclosed in the notes to financial statements in accordance with paragraphs 10–19 of FASB ASC 825-10-50?

Reply—The measurement principles of FASB ASC 820 apply when determining for disclosure purposes the fair value of financial instruments that are not recognized at fair value in the statement of financial position. FASB ASC 820-10-15-1, which establishes the scope of FASB ASC 820, provides that “Except as noted below, this Topic applies when another Topic requires or permits fair value measurements or disclosures about fair value measurements (and measurements, such as fair value less costs to sell, based on fair value or disclosures about those measurements).” The exceptions relate to (a) share-based payment transactions, (b) FASB ASC sections, subtopics, or topics that require or permit measurements that are similar to fair value but that are not intended to measure fair value, and (c) certain fair value measurements for purposes of lease classification or measurement in accordance with FASB ASC 840.

In addition, certain disclosure requirements of FASB ASC 820 apply to financial instruments for which fair value is only disclosed. Specifically, FASB ASC 820-10-50-2E provides that for each class of assets and liabilities not measured at fair value in the statement of financial position but for which the fair value is disclosed,

a reporting entity shall disclose the information required by paragraph 820-10-50-2(b), (bbb), and (h). However, a reporting entity is not required to provide the quantitative disclosures about significant unobservable inputs used in fair value measurements categorized within Level 3 of the fair value hierarchy required by paragraph 820-10-50-2 (bbb). For such

assets and liabilities, a reporting entity does not need to provide the other disclosures required by this Topic.

[Issue Date: May 2010; Revised, April 2014, to reflect conforming changes necessary due to revisions to FASB ASC.]

.06 Applicability of Fair Value Disclosure Requirements in FASB ASC 820 to Financial Statements Prepared in Accordance With a Special Purpose Framework

Inquiry—If management prepares an entity’s financial statements in accordance with a special purpose framework, and those financial statements include accounts measured at fair value, what is the auditor’s responsibility with respect to fair value disclosure requirements in FASB ASC 820-10-50?

Reply—As indicated in paragraph .19 of AR section 80, *Compilation of Financial Statements* (AICPA, *Professional Standards*), and paragraph .32 of AR section 90, *Review of Financial Statements* (AICPA, *Professional Standards*), “financial statements prepared in accordance with an OCBOA¹ are not considered appropriate in form unless the financial statements include informative disclosures similar to those required by GAAP if the financial statements contain items that are the same as, or are similar to, those in financial statements prepared in accordance with GAAP.” Additionally, paragraph .A20 of AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* (AICPA, *Professional Standards*), states “when the special purpose financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP, informative disclosures similar to those required by GAAP are necessary to achieve fair presentation.”

Therefore, if special purpose financial statements reflect assets or liabilities measured at fair value in accordance with FASB ASC 820, the accountant/auditor should consider whether the financial statements (including the accompanying notes) include the fair value disclosure requirements of FASB ASC 820 as appropriate for the basis of accounting used.

[Issue Date: June 2010; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[The next page is 561.]

¹ The cash, tax, and regulatory bases of accounting are commonly referred to as *other comprehensive bases of accounting* (OCBOA). [Footnote added, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

Section 1900

Interim Financial Information

.01 Condensed Interim Financial Reporting by Nonissuers

Inquiry—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 270, *Interim Reporting*, provides accounting and disclosure guidance relating to *recognition and measurement* in interim financial information (including condensed interim financial statements). FASB ASC 270 does not provide a reporting framework for condensed interim financial statements—that is, minimum requirements for the *form and content* of condensed interim financial statements. Article 10 of Securities and Exchange Commission (SEC) Regulation S-X provides guidance on the form and content of condensed interim financial statements of issuers. When preparing condensed interim financial statements, because specific guidance with respect to form and content is absent, may nonissuers apply Article 10 of SEC Regulation S-X in addition to complying with FASB ASC 270 with respect to recognition and measurement?

Reply—Yes. In the absence of established accounting principles for form and content in preparing condensed interim financial statements, nonissuers may analogize to the guidance in Article 10 of SEC Regulation S-X.

Preparers should keep in mind that the purpose of *condensed* interim financial statements is to provide an update to users of the entity's annual financial statements prepared in accordance with generally accepted accounting principles. Article 10 of SEC Regulation S-X also has this premise. Therefore, to avoid being considered misleading,

- such condensed interim financial statements would include a note that the financial information should be read in conjunction with the entity's latest annual financial statements, and
- the entity's latest annual financial statements would either accompany such condensed interim financial statements or be made readily available by the entity. The financial statements are deemed to be readily available if a user can obtain the financial statements without any further action by the entity (for example, financial statements on an entity's Web site may be considered readily available, but being available upon request is not considered readily available).

[Issue Date: January 2009; Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[The next page is 701.]

TIS Section 2000

ASSETS

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[The next page is 721.]

Section 2110

Cash

[.01] Reserved

.02 Checks Held at Balance Sheet Date

Inquiry—It is the practice of a company to eliminate its recorded accounts payable balance at the end of each month by writing checks to all of its trade vendors prior to the end of the month. To prevent overdrafts that would result from this practice, the company retains possession of the checks and only mails them to the vendors after the end of the month, when sufficient funds are available to satisfy them.

How should these held checks be accounted for by the company at month end?

Reply—At month end the aggregate dollar amount of held checks should be added back to cash and accounts payable. Checks which have not left the custody of the company should not reduce the company's recorded cash or accounts payable balances because they have not been tendered to the vendor to satisfy the debt.

[.03] Reserved

[.04] Reserved

[.05] Reserved

.06 Disclosure of Cash Balances in Excess of Federally Insured Amounts

Inquiry—Should the existence of cash on deposit with banks in excess of FDIC-insured limits be disclosed in the financial statements?

Reply—The existence of uninsured cash balances should be disclosed if the uninsured balances represent a significant concentration of credit risk. *Credit risk* is defined in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary as follows:

For purposes of a hedged item in a fair value hedge, credit risk is the risk of changes in the hedged item's fair value attributable to both of the following:

- a. Changes in the obligor's creditworthiness
- b. Changes in the spread over the benchmark interest rate with respect to the hedged item's credit sector at inception of the hedge.

For purposes of a hedged item in a cash flow hedge, credit risk is the risk of changes in the hedged item's cash flows attributable to all of the following:

- a. Default
- b. Changes in the obligor's creditworthiness
- c. Changes in the spread over the benchmark interest rate with respect to the hedged item's credit sector at inception of the hedge.

As a result, bank statement balances in excess of FDIC-insured amounts represent a credit risk.

A concentration of credit risk exists if an entity has exposure with an individual counterparty or groups of counterparties. For example, a material uninsured cash balance with a single bank should generally be disclosed. In contrast, numerous immaterial uninsured cash balances on deposit with several banks may not require disclosure. The threshold for “significance” is a matter of judgment and will vary with individual circumstances.

An example of disclosure for this circumstance might be:

The Company maintains its cash accounts primarily with banks located in Alabama. The total cash balances are insured by the FDIC up to \$100,000 per bank. The Company has cash balances on deposit with two Alabama banks at December 31, 1996 that exceeded the balance insured by the FDIC in the amount of \$1,100,000.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[The next page is 761.]

Section 2120

Temporary Investments

[.01] Reserved

[.02] Reserved

[.03] Reserved

[.04] Reserved

[.05] Reserved

.06 Accounting for Preferred Dividends Received on Investments in Common Stock

Inquiry—A company received dividends on its investment in common stock of another company in the form of preferred stock. How should the dividend be recorded?

Reply—The assets and related dividend income should be recorded at fair value. Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 845-10-30-1 states that in general, accounting for nonmonetary transactions should be based on the fair values of the assets (or services) involved which is the same basis as that used in monetary transactions and that a nonmonetary asset received in a nonreciprocal transfer should be recorded at the fair value of the asset received. (FASB ASC 505, *Equity*, discusses accounting for stock dividends by the recipient; however, the scope of that pronouncement specifically excludes distributions of a different class of shares from that owned.)

[Amended, June 1995; Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.07] Reserved

[.08] Reserved

[The next page is 811.]

Section 2130

Receivables

[.01] Reserved

[.02] Reserved

[.03] Reserved

[.04] Reserved

.05 Out-of-Pocket Costs Incurred by a Law Firm

Inquiry—A law firm incurs certain out-of-pocket costs on behalf of its clients. If the law firm’s efforts on behalf of the client are successful, these costs are recovered from the client in addition to the legal fees. If the case is lost, the costs are absorbed by the law firm. How should these costs be treated by the law firm?

Reply—These out-of-pocket costs should be reported as an asset in the financial statements of the law firm (for example, in an account called “client costs receivable”). At each balance sheet date, the law firm should apply the criteria in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 450-20-25-1 to determine whether a loss contingency should be accrued.

If an asset is recorded, an allowance for unrecoverable client disbursements should be established representing the estimated amount of such costs that will not be realized. If these out-of-pocket costs become uncollectible because a case is lost, they should be written off against the allowance.

[Amended, June 1995; Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.06] Reserved

.07 Requirement for Doubtful Accounts Allowance

Inquiry—Do generally accepted accounting principles require an enterprise to establish an allowance for doubtful accounts even though management, based on analysis of the receivables and past charge-off experience, believes that no accounts are uncollectible at the balance sheet date?

Reply—FASB ASC 310-10-35-7 states that “the conditions under which receivables exist usually involve some degree of uncertainty about their collectibility, in which case a contingency exists . . .” FASB ASC 450-20-25-2 would require an accrual of a loss by a charge to income if both of the following conditions exist:

- a. “Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired . . . at the date of the financial statements.” and
- b. “The amount of loss can be reasonably estimated.”

If both conditions are not met, an allowance for doubtful accounts would not be required. Further, there is no requirement to disclose the absence of a loss accrual. If the conditions are met, an accrual for the loss should be recognized

even though the specific receivables that are uncollectible may not be identifiable.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.08] Reserved

.09 Scope Part I: Application of FASB ASC 310-30 to Debt Securities

Inquiry—Does the scope of FASB ASC 310-30 include debt securities?

Reply—Yes. FASB ASC 310-30 applies to *loans*, as defined in the FASB ASC glossary, as follows:

Loan: A contractual right to receive money on demand or on fixed or determinable dates that is recognized as an asset in the creditor's statement of financial position. Examples include but are not limited to accounts receivable (with terms exceeding one year) and notes receivable. This definition encompasses loans accounted for as debt securities.

Debt Security: Any security representing a creditor relationship with an entity. The term debt security also includes all of the following:

- a. Preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor
- b. A collateralized mortgage obligation (or other instrument) that is issued in equity form but is required to be accounted for as a nonequity instrument regardless of how that instrument is classified (that is, whether equity or debt) in the issuer's statement of financial position
- c. U.S. Treasury securities
- d. U.S. government agency securities
- e. Municipal securities
- f. Corporate bonds
- g. Convertible debt
- h. Commercial paper
- i. All securitized debt instruments, such as collateralized mortgage obligations and real estate mortgage investment conduits
- j. Interest-only and principal-only strips.

The term debt security excludes all of the following:

- a. Option contracts
- b. Financial futures contracts
- c. Forward contracts
- d. Lease contracts
- e. Receivables that do not meet the definition of security and, so, are not debt securities (unless they have been securitized, in which case they would meet the definition of a security), for example:
 1. Trade accounts receivable arising from sales on credit by industrial or commercial entities

2. Loans receivable arising from consumer, commercial, and real estate lending activities of financial institutions.

Therefore, the scope of FASB ASC 310-30 includes acquired loans that are accounted for as debt securities.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.10 Scope Part II: Instruments Accounted for as Debt Securities Under FASB ASC 310-30

Inquiry—Some types of instruments are measured like debt securities. In accordance with the guidance of FASB ASC 310-30 and considering expected cash flows for instruments measured like debt securities, when does the investor follow the guidance of paragraphs 8–9 of FASB ASC 310-30-35 (loans accounted for as debt securities) or paragraphs 10–11 of FASB ASC 310-30-35 (loans not accounted for as debt securities)?

Reply—FASB ASC 860-20-35-2 provides an example of instruments that are measured like debt securities:

Financial assets, except for instruments that are within the scope of Subtopic 815-10, that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment shall be subsequently measured like investments in debt securities classified as available for sale or trading under Topic 320. Examples of such financial assets include, but are not limited to, interest-only strips, other beneficial interests, loans, or other receivables.

For these types of instruments measured like debt securities, investors should follow the impairment guidance in paragraphs 8–9 of FASB ASC 310-30-35 (loans accounted for as debt securities) unless the asset is otherwise excluded according to FASB ASC 310-30-15.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC; Revised, April 2014, to reflect conforming changes necessary due to revisions to FASB ASC.]

.11 Determining Evidence of Significant Delays and Shortfalls Relative to FASB ASC 310-30

Inquiry—FASB ASC 310-30-15-8 states that “investors shall consider the significance of delays and shortfalls for a loan so FASB ASC 310-30 is not applied in evaluating payment collectability when such delays and shortfalls are insignificant with regard to the contractually required payments.” How might that assessment be determined?

Reply—That assessment will likely be based on individual facts and circumstances and should be guided by an accounting policy adopted and applied consistently by the investor. For instance a percentage could be established to indicate an “insignificant” shortfall and for those items that meet the percentage shortfall, the dollar shortfall itself would be evaluated as to whether it is insignificant in the aggregate.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.12 Determining Evidence of Deterioration of Credit Quality and Probability of Contractual Payment Deficiency in Accordance With FASB ASC 310-30

Inquiry—In accordance with FASB ASC 310-30, how can an investor identify loans that have evidence of deterioration of credit quality and for which it is probable that the investor will be unable to collect all contractually required payments receivable so that they can identify whether the loans are in the scope of FASB ASC 310-30?

Reply—There are several things to consider when determining whether certain loans are within the scope of FASB ASC 310-30. An investor may set policies, including thresholds based on the type of loan product. Commercial loans are generally classified or graded into risk categories as part of an ongoing credit review process. An investor may identify commercial loans with evidence of deterioration using the previous owner's record of changes in classification and accrual status. Such records may also provide evidence concerning whether it is probable that the investor will be unable to collect all contractually required payments receivable. In contrast, consumer loans are generally not individually reviewed or graded and non-accrual and charge-off policies vary by product. For instance, some types of consumer loans are immediately charged-off when the loan is a certain number of days past due and may never be classified as non-accrual. As a result, indicators of credit quality deterioration for consumer products may vary depending on the product and may include non-accrual classification, past due status, or FICO score and changes therein. For debt securities, investors may establish other criteria to determine when securities should be considered for review for application under FASB ASC 310-30; for example, downgrades in credit grade categories.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.13 Non-Accrual Loans Part I: Acquired Non-Accrual Loans Under FASB ASC 310-30

Inquiry—Does an acquired loan (purchased individually or as part of a business combination) that was classified by the seller as non-accrual fall within the scope of FASB ASC 310-30?

Reply—Non-accrual status may be an indicator that a loan that meets the criteria of FASB ASC 310-30. However, the investor should analyze whether the loan meets all the scope criteria in FASB ASC 310-30-15, including evidence of credit deterioration. Classification of a loan as non-accrual by the seller and/or investor does not provide an exemption from FASB ASC 310-30. FASB ASC 310-30 does not prohibit carrying acquired loans on non-accrual status, when appropriate. However, certain disclosures are required for such loans in accordance with FASB ASC 310-30-50-2(a)(4).

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.14 Non-Accrual Loans Part II: Consumer Loans on Non-Accrual Status Under FASB ASC 310-30

Inquiry—Should FASB ASC 310-30 be applied to non-accrual (for example, 90 days past due) consumer loans that are reported as non-performing loans when such loans may be charged off completely in relatively short order (that is, after 120 days)?

Reply—Yes. FASB ASC 310-30 is applicable to all loans within its scope, including non-accrual loans. The accrual accounting specified in FASB ASC 310-30 should be applied if the investor is able to estimate expected cash flows,

including cash flows resulting from foreclosure and other collection efforts. However, when the investor does not have the ability to reasonably estimate cash flows, FASB ASC 310-30 does not prohibit carrying loans on non-accrual. Also, investors should note there are additional disclosure requirements for these circumstances.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.15 Loans Held for Sale in Accordance With FASB ASC 310-30

Inquiry—Why are only mortgage loans held for sale and not all loans held for sale excluded from the scope of FASB ASC 310-30?

Reply—Only mortgage loans held for sale that are accounted for under FASB ASC 948, *Financial Services—Mortgage Banking*, are excluded from the scope because FASB ASC 948 had to provide an exception.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.16 Treatment of Commercial Revolving Loans Under FASB ASC 310-30

Inquiry—FASB ASC 310-30-15-2(f) excludes revolving credit agreements from its scope specifically noting as examples two types of consumer revolving agreements, credit cards and home equity loans. *Revolving privilege* is defined in the FASB ASC glossary as “a feature in a loan that provides the borrower with the option to make multiple borrowings up to a specified maximum amount, to repay portions of previous borrowings, and then to reborrow under the same loan.” Are commercial revolving loans also excluded from the scope of FASB ASC 310-30?

Reply—Commercial revolving loans should be treated the same as consumer revolving loans. Thus, commercial revolving loans are excluded as well, if the borrower has revolving privileges at the acquisition date.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.17 Application of FASB ASC 310-30

Inquiry—The scope of FASB ASC 310-30 excludes loans that are retained (transferor’s beneficial) interests. How does the scope of FASB ASC 310-30 relate to the scope of FASB ASC 325-40?

Reply—Accounting for retained interests should follow FASB ASC 325-40 and for purchased interests should follow FASB ASC 310-30 if they meet the scope criteria in FASB ASC 310-30-15.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.18 Loans Reacquired Under Recourse Under FASB ASC 310-30

Inquiry—If a loan that was transferred with recourse and qualified for accounting as a sale under FASB ASC 860, *Transfers and Servicing*, is subsequently repurchased under the recourse provision, is it within the scope of FASB ASC 310-30?

Reply—Yes, if it meets the criteria in FASB ASC 310-30-15 related to credit quality. Except for purchases triggered by initial representations and warranty deficiencies, it is likely that the repurchased loan would meet the criteria to be included in the scope of FASB ASC 310-30. FASB ASC 310-30 includes guidance

on the evidence of credit deterioration. (See TIS section 2130.11, “Determining Evidence of Significant Delays and Shortfalls Relative to FASB ASC 310-30.”)

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.19 Acquired Loans Where Purchase Price Is Greater Than Fair Value Under FASB ASC 310-30

Inquiry—If the fair value of a purchased loan is less than the purchase price because a loan is repurchased under a recourse provision, does FASB ASC 310-30 permit recording the loan at the purchase price?

Reply—If a loan meets the criteria of FASB ASC 310-30-15 such that it is in the scope of FASB ASC 310-30 and the seller repurchases the asset at a price that is more than fair value, the seller should record the asset at its fair value and record a loss for the difference between the price paid and the fair value, if not already recognized. An allowance for loan losses to offset recording the loan at the purchase price should not be recorded. In most cases, if the loan had previously been transferred with recourse, the seller should already have recognized an associated liability for the recourse obligation in accordance with FASB ASC 450, *Contingencies*, and FASB ASC 860, *Transfers and Servicing*, as well as FASB ASC 460, *Guarantees*.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.20 Acquired Loans Where Purchase Price Is Less Than Fair Value Under FASB ASC 310-30

Inquiry—In accordance with FASB ASC 310-30, if the fair value of a purchased loan is more than the purchase price because a loan is acquired (for example, as part of a clean up call) should the seller record a gain?

Reply—No. There may be instances where the seller is required or has an option to re-purchase an asset at a price that is less than fair value. In that situation and if the loan is within the scope of FASB ASC 310-30, the investor should record the asset at the purchase price and the excess of expected cash flows over the initial investment should be recognized as the yield under FASB ASC 310-30.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.21 Accounting for Loans With Cash Flow Shortfalls That Are Insignificant Under FASB ASC 310-30

Inquiry—Related to FASB ASC 310-30-15-8, an investor might establish a policy that a shortfall in contractually required payments below a certain amount or percentage is insignificant and thus, certain acquired loans would not be in the scope of FASB ASC 310-30. For loans with shortfalls in payments of less than the established threshold, how should those discounts be accreted into income as a yield adjustment?

Reply—If a loan is not in the scope of FASB ASC 310-30, then FASB ASC 310-20 applies, and FASB ASC 310-20-35-15 requires that the entire discount be accreted to income over the life of the loan.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.22] Reserved**.23 Carrying Over the Allowance for Loan and Lease Losses (ALLL) Under FASB ASC 310-30 (Part II)**

Inquiry—Are there any recommendations on calculating allowance ratios relating to loans in the scope of FASB ASC 310-30?

Reply—Although the nonaccretable difference is akin to an ALLL because it represents amounts that are not expected to be collected, it should not be included in the ALLL or ALLL ratios. The only time there is any ALLL for the loans within the scope of FASB ASC 310-30 is when the expected cash flows have decreased after acquisition and a loss is recognized by the investor. In other words, at the purchase date, for loans within the scope of FASB ASC 310-30, the allowance-to-loans ratio is always zero. The investor may wish to disclose in the notes to the financials the amount of the nonaccretable difference so that the readers understand by how much the loans have already been “written down.”

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.24] Reserved**.25 Income Recognition for Non-Accrual Loans Acquired Under FASB ASC 310-30 (Part I)**

Inquiry—What is the accounting for a purchased loan that was classified by the previous owner as non-accrual and for which cash flows cannot be reasonably estimated under FASB ASC 310-30?

Reply—FASB ASC 310-30 does not prohibit placing (or keeping) loans on non-accrual. At inception or thereafter the investor may place a loan on non-accrual, if the conditions in FASB ASC 310-30-35-3 are met. FASB ASC 310-30-50-2(a)(4) requires certain disclosures for purchases of non-accrual loans.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.26 Income Recognition for Non-Accrual Loans Acquired Under FASB ASC 310-30 (Part II)

Inquiry—A loan is classified as non-accrual by a seller because the debtor is not meeting its obligations under the loan’s contractual terms. That loan is sold to an investor who determines that the loan meets the requirements of FASB ASC 310-30. If the investor can reasonably estimate cash flows, should the investor classify the loan as an accruing loan?

Reply—Yes, if the investor can reasonably estimate cash flows, it should recognize an accretable yield and the loan is an accruing loan as discussed in FASB ASC 310-30-35-3.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.27 Income Recognition for Non-Accrual Loans Acquired Under FASB ASC 310-30 (Part III)

Inquiry—Assuming the investor followed the cost recovery method on a loan, and assuming the loan was brought current for a period of time, could the investor return the loan to accrual status and account for the loan as a new loan?

Reply—If the loan was within the scope of FASB ASC 310-30 when it was purchased, it is not accounted for as a new loan but is always under the requirements of FASB ASC 310-30, even if the loan's performance improves. However, as discussed in TIS section 2130.26, the loan should be accruing income whenever the investor is able to reasonably estimate cash flows. Also, if the currently expected cash flows exceed the originally expected cash flows, the guidance in paragraphs 8–11 of FASB ASC 310-30-35 should be applied, which may result in recognizing income at a higher yield than originally expected.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.28 Estimating Cash Flows Under FASB ASC 310-30

Inquiry—In accordance with the guidance in FASB ASC 310-30, how often should an investor reassess the cash flows expected to be collected?

Reply—Investors should reassess expected cash flows at the end of each reporting period. Thus, for entities that prepare quarterly GAAP-basis financial statements, it is expected that cash flows will be re-assessed at least quarterly.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.29 Implications of FASB ASC 310-20-35-11 With a Restructured or Refinanced Loan Under FASB ASC 310-30 (Part I)

Inquiry—Can a loan that meets the requirements of FASB ASC 310-20-35-11 be removed from the scope of FASB ASC 310-30? If a loan is within the scope of FASB ASC 310-30 and there are modifications to that loan, should the guidance in FASB ASC 310-20-35-11 apply?

Reply—No. FASB ASC 310-20-35-11 only applies to loans that are not within the scope of FASB ASC 310-30. The point of FASB ASC 310-30-35-13 is that a loan stays in the scope of FASB ASC 310-30, regardless of restructuring or refinancing, except for a troubled debt restructuring.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.30 Implications of FASB ASC 310-20-35-11 With a Restructured or Refinanced Loan Under FASB ASC 310-30 (Part II)

Inquiry—Can a loan that has been extinguished in accordance with FASB ASC 310-20-35-11 and given a new loan number, with new terms, but which has not been paid off, be accounted for as a new loan under the guidance in FASB ASC 310-30? What steps could the investor and borrower take to permit the loan to be accounted for as a new loan?

Reply—A loan within the scope of FASB ASC 310-30 can never be accounted for as a new loan, except through a troubled debt restructuring in accordance with FASB ASC 310-40.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.31 Variable Rate Loans and Changes in Cash Flows and FASB ASC 310-30

Inquiry—In accordance with the guidance in FASB ASC 310-30, should an investor in variable rate loans determine the cause of a decrease in expected cash flows?

Reply—Yes. To the extent that the investor can directly attribute a decrease in expected cash flows to a decrease in the contractual interest rate, the investor should reduce the yield recognized in income on a prospective basis. However, if the investor is not able to directly attribute the decrease in expected cash flows to a decrease in the contractual interest rate (for example, because the change in the index or rate has no direct effect on the cash flows available to the borrower to service the loan or because the change in the index or rate had no direct effect on expected cash flows that relate to the value of the collateral) the investor should immediately recognize any decrease in expected cash flows as an impairment, not over time as reduced yield.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.32 Pool Accounting Under FASB ASC 310-30 (Part I)

Inquiry—In accordance with the guidance in FASB ASC 310-30, if a loan is removed from a pool, how is the specific carrying amount of a loan determined?

Reply—As discussed in FASB ASC 310-30-40-1, once a pool has been assembled the integrity of the pool should be maintained. If the loan is removed under the specific criteria in FASB ASC 310-30-40-1, it should be removed at its carrying amount. In some cases the cash flows of the pool will have been estimated for the pool as a whole such that there is no specific information on the carrying amount and cash flows related to any particular loan. In that case, an allocation of carrying amount to the loan on a pro rata basis is an appropriate way to achieve the goal of not impacting the accounting for the remaining pool. In other cases, the cash flows of the pool may have been built up as the sum of cash flows of individual loans and there is specific information related to the loan being removed. In that case, the carrying amount is allocated on the basis of the specific information for the loan removed. In either case, the goal remains the same—that is, to not have a removal event result in either impairment or an increase in yield for the remaining pool.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.33 Pool Accounting Under FASB ASC 310-30 (Part II)

Inquiry—Alternatively, and related to TIS section 2130.32, should the loan be removed at its initial fair value in accordance with the guidance in FASB ASC 310-30?

Reply—Generally, no. Removing a loan at its initial fair value, unless done very shortly after acquisition of the loan and creation of the pool, would likely result in a change in the effective yield of the remaining pool and the stated intent of FASB ASC 310-30 is that removing a loan from a pool should not result in such a change.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.34 Application to Fees Expected to Be Collected Under FASB ASC 310-30

Inquiry—In accordance with the guidance in FASB ASC 310-30, should fees be included in “expected cash flows?” The FASB ASC glossary definition for *cash flows expected at acquisition* includes “principal, interest and other cash flows expected to be collected.” Does FASB ASC 310-30 address late fees and other fees?

Reply—“Other cash flows expected to be collected” includes all fees. If late fees are expected to be collected and are contractual, the investor should include them in total contractual cash flows and expected cash flows for purposes of calculating yield and making disclosures. If late fees are contractual but not expected to be collected, the investor should exclude late fees from contractual cash flows and disclose that accounting policy (if it is considered material).

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.35 Application to Cash Flows From Collateral and Other Sources Under FASB ASC 310-30

Inquiry—In accordance with the guidance in FASB ASC 310-30, should cash expected to be received from the ownership and sale of assets taken in settlement of loans be included in “other cash flows expected to be collected?”

Reply—Cash flows expected at acquisition includes all cash flows directly related to the acquired loan, including those expected from collateral. Although yield is measured on this basis under FASB ASC 310-30 for the loan prior to foreclosure, an asset received by the investor in full or partial settlement of a loan should be accounted for in accordance with paragraphs 2–4 of FASB ASC 310-40-40.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.36 Impact on Cash Flows on a Group of Loans Accounted for as a Pool in Accordance With FASB ASC 310-30 if There Is a Confirming Event, and One Loan Is Removed as Expected

Inquiry—FASB ASC 310-30-15-6 states that investors may aggregate loans acquired in the same fiscal quarter that have common risk characteristics and thereby use a composite interest rate and expectation of cash flows expected to be collected for the pool. FASB ASC 310-30-40-1 states that once the pool is assembled, the integrity of the pool should be maintained. What is the impact on the accounting for a group of loans accounted for as a pool, if there is a confirming event, and one loan is removed from the pool as expected?

Reply—The following is an example of the impact on the accounting for a pool of loans, if there is a confirming event, and one loan is removed as expected.

FASB ASC 310-30 Example

Group of Loans

Example 1—Confirming Event, One Loan Is Removed From Pool, as Expected

Facts: The investor purchases 10 loans that individually meet the scope of FASB ASC 310-30 for \$800. Based on the aggregation criteria, the investor assembles the loans into a pool. The investor initially expects to collect \$929.29 in cash flows (which generates a yield of approximately 5.387 percent over 3 years). The investor recognizes one month of yield income. The investor then receives notification that one obligor has become bankrupt and that it will make no further payments on its loan. The investor concludes that event is in accordance with the original expectation of cash flows. That is, the investor continues to expect that it will collect \$929.29 from the pool of loans. The investor removes the contractual cash flows from that loan and an equal amount of nonaccretable difference, in the amount of \$117.42, from the pool such that the yield is unaffected. This TPA does not address charge-offs.

Receivables

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	<u>Original Purchase</u>	<u>Accrue Income</u>	<u>Receive Payment</u>	<u>Balance</u>	<u>Removal of Loan</u>	<u>Balance</u>
Contractual Cash Flows	1,200.00		(25.81)	1,174.19	(117.42)	1,056.77
Nonaccretable Difference	(270.71)			(270.71)	117.42	(153.29)
Expected Cash Flows	929.29		(25.81)	903.48	0.00	903.48
Accretable Yield	(129.29)	6.67		(122.62)	0.00	(122.62)
Recorded Amount	800.00	6.67	(25.81)	780.86	0.00	780.86
Bad Debt Expense/ALLL	0.00			0.00	0.00	0.00
Carrying Amount	800.00	6.67	(25.81)	780.86	0.00	780.86
Yield (computed on carrying amount)*	5.387%			5.384%		5.384%
Principal Balance	1,000.00		(19.14)	980.86	(98.09)	882.77
Delinquent Accrued Interest Rec.	50.00			50.00	(5.00)	45.00
Balance	1,050.00		(19.14)	1,030.86	(103.09)	927.77
Remaining Interest Due Under Contract	150.00		(6.67)	143.33	(14.33)	129.00
Nonaccretable Difference	(270.71)			(270.71)	117.42	(153.29)
Expected Cash Flows	929.29		(25.81)	903.48	0.00	903.48
Accretable Yield	(129.29)	6.67		(122.62)	0.00	(122.62)
Recorded Amount	800.00	6.67	(25.81)	780.86	0.00	780.86
Bad Debt Expense/ALLL	0.00			0.00	0.00	0.00
Carrying Amount	800.00	6.67	(25.81)	780.86	0.00	780.86

* Yield =Accretable yield divided by the carrying amount divided by 36 times 12

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.37 Impact on Cash Flows on a Group of Loans Accounted for as a Pool in Accordance With FASB ASC 310-30 if There Is a Confirming Event, One Loan Is Removed From the Pool, and the Investor Decreases Its Estimate of Expected Cash Flows

Inquiry—FASB ASC 310-30-15-6 states that investors may aggregate loans acquired in the same fiscal quarter that have common risk characteristics and thereby use a composite interest rate and expectation of cash flows expected to be collected for the pool. FASB ASC 310-30-40-1 states that once the pool is assembled, the integrity of the pool should be maintained. What is the impact on the on the accounting for a group of loans accounted for as a pool, if there is a confirming event, one loan is removed from the pool, and the investor decreases its estimate of expected cash flows?

Reply—The following is an example of the impact on the accounting for a group of loans accounted for as a pool, if there is a confirming event, one loan is removed from the pool, and the investor decreases its estimate of expected cash flows:

FASB ASC 310-30 Example

Group of Loans

Example 2—Confirming Event, One Loan Is Removed From Pool, and Investor Decreases Estimate of Expected Cash Flows From Pool

Facts: The investor purchases 10 loans that individually meet the scope of FASB ASC 310-30 for \$800. Based on the aggregation criteria, the investor assembles the loans into a pool. The investor initially expects to collect \$929.29 in cash flows (which generates a yield of approximately 5.387 percent over 3 years). The investor recognizes one month of yield income. The investor then receives notification that one that one obligor has become bankrupt and that it will make no further payments on its loan. The investor concludes that the expected cash flows from the pool are decreased by \$90.35, which has a present value at 5.387 percent of \$78.09. The investor records a provision of \$78.09, increasing the loan loss allowance by \$78.09. In addition, the investor removes the contractual cash flows from that loan and an equal amount of nonaccretable discount, in the amount of \$117.42, from the pool such that the yield is unaffected. This TPA does not address charge-offs.

	Original Purchase	Accrue Income	Receive Payment	Decrease in Expected Cash Flows		Removal of Loan		Balance
				Balance	Balance	Balance	Balance	
Contractual Cash Flows	1,200.00		(25.81)	1,174.19	1,174.19	(117.42)	1,056.77	
Nonaccretable Difference	(270.71)			(270.71)	(282.97)	117.42	(165.55)	
Expected Cash Flows	929.29		(25.81)	903.48	(12.26)	0.00	891.22	
Accretable Yield	(129.29)	6.67		(122.62)	12.26	0.00	(110.36)	
Recorded Amount	800.00	6.67	(25.81)	780.86	0.00	0.00	780.86	
Bad Debt Expense/ALLL	0.00			0.00	(78.09)		(78.09)	
Carrying Amount	800.00	6.67	(25.81)	780.86	(78.09)	0.00	702.77	
Yield (computed on carrying amount)*	5.387%			5.384%			5.384%	
Principal Balance	1,000.00		(19.14)	980.86	0.00	(98.09)	882.77	
Delinquent Accrued Interest Rec. Balance	50.00			50.00	0.00	(5.00)	45.00	
Remaining Interest Due Under Contract	1,050.00		(19.14)	1,030.86	0.00	(103.09)	927.77	
Nonaccretable Difference	150.00		(6.67)	143.33	0.00	(14.33)	129.00	
Expected Cash Flows	(270.71)			(270.71)	(12.26)	117.42	(165.55)	
Accretable Yield	929.29	6.67	(25.81)	903.48	(12.26)	0.00	891.22	
Recorded Amount	(129.29)	6.67	(25.81)	(122.62)	12.26	0.00	(110.36)	
Bad Debt Expense/ALLL	800.00	6.67	(25.81)	780.86	0.00	0.00	780.86	
	0.00			0.00	(78.09)		(78.09)	
Carrying Amount	800.00	6.67	(25.81)	780.86	(78.09)	0.00	702.77	

* Yield =Accretable yield divided by the carrying amount divided by 36 times 12

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.38 Certificates of Deposit and FASB ASC 820, *Fair Value Measurements and Disclosures*

Inquiry—Are certificates of deposit within the scope of the disclosure requirements of FASB ASC 820, *Fair Value Measurements and Disclosures*?

Reply—Generally not. Certificates of deposit that meet the definition of a security in FASB ASC 320, *Investments—Debt and Equity Securities*, are subject to the disclosure requirements of FASB ASC 820-10-50; those that do not meet the definition are not subject to those disclosure requirements. FASB ASC 320-10-20 defines a *security* as:

A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:

- a. It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.
- b. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment.
- c. It either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.

Most certificates of deposit would not meet that definition. However, some negotiable certificates of deposit may meet the definition of a security and, therefore, may be subject to the disclosure requirements of FASB ASC 820-10-50 if they are not classified as held to maturity.

[Issue Date: May 2010.]

.39 Balance Sheet Classification of Certificates of Deposit

Inquiry—Where should a certificate of deposit be classified on the balance sheet?

Reply—Certificates of deposit with original maturities of 90 days or less are commonly considered “cash and cash equivalents” under FASB ASC 305. A certificate of deposit with an original maturity greater than 90 days would not be included in cash and cash equivalents. If the certificate of deposit is not a security, as defined in FASB ASC 320, it could be included in “investments—other.”

The following is an example of a policies and procedures note disclosure:

Investments—Other

Certificates of deposit held for investment that are not debt securities are included in “investments—other.” Certificates of deposit with original maturities greater than three months and remaining maturities less than one year are classified as “short-term investments—other.” Certificates of deposit with remaining maturities greater than one year are classified as “long-term investments—other.”

[Issue Date: May 2010.]

.40 Certificates of Deposit and FASB ASC 320

Inquiry—Are certificates of deposit within the scope of FASB ASC 320?

Reply—Generally not. FASB ASC 320-10-20 defines a *security* as:

A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:

- a. It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.
- b. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment.
- c. It either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.

Most certificates of deposit would not meet that definition. Certain negotiable certificates of deposit, however, may meet the definition of a security and, therefore, may be subject to FASB ASC 320.

[Issue Date: May 2010.]

[The next page is 861.]

Section 2140

Inventories

.01 Warehousing Included in Cost of Inventory

Inquiry—A client deals in wholesaling and retailing automotive tires for foreign cars. Most of the inventory is imported, and it is valued on the company's records at the actual inventory cost plus freight-in. At year-end, the warehousing costs are prorated over cost of goods sold and ending inventory. The company's auditor believes the warehousing costs should not be capitalized to inventory, but the entire amount should be expensed in the year the costs are incurred. Are warehousing costs considered to be product costs or period costs?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 330-10-30-1 states, in part:

As applied to inventories, cost means in principle the sum of the applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location.

Kieso and Weygandt, *Intermediate Accounting*, 9th Edition states:

Product costs are those costs that "attach" to the inventory and are recorded in the inventory accounts. These costs are directly connected with the bringing of goods to the place of business of the buyer and converting such goods to a saleable condition. Such charges would include freight charges on goods purchased, other direct costs of acquisition and labor, and other production costs incurred in processing the goods up to the time of sale. It would seem proper also, to allocate to inventories a share of any buying costs or expenses of a purchasing department, storage costs, and other costs incurred in storing or handling goods before they are sold (i.e., warehousing costs). Because of the practical difficulties involved in allocating such costs and expenses, however these items are not ordinarily included in valuing inventories.

Costs of delivering the goods from the warehouse would be considered a selling expense and should not be allocated to the goods that are still in the warehouse.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.02 Obsolete Items in Inventory—I

Inquiry—A client purchased in bulk various inventories of stock material. This material is used to produce various specialized parts used in electronic equipment. The bulk purchase took place some eighteen months ago, and less than ten percent of these inventories have been used. The client claims that there may be some obsolete stock on hand from this bulk purchase, but an eighteen month period is not enough time to effectively determine the complete degree of obsolescence because the highly specialized nature of the product line may not lead to renewed orders until periods beyond one or more operating cycles. Based on the information available to the client, about one-third of the original bulk purchase will be written off because of obsolescence. For the remaining inventories, the client will present a representation letter indicating that he or she believes the remaining inventory not to be obsolete.

There may be more obsolete inventory than the client is willing to admit. The poor turnover of such items is the chief reason for concern. Pricing the inventory at the lower of cost or market will be difficult. The nature of the inventory (many small items at low unit cost) and its poor turnover make obtaining market prices difficult.

What is the responsibility of auditors, not being inventory experts, in determining the extent of obsolescence?

Reply—Paragraphs .11 and .A25 of AU-C section 501, *Audit Evidence—Specific Considerations for Selected Items* (AICPA, *Professional Standards*), address the auditor's responsibility to obtain sufficient appropriate audit evidence regarding the condition of inventory, which includes identifying obsolete, damaged or aging inventory. This audit evidence might include the opinion of other experts, for example an electronics engineer, with respect to the quality of the inventories in this case.

Over the eighteen-month period since the inventories were purchased, less than ten percent have been utilized. Such a usage rate indicates that the client has close to an estimated fifteen year supply of these inventories. This would indicate that little or no value should be assigned to these inventories.

[Revised, May 2007; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[.03] Reserved

.04 Airplanes Chartered While Held for Sale

Inquiry—A company purchases airplanes for sale to others. However, until they are sold, the company charters and services the planes. What would be the proper way to report these airplanes in the company's financial statements?

Reply—The primary use of the airplanes should determine their treatment on the balance sheet. Since the airplanes are held primarily for sale, and chartering is only a temporary use, the airplanes should be classified as current assets. However, depreciation would not be appropriate if the planes are considered inventory. Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary states, in part, that the term inventory “excludes long-term assets subject to depreciation accounting, or goods which, when put into use, will be so classified.”

If the use period were to exceed one year, reclassification to fixed assets and recognition of depreciation expense would be appropriate under generally accepted accounting principles (GAAP).

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.05] Reserved

.06 Inventory of Meat Packer

Inquiry—A client engaged in the meat packing business uses the “National Provisioner Daily Market Service” quotations in valuing its inventories. The client contends that these quotations, adjusted for freight differentials, reflect an accurate approximation of actual costs and, in lieu of a complete cost accounting system, should be considered as cost for inventory valuation. Is this method of inventory valuation acceptable for meat packers?

Reply—Meat packing companies generally value their work in process and finished goods inventories at market price less cost to bring to market in accordance with Financial Accounting Standards Board (FASB) *Accounting*

Standards Codification (ASC) 330, *Inventory*. Live animals and whole carcasses are carried at lower of cost or market. Many companies use quoted costs such as the National Provisioner quotations which are estimated costs of producing a particular cut of meat adjusted for the fluctuating daily livestock prices and other factors. These quoted prices must be further adjusted by the individual meat packers to take into account individual factors such as freight and storage.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.07] Reserved

.08 Valuing Precious Metals Inventory Used in Manufacturing Applications

Inquiry—Should inventories of precious metals used in manufacturing applications (for example, diamonds used in drill bits, plutonium or uranium used in steel fabrication, or titanium used in paint manufacturing) be valued at market or at the lower of cost or market?

Reply—These inventories should be valued at the lower of cost or market in accordance with Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 330-10-35-2. The excess of market value over cost may be disclosed.

The exception to “lower of cost or market” that allows precious metals to be recorded at market on the balance sheet does not apply to these industrial applications because the metals will be used in the manufacturing process rather than held for immediate sale and do not meet the other conditions specified in FASB ASC 330-10-35-15, which states:

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.

FASB ASC 330-10-50-3 further states:

Where goods are stated above cost, this fact shall be fully disclosed.

[Amended, June 1995; Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.09 Standard Cost for Inventory Valuation

Inquiry—A client uses standard costs for valuing inventory. What disclosure is necessary in the financial statements regarding inventory valuation?

Reply—Ordinarily, standard costs should be adjusted to a figure which approximates the lower of cost or market. If this is done, then it is appropriate to use standard costs for financial reporting purposes. This is usually the case where standards are currently and frequently adjusted.

Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 330-10-30-13 states:

Standard costs are acceptable if adjusted at reasonable intervals to reflect current conditions so that at the balance sheet date standard costs reasonably approximate costs computed under one of the recognized bases. In such cases descriptive language shall be used which will express this relationship, as, for instance, “approximate costs determined on the first-in first-out basis,” or, if it is desired to mention standard costs, “at standard costs, approximating average costs.”

Accordingly, if in this particular case standard costs do in fact approximate the lower of cost or market, then disclosure along the lines indicated in the above reference is adequate.

On the other hand, if the difference between standard costs and the lower of cost or market is material, then mere footnote disclosure will not cure the known statement imperfection.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.10] Reserved

.11 Average Cost Method for Subsidiary

Inquiry—Company A and all of its subsidiaries, except one, determine the cost of inventories by the last-in, first-out method (LIFO). The one subsidiary uses an average cost method. Is the average cost method acceptable for determining the cost of inventory? Is it acceptable for one subsidiary to use the average cost method and Company A and the other subsidiaries to use the LIFO method?

Reply—The average cost method is an acceptable method for determining the cost of inventory. An entity may use more than one method to determine the cost of inventory provided the methods are disclosed.

.12 Classification of Replacement Parts Under a Maintenance Agreement

Inquiry—Company A has entered into a maintenance agreement with Company B, an unrelated party, to provide maintenance and service for specialized computer equipment leased by Company B to third parties. The maintenance contract between A and B requires that A maintain a spare/replacement parts inventory for the equipment. Company A has no use for these parts other than to fulfill the obligation under its contract with Company B. The term of the contract between Company A and Company B is for several years.

Most of the spare parts (i.e., circuit boards) are of a repairable nature, and it is expected that as A replaces a part, A will have the removed part refurbished, at its own cost. The refurbished parts will be available for future use as necessary.

Should Company A classify the refurbished replacement parts as inventory? Should Company A's investment in the parts be amortized?

Reply—Company A should classify the refurbished replacement parts as inventory. Inventory costs should not be amortized; a loss in their utility should be reflected as a charge against revenues of the period in which it occurs, as discussed in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 330-10-35-2.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.13 Classification of Slow-Moving Inventory

Inquiry—A client, engaged in an oil field related industry, has slow-moving products that are not considered obsolete. The inventory is properly stated at the lower of cost or market. The client plans to continue selling the inventory on hand but will cease manufacturing the specialized product. Based on current sales estimates and demand for the product, it appears likely that the client will be able to sell all of the items in the inventory over a period of about four years. Is it correct to classify a portion of the slow-moving inventory as a long-term asset in the client's classified balance sheet?

Reply—The portion of the slow-moving inventory not reasonably expected to be realized in cash during the client's normal operating cycle should be classified as a long-term asset in the company's classified balance sheet. Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 310-10-45-9 states that the term *current assets* is used to designate cash and other assets or resources commonly identified as those that are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.14 Disclosure of LIFO Reserve

Inquiry—Should a company using the last-in, first-out (LIFO) method of inventory valuation be required to disclose the LIFO reserve in its financial statements or in the accompanying footnotes?

Reply—Yes. The Accounting Standards Division Issues Paper, *Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories*, addresses this matter in section 2, paragraphs 24 through 28. Paragraph 28 indicates that the task force voted (9 yes, 0 no) that either the LIFO reserve or replacement cost and its basis for determination should be disclosed. Paragraph 26 states that the Securities and Exchange Commission (SEC) requires companies whose securities trade publicly to disclose this information [Regulation S-X, section 210.5-02.6(c)] and that many nonpublic companies also disclose this information.

[Amended, June 1995; Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

[.15] Reserved

[.16] Reserved

[The next page is 1161.]

Section 2210

Fixed Assets

.01 Settlement of Mortgage Installment on Real Estate Between Buyer and Seller

Inquiry—A company purchased an office building subject to the seller’s assumable mortgage. The closing of the transaction occurred in the middle of a month which was between payment dates on the mortgage. The closing statement reflected a credit from the seller to the buyer for the interest that accrued on the mortgage from the last payment date until the date of the closing. How should this credit be accounted for by the buyer?

Reply—The buyer would treat the accrued interest credit as a reduction of interest expense for the first month of ownership. When the buyer makes the first interest payment after the closing, the credit will offset the full month’s interest paid and thus reduce the buyer’s net interest expense to the amount attributable to the period that the property was owned by the buyer.

[Amended, June 1995.]

.02 Broker’s Commission Received by Purchaser of Property as Purchase Price Concession

Inquiry—A corporation (“purchaser”) is engaged in negotiations to purchase real property. During the negotiations, the purchaser was unwilling to accept the seller’s best offer. To induce the purchaser to agree to the sale, the broker agreed to rebate a portion of the seller-paid commission to the purchaser.

Would this rebate be considered income to the purchaser or a reduction of the cost of the property acquired?

Reply—The “rebate” received from the broker should be accounted for as a reduction of the cost of the property rather than as income. Income should not be recognized on a purchase. The receipt of the rebate was part of the acquisition of the real estate and, when netted against the purchase price, reflects the amount the purchaser was willing to pay for the property.

[Amended, June 1995.]

[.03] Reserved

[.04] Reserved

[.05] Reserved

.06 Valuation of Cattle Herd

Inquiry—A client, in the business of raising and selling cattle, has not been in business long enough to develop enough cost information to reliably value the cattle raised by them. Each cow costs \$2,000 or more and has an estimated salvage value of about \$300 at the end of its productive breeding life. The client has adopted a life of seven years for its breeding herd based on the various ages of the cows.

The client proposes to price the cattle raised as follows:

Purchased calves

When a cow is purchased with a “calf at side,” twenty percent of the purchase price is allocated to the calf. An additional \$50 is allocated to the calf

every six months for the first eighteen months. At eighteen months of age, the cows are considered mature enough for breeding and are then either sold or placed in the breeding herd and depreciated.

Raised calves

Since the mother is maintained principally for breeding and is expected to produce one calf each year, the calf birthed and raised is allocated one year's depreciation of the mother, plus \$50 at birth. An additional \$50 is allocated every six months for the first eighteen months.

The problem of valuing the cattle is compounded by the fact that cattle purchased for breeding and those purchased for sale are not separated, and any cow may be sold at any time. What improvements could be made in the pricing scheme, and how should the breeding herd and the herd held for sale be shown on the balance sheet?

Reply—Rather than setting an average breeding life of seven years for the breeding herd, it would appear more reasonable to set an estimated age at which a cow should be fully depreciated and to depreciate the cost of each cow over the remaining estimated years of life. Also, instead of allocating twenty percent of the purchase price of the cow to the calf “at side,” it would be better to determine the percent applicable to the calf on the basis of the number of expected additional calves for that cow.

In valuing the calves, if the \$50 figure is a reasonable estimate of six months of costs, the method seems reasonable. However, instead of allocating one year's depreciation of the mother plus \$50 at birth, it might be better to allocate only the depreciation plus the direct expenses of birth such as veterinarian's fees, etc.

Since it is difficult to determine which of the cattle are “inventory” and which are “fixed assets,” it might not be appropriate in this case to classify the assets and liabilities as current or long-term in the balance sheet.

.07 Costs of Ski Slopes and Lifts

Inquiry—A company has developed a piece of land into a skiing resort. The company has cut the trees, cleared and graded the land and hills, and constructed ski lifts and platter pulls.

Should the tree cutting, land clearing, and grading costs of constructing the ski slopes be capitalized to land? If so, are these costs amortizable?

Should the clearing and grading costs connected with the construction of the ski lifts and platter pulls be capitalized to this equipment and depreciated?

Reply—All expenditures incurred which are made for the purpose of making the land suitable for its intended use or purpose (whether that use be for the construction of a ski lodge, lifts, slopes, platter pulls, or other facilities) are properly capitalizable as land costs, and land is not subject to depreciation. During the course of clearing the land to make it useful for the purpose acquired, salable timber may be recovered, and since the clearing costs are capital items, amounts realized from the sale of the timber may properly be credited to the land account. Recurring maintenance of right-of-way (i.e., the slope and ski-lift areas) would be properly treated as a period cost.

.08 Restaurant Dishes and Silverware

Inquiry—Should a base stock inventory of silverware and dishes be shown on the balance sheet of a restaurant as a fixed asset? In the base stock method, the base stock is recorded at an unchanging amount and additions to the stock are charged to expenses for the period. Inasmuch as fixed assets are specific

items which are subject to depreciation (except land), and the base stock is an approximate figure for many items and is not depreciated, it would seem that the base stock should not be classified as a fixed asset.

Reply—Various publications recommending treatment for large stocks of short-lived, replaceable assets such as silverware and dishes indicate that the assets should be valued on the basis of physical inventories at year-end, with used equipment being valued at 50 percent of current cost, and unused equipment valued at full cost. This, in effect, assigns an average useful life of two years for the equipment. It is recommended that such assets be included in fixed assets.

The classification in the balance sheet should not depend upon the method of valuing the assets. Therefore, regardless of the method of valuation, the assets should be included in fixed assets. If the valuation differs materially from the depreciated cost of individual goods on hand at year-end, the presentation is not in accordance with generally accepted accounting principles.

[.09] **Reserved**

[.10] **Reserved**

[.11] **Reserved**

[.12] **Reserved**

[.13] **Reserved**

[.14] **Reserved**

.15 Capitalization of Cost of Dredging Log Pond

Inquiry—Corporation A operates a log pond and dredged the pond during the year at a cost of \$350,000. Thus, the useful life of the log pond was extended several years. Should the dredging cost be expensed or capitalized?

Reply—FASB Concept No. 6, *Elements of Financial Statements—a replacement of FASB Concepts Statement No. 3 (incorporating an amendment of FASB Concepts Statement No. 2)*, paragraph 149 states, in part, “. . . many assets yield their benefits to an entity over several periods . . . Expenses resulting from their use are normally allocated to the periods of their estimated useful lives (the periods over which they are expected to provide benefits) by a ‘systematic and rational’ allocation procedure, for example, by recognizing depreciation or other amortization.”

Since the dredging cost will benefit future periods, Corporation A should capitalize the cost and amortize it in a systematic and rational manner over the estimated period of benefit.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.16] **Reserved**

[.17] **Reserved**

.18 Revaluation of Assets

Inquiry—Company A acquired a material amount of treasury stock resulting in a stockholders’ equity deficit. Since state law (where Company A is incorporated) prohibits the impairment of legal capital, Company A revalued certain of its assets at fair market value. Should Company A record depreciation for the revalued assets based on historical cost or fair market value?

Reply—An opinion expressed on the financial statements of Company A should be qualified or adverse because the write-up of assets is a departure from generally accepted accounting principles.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.19] Reserved

.20 Compounding Capitalized Interest

Inquiry—Company A is constructing a building for its own use. The company capitalized interest cost on the average amount of accumulated expenditures for the asset during the current year end. The building was completed in the next year. Should the company capitalize interest on the average amount of expenditures for the assets that were made during the current period only or the average amount of accumulated expenditures for the asset during the period including the expenditures made in the prior period, which already includes capitalized interest cost?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 835-20-30-3 states, in part:

The amount capitalized in an accounting period shall be determined by applying the capitalization rate to the average amount of accumulated expenditures for the asset during the period.

FASB ASC 835-20-35-3 further states:

The compounding of capitalized interest is conceptually consistent with the conclusion that interest on expenditures for the asset is a cost of acquiring the asset.

Accordingly, the rate should be applied to the average of all the accumulated expenditures.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.21] Reserved

[.22] Reserved

[.23] Reserved

[.24] Reserved

.25 Capitalization of Interest Costs Incurred by Subsidiary

Inquiry—A subsidiary with an asset qualifying for interest capitalization under Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 835, *Interest*, incurs its entire interest cost from a loan from its parent.

What is the extent of interest that may be appropriately capitalized?

Reply—FASB ASC 835-20-30-3 states, in part: “the amount capitalized in an accounting period shall be determined by applying the capitalization rate to the average amount of accumulated expenditures for the asset during the period.” FASB ASC 835-20-30-6 further states

The total amount of interest cost capitalized in an accounting period shall not exceed the total amount of interest cost incurred by the entity in that period. In consolidated financial statements, that limitation shall be applied by reference to the total amount of interest cost

incurred by the parent entity and consolidated subsidiaries on a consolidated basis. In any separately issued financial statements of a parent entity or a consolidated subsidiary and in the financial statements (whether separately issued or not) of unconsolidated subsidiaries and other investees accounted for by the equity method, the limitation shall be applied by reference to the total amount of interest cost (including interest on intra-entity borrowings) incurred by the separate entity.

Such financial statements should disclose related party transactions as required by FASB ASC 850, *Related Party Disclosures*.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.26] Reserved

.27 Construction of Asset—Foreign Currency Transaction Gains/Losses

Inquiry—A company is constructing a building in the United States for its own use. In order to finance the cost of the building, a loan denominated in a foreign currency is obtained from a bank in a foreign country. The company is appropriately capitalizing interest incurred as part of the cost of the building in accordance with Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 835, *Interest*. However, the company wants to also capitalize as part of the cost of the building any foreign currency transaction gains or losses it incurs as a result of the loan with the bank in the foreign country. The company's rationale is that the transaction gains or losses relate specifically to the building and therefore should be considered part of the cost of the building. Is this appropriate?

Reply—No. According to FASB ASC glossary, *foreign currency transactions* are transactions whose terms are denominated in a currency other than the entity's functional currency. Foreign currency transactions arise when a reporting entity does any of the following:

- a. Buys or sells on credit goods or services whose prices are denominated in foreign currency
- b. Borrows or lends funds and the amounts payable or receivable are denominated in foreign currency
- c. Is a party to an unperformed forward exchange contract
- d. For other reasons, acquires or disposes of assets, or incurs or settles liabilities denominated in foreign currency.

FASB ASC 830-20-05-2 states:

Foreign currency transactions may produce receivables or payables that are fixed in terms of the amount of foreign currency that will be received or paid.

FASB ASC 830-20-35-1 further states:

A change in exchange rates between the functional currency and the currency in which a transaction is denominated increases or decreases the expected amount of functional currency cash flows upon settlement of the transaction. That increase or decrease in expected functional currency cash flows is a foreign currency transaction gain or loss that generally shall be included in determining net income for the period in which the exchange rate changes.

Thus, even though the loan was obtained to construct the building, the transaction gains and losses are not part of the cost of the building, but are a result of the change in the exchange rate and are included in income each period in which the exchange rate fluctuates.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.28 Accounting for Certain Liquidated Damages

Inquiry—“Liquidated damages” represent contractual payments to a buyer of property, plant, and equipment (PP&E) for the nondelivery or noncompletion of construction of PP&E by a stated completion date. The amount is specified in advance by contract—for example, a stated amount per day of delay—rather than a computation of actual losses of the buyer caused by the delay. Liquidated damages are negotiated to represent compensation for a reasonable estimate of the buyer’s costs associated with a delay. Liquidated damages are specified in advance in order to eliminate the need for possibly contentious after-the-fact negotiations about actual costs incurred. How should a buyer of PP&E account for liquidated damages, as defined above?

Reply—Because the buyer does not provide the payer of the damages with an identifiable benefit in exchange for the payment, a buyer typically records liquidated damages as a reduction of the payments it has made to the vendor for the PP&E (that is, a reduction of the cost of the PP&E). Amounts of liquidated damages in excess of the total cost of PP&E would be recognized by the buyer as income.

The basis for this reply is Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 605-50. The underlying principle in FASB ASC 605-50 is that unless the customer provides the vendor with an identifiable benefit, the payment received from the vendor is a reduction of the purchase price of the goods purchased from the vendor—that is, a return of amounts paid.

Contracts between a buyer and provider of PP&E could be drafted in two ways—with a realistic completion date and contract price with liquidated damages for late delivery, or with a pessimistic completion date and a bargain contract price with a bonus for early delivery. The accounting for liquidated damages, as noted in this reply, results in the same accounting for the buyer regardless of how the contract is drafted.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[The next page is 1261.]

Section 2220

Long-Term Investments

.01 Equity Method When Current Direct Ownership Less Than Twenty Percent

Inquiry—Company A purchased a 19 percent stock ownership interest in B. The company also made a loan to B that is convertible into stock of B and is secured by shares of C (B's subsidiary). For as long as the loan is outstanding, Company A will have several seats on B's board. The company also has options to purchase shares of C.

Is the company required to report its investment in B under the equity method?

Reply—Paragraphs 6 and 8 of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 323-10-15 state that the ability to exercise the type of influence contemplated in FASB ASC 323, *Investments—Equity Method and Joint Ventures*, may be indicated in several ways such as representation on the board of directors and investment (direct or indirect) of 20 percent or more in the voting stock of an investee.

The company would own only 19 percent of the outstanding voting stock. Although it is not indicated whether the conversion feature of the loan may result in ownership of 20 percent or more, or whether the board seats would allow A to significantly influence the voting at meetings of B's board of directors, the overall impact of the proposed transaction could demonstrate that the company has the ability to exercise significant influence over the investee. Therefore, the equity method should be followed in accounting for the investment.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.02] Reserved

.03 Equity Method for Investee Following Completed Contract Method

Inquiry—A client, a contractor who follows the percentage of completion method for income recognition, has entered into a joint venture. The joint venture follows the completed contract method in its financial statements. The client accounts for his investment in the joint venture on the equity basis. May the client recognize his share of the venture's income (determined on the percentage of completion method) even though the venture will not recognize income until the contract is completed?

Reply—The FASB ASC glossary defines the terms *earnings or losses of an investee* and *financial position of an investee* as “net income (or net loss) of an investee determined in accordance with U.S. generally accepted accounting principles” and “financial position of an investee determined in accordance with U.S. generally accepted accounting principles,” respectively.

Both the completed contract method and the percentage of completion method are generally accepted, and the investor should not change the investee's method of accounting from completed contract to percentage of completion in applying the equity method. If the investee's financial statements are prepared on a comprehensive basis of accounting other than generally accepted accounting principles (GAAP), the investor should eliminate material variances

from GAAP in applying the equity method, in accordance with FASB ASC 970-323-35-20.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.04] Reserved

.05 Assuming Pro Rata Share of Venture's Revenues and Expenses

Inquiry—A company has entered into a joint venture with another venturer. Would it be permissible for the company to include in its income its pro rata share of each of the revenue and expense accounts of the venture?

Reply—FASB ASC 323-10-45-1 states:

Under the equity method, an investment in common stock shall be shown in the balance sheet of an investor as a single amount. Likewise, an investor's share of earnings or losses from its investment shall be shown in its income statement as a single amount except for the extraordinary items as specified in the following paragraph.

However, FASB ASC 810-10-45-14, relating to accounting for investments in unincorporated joint ventures states, in part:

If the investor-venturer owns an undivided interest in each asset and is proportionately liable for its share of each liability, the provisions of paragraph 323-10-45-1 may not apply in some industries. For example, in certain industries the investor-venturer may account in its financial statements for its *pro rata* share of the assets, liabilities, revenues, and expenses of the venture.

Guidance for transactions of this type relating to real estate can be found in FASB ASC 970-323-25-12 and FASB ASC 970-810-45-1.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.06] Reserved

[.07] Reserved

.08 Acquisition of Subsidiaries by Exchange of Assets With No Book Value

Inquiry—A client, a computer services company, acquired 50 percent of the capital stock of a corporation in exchange for rights to computer programs. The cost of these programs had been expensed by the client. Another party acquired the remaining 50 percent of the stock for \$150,000. The client recorded this transaction as a debit to investments in subsidiaries and a credit to earnings of \$150,000.

A similar transaction, an exchange of rights to computer programs for capital stock with a stated value of \$200,000, occurred later. Investments in subsidiaries was debited and earnings was credited for \$200,000.

The subsidiaries are accounted for under the equity method.

Can the earnings recorded on the exchange of expensed computer programs for common stock be reflected in parent company financial statements, or do generally accepted accounting principles require elimination?

Reply—Intra-entity profit eliminations under the equity method is discussed in FASB ASC 323-10-35-8 and states, in part, "All intra-entity transactions are eliminated in consolidation under that Subtopic, but under the

equity method intra-entity profits or losses are normally eliminated only on assets still remaining on the books of an investor or an investee.”

FASB ASC 323 indicates that the intercompany gain (\$150,000 and \$200,000) recorded by the investor company would be eliminated under the equity method.

In the second case, measuring the value of the computer programs by the \$200,000 stated value of the stock may not be appropriate, and the auditor should try to satisfy himself concerning the estimated values assigned to the tangible and intangible assets contributed by the other stockholders. (See FASB ASC 323, FASB ASC 350, *Intangibles—Goodwill and Other*, and FASB ASC 805, *Business Combinations*.)

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.09] Reserved

[.10] Reserved

[.11] Reserved

.12 Investor's Share of Losses in Excess of Its Investment

Inquiry—Company A's share of the losses of a real estate venture exceeds its investment in the venture. How should Company A account for its investment?

Reply—FASB ASC 970-323 recommends that the equity method be used to account for investments in corporate or noncorporate real estate ventures. Paragraphs 19–22 of FASB ASC 323-10-35 state, in part:

An investor's share of losses of an investee may equal or exceed the carrying amount of an investment accounted for by the equity method plus advances made by the investor. The investor ordinarily shall discontinue applying the equity method if the investment (and net advances) is reduced to zero and shall not provide for additional losses unless the investor has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee. An investor shall, however, provide for additional losses if the imminent return to profitable operations by an investee appears to be assured. For example, a material, nonrecurring loss of an isolated nature may reduce an investment below zero even though the underlying profitable operating pattern of an investee is unimpaired. If the investee subsequently reports net income, the investor shall resume applying the equity method only after its share of that net income equals the share of net losses not recognized during the period the equity method was suspended.

Accordingly, the investor should reflect its investment at a zero amount and disclose in a note to the financial statements the amount of its share of investee losses in excess of the zero amount.

If the investor is committed to provide further financial support to the investee, the investor should show the excess of its share of investee losses over its investment and advances as a liability up to the amount of its commitment.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.13 A Change in Circumstances Using the Equity Method of Accounting for an Investment

Inquiry—An investor had guaranteed obligations of an investee and the investor's share of losses of this investee have exceeded the carrying amount of the investment on the investor's book in a prior year. This procedure is in accordance with paragraphs 19–22 of FASB ASC 323-10-35. In the current year, the investee fully paid the obligation which was guaranteed by the investor; accordingly, the investor will no longer guarantee the obligations of the investee and, therefore, will not record its share of the investee's losses.

- (1) Does this constitute a change of accounting principle?
- (2) How should the liability recorded on the investor's books be accounted for?

Reply—(1) This is not a change in accounting principle. According to FASB ASC 250-10-45-1, an "adoption or modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring" is not a change in accounting principle. The situation described is a change in circumstances and not a change in accounting principle.

(2) The liability recorded on the investor's books should be reversed in the current year and reported in the income statement with appropriate footnote disclosure.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.14] Reserved**.15 Accounting for Distribution From Joint Venture**

Inquiry—A corporation invests in a joint venture which is involved in real estate. The joint venture is a corporation and it is not controlled by the corporate investor. It accounts for this investment in accordance with FASB ASC 323. The joint venture incurred losses over the next few years. That resulted in the investment account on the corporation's books to decline to zero. At this point, the joint venture paid the corporation a cash distribution. How should the corporation account for this distribution?

Reply—FASB ASC 323 states that the investor ordinarily shall discontinue applying the equity method when the investment (and net advances) is reduced to zero and shall not provide for additional losses unless the investor has guaranteed obligations of the investee or is otherwise committed to provide financial support for the investee.

In this situation, the corporate investor in the joint venture should account for the cash distributions received as income if the distribution is not refundable by agreement or by law and the investor is not liable for the obligations of the joint venture and is not otherwise committed to provide financial support to the joint venture.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.16] Reserved**.17 Tax Basis Accounting—Use of Equity Method**

Inquiry—Can an investor who prepares its financial statements in accordance with U.S. GAAP use the equity method of accounting for an investment

in the common stock of an investee that presents its financial statements on the income tax basis of accounting if the investment would otherwise qualify for the equity method?

Reply—FASB ASC 323-10-35-4 states, in part:

Under the equity method, an investor shall recognize its share of the earnings or losses of an investee in the periods for which they are reported by the investee in its financial statements.

The FASB ASC glossary defines the term *earnings or losses of an investee* as the “net income (or net loss) of an investee determined in accordance with U.S. generally accepted accounting principles.”

If the investment qualifies for equity method accounting, the investor must adjust the investee’s tax basis financial statements to GAAP basis to determine its share of earnings or losses. If the adjustment cannot be determined, and the amounts are material, it would be considered a GAAP exception.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

Sections 2220.18–.27 are intended to assist reporting entities when implementing the provisions of FASB ASC 820, *Fair Value Measurements and Disclosures*, to estimate the fair value of their investments in certain entities that calculate net asset value. Sections 2220.18–.27 apply to investments that are required to be measured and reported at fair value and are within the scope of paragraphs 4–5 of FASB ASC 820-10-15.

.18 Applicability of Practical Expedient

Inquiry—Which investments are permitted, as a practical expedient, to be measured at fair value on the basis of the net asset value (NAV)?

Reply—FASB ASC 820-10-35-59 permits reporting entities, as a practical expedient, to estimate the fair value of their investments in certain entities that calculate NAV per share (or its equivalent) by using NAV. Such investments, which are often referred to as alternative investments, include interests in hedge funds, private equity funds, real estate funds, venture capital funds, commodity funds, offshore fund vehicles, and funds of funds, as well as some bank common/collective trust funds and other similar funds. Companies in various industries, including investment companies, broker-dealers, banks, insurance companies, employee benefit plans, healthcare organizations, and not-for-profit organizations, often invest in alternative investments.

[Issue Date: December 2009]

.19 Unit of Account

Inquiry—According to the FASB ASC glossary, the *unit of account* is “[t]hat which is being measured by reference to the level at which an asset or liability is aggregated (or disaggregated).” How should the unit of account be identified for an interest in an alternative investment?

Reply—For interests in alternative investments, the appropriate unit of account is the interest in the investee fund itself, not the underlying investments within the investee fund; this is because the reporting entity owns an undivided interest in the whole of the investee fund portfolio and typically lacks the ability to dispose of individual assets and liabilities in the investee fund portfolio. However, as discussed in FASB ASC 820-10-35-61, if it is probable at

the measurement date that a reporting entity will sell a portion of an investment at an amount different from NAV, and the criteria described in FASB ASC 820-10-35-62 are met, the portion that the reporting entity intends to sell is valued in accordance with other provisions of FASB ASC 820. The remaining portion of the interest that is not probable of being sold may be valued by using NAV as a practical expedient in accordance with FASB ASC 820-10-35-59.

[Issue Date: December 2009]

.20 Determining Whether NAV Is Calculated Consistent With FASB ASC 946, Financial Services—Investment Companies

Inquiry—FASB ASC 820-10-35-59 states:

A reporting entity is permitted, as a practical expedient, to estimate the fair value of an investment within the scope of paragraphs 820-10-15-4 through 15-5 using the net asset value per share (or its equivalent, such as member units or an ownership interest in partners' capital to which a proportionate share of net assets is attributed) of the investment, if the net asset value per share of the investment (or its equivalent) is calculated in a manner consistent with the measurement principles of Topic 946 as of the reporting entity's measurement date.

How does a reporting entity conclude that the NAV, as most recently reported by the manager of the alternative investment (reported NAV), has been calculated in a manner consistent with the measurement principles of FASB ASC 946, *Financial Services—Investment Companies*?

Reply—A reporting entity's management is responsible for the valuation assertions in its financial statements. Determining that reported NAV is calculated consistently with FASB ASC 946, including measurement of all or substantially all of the underlying investments of the investee in accordance with FASB ASC 820, requires a reporting entity to independently evaluate the fair value measurement process utilized by the investee fund manager to calculate the NAV. Such an evaluation is a matter of professional judgment and includes determining that the investee fund manager has an effective process and related internal controls in place to estimate the fair value of its investments that are included in the calculation of NAV. The reporting entity's controls used to evaluate the process of the investee fund manager may include the following:

- *Initial due diligence* (procedures performed before the initial investment)
- *Ongoing monitoring* (procedures performed after the initial investment)
- *Financial reporting controls* (procedures related to the accounting for, and reporting of, the investment) (Refer to the AICPA Audit Guide *Special Considerations in Auditing Financial Instruments* and the AICPA nonauthoritative practice aid *Alternative Investments—Audit Considerations* for examples of these controls.¹)

Before concluding that the reported NAV is calculated in a manner consistent with the measurement principles of FASB ASC 946, the reporting entity might evaluate the evidence that is gathered via the initial due diligence and ongoing monitoring of the investee fund. Only after considering all relevant factors can the reporting entity reach a conclusion about whether the reported NAV is

¹ The AICPA nonauthoritative practice aid *Alternative Investments—Audit Considerations* is available on the AICPA website at www.aicpa.org/InterestAreas/FRC/AuditAttest/Fieldwork/DownloadableDocuments/Alternative_Investments_Practice_Aid.pdf.

calculated in a manner consistent with the measurement principles of FASB ASC 946. For example, the reporting entity might consider the following key factors relating to the valuation received from the investee fund manager:

- The investee fund's fair value estimation processes and control environment, and any changes to those processes or the control environment²
- The investee fund's policies and procedures for estimating fair value of underlying investments, and any changes to those policies or procedures³
- The use of independent third party valuation experts to augment and validate the investee fund's procedures for estimating fair value
- The portion of the underlying securities held by the investee fund that are traded on active markets
- The professional reputation and standing of the investee fund's auditor (this is not intended to suggest that the auditor is an element of the investee fund's internal control system, but as a general risk factor in evaluating the integrity of the data obtained from the investee fund manager)
- Qualifications, if any, of the auditor's report on the investee fund's financial statements
- Whether there is a history of significant adjustments to the NAV reported by the investee fund manager as a result of the annual financial statement audit or otherwise
- Findings in the investee fund's advisor or administrator's Statements on Standards for Attestation Engagements No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801),⁴ report on management's description of a service organization's system and the suitability of the design of controls (a type 1 report) or on management's description of a service organization's system and the suitability of the design and operating effectiveness of controls (a type 2 report), if any
- Whether NAV has been appropriately adjusted for items such as carried interest and clawbacks (more fully described in section 6910.29, "Allocation of Unrealized Gain (Loss), Recognition of Carried Interest, and Clawback Obligations")
- Comparison of historical realizations to last reported fair value

If the last reported NAV is not as of the reporting entity's measurement date, refer to section 2220.22 for further considerations.

² For further guidance, see AU-C section 501, *Audit Evidence—Specific Considerations for Selected Items* (AICPA, *Professional Standards*), and the AICPA nonauthoritative practice aid *Alternative Investments—Audit Considerations*. [Footnote revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

³ See footnote 2.

⁴ Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801), establishes the requirements and application guidance for a service auditor reporting on controls at a service organization relevant to user entities' internal control over financial reporting. AU-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization* (AICPA, *Professional Standards*), contains the requirements and application guidance related to an auditor's use of a service auditor's report in an audit of the financial statements of an entity that uses a service organization. [Footnote revised, August 2011, to reflect conforming changes necessary due to the issuance of SSAE No. 16. Footnote revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

In cases when the reporting entity invests in a fund of funds (the investee fund invests in other funds that do not have readily determinable fair values), the reporting entity might conclude that the NAV reported by the fund of funds manager is calculated in a manner consistent with FASB ASC 946 by assessing whether the fund of funds manager has a process that considers the previously listed items in the calculation of the NAV reported by the fund of funds, and that the fund of funds manager has obtained or estimated NAV from underlying fund managers in a manner consistent with paragraphs 59–62 of FASB ASC 820-10-35 as of the measurement date. The reporting entity is not required to look through the fund of funds interest to underlying fund investments if the reporting entity has concluded that the fund of funds manager reports NAV consistent with FASB ASC 946 for the fund of funds interest.

[Issue Date: December 2009; Revised, June and August 2011, to reflect conforming changes necessary due to the issuance of SSAE No. 16; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.21 Determining Whether an Adjustment to NAV Is Necessary

Inquiry—FASB ASC 820-10-35-60 allows the reporting entity, as a practical expedient, to estimate the fair value of an investment within the scope of paragraphs 4 and 5 of FASB ASC 820-10-15 using the NAV as reported by the investee when the reporting entity has satisfied itself that (a) the investee has calculated NAV consistent with FASB ASC 946 (see section 2220.20), and (b) the NAV has been calculated as of the reporting entity's financial reporting (measurement) date.

FASB ASC 820-10-35-60 further states:

If the net asset value per share of the investment obtained from the investee is not as of the reporting entity's measurement date or is not calculated in a manner consistent with the measurement principles of Topic 946, the reporting entity shall consider whether an adjustment to the most recent net asset value per share is necessary. The objective of any adjustment is to estimate a net asset value per share for the investment that is calculated in a manner consistent with the measurement principles of Topic 946 as of the reporting entity's measurement date.

How does a reporting entity determine whether an adjustment to the last reported NAV is necessary?

Reply—Examples of when an adjustment to the last reported NAV may be necessary include, but are not limited to the following:

- NAV is not as of the reporting entity's measurement date
- NAV is not calculated in a manner consistent with the measurement principles of FASB ASC 946 (which requires, among other things, measurement of all or substantially all of the underlying investments of the investee in accordance with FASB ASC 820)
- Both

The existence of either of these factors may lead the reporting entity to conclude that an adjustment to the last reported NAV may be necessary. Practically, it is difficult to assess whether an adjustment is necessary unless an estimate of the adjustment is calculated.

[Issue Date: December 2009]

.22 Adjusting NAV When It Is Not as of the Reporting Entity's Measurement Date

Inquiry—If the reporting entity concludes that the reported NAV is calculated consistently with FASB ASC 946, but an adjustment is necessary because the NAV is not as of the reporting entity's measurement date, how should the reporting entity estimate the adjustment? (Refer to the inquiry in section 2220.21 for applicable FASB literature.)

Reply—FASB ASC 820-10-35-60 states that “The objective of any adjustment is to estimate a net asset value per share for the investment that is calculated in a manner consistent with the measurement principles of Topic 946 as of the reporting entity's measurement date.” If the last reported NAV is calculated consistently with FASB ASC 946 but is not as of the reporting entity's measurement date, the reporting entity may either request the investee fund manager to provide a supplemental NAV calculation consistent with the measurement principles of FASB ASC 946 as of the reporting entity's measurement date, or it may be necessary to adjust or roll forward (or roll back)⁵ the reported NAV for factors that might cause it to differ from the NAV at the measurement date. For example, the following factors might necessitate an adjustment to the reported NAV when it is not calculated as of the reporting entity's measurement date:

- The reporting entity has made an additional investment(s) (capital contributions) since the calculation date of the reported NAV and prior to the reporting entity's measurement date
- The reporting entity has received a distribution(s) or partial redemption since the calculation date of the reported NAV
- The reporting entity has become aware (through inquiry of the investment manager or communication by the investment manager to the reporting entity) of changes in the value of underlying investments since the calculation date of the reported NAV
- Market changes or other economic conditions have changed to affect (favorably or unfavorably) the value of the investee's portfolio after the calculation date of the reported NAV
- Changes have occurred in the composition of the underlying investment portfolio of the investee fund after the NAV calculation date

The roll forward NAV might be calculated as follows:

i. Last Reported NAV (calculated consistently with FASB ASC 946)	\$ X,XXX
ii. Add capital contributions/subscriptions	C,CCC
iii. Subtract distributions/redemptions/withdrawals	(D,DDD)
iv. Adjust for changes in valuations ^(a)	V,VVV
Roll forward NAV (as of the reporting entity's measurement date)	\$ R,RRR

(continued)

⁵ When the reporting entity's measurement date is prior to the net asset value (NAV) calculation date, it may be more appropriate to use that NAV and perform a roll back rather than using a reported NAV calculated prior to the entity's measurement date.

- (a) Market changes refer to market fluctuations between the date of the reported NAV and the reporting entity's measurement date. Examples of other economic conditions for which it may be necessary to adjust a reported NAV include, but are not limited to, a portfolio company being acquired, going public, or declaring bankruptcy between the date of the reported NAV and the reporting entity's measurement date, or changes in the value of underlying investments caused by company performance or market conditions, or both.

[Issue Date: December 2009]

.23 Adjusting NAV When It Is Not Calculated Consistent With FASB ASC 946

Inquiry—If the reporting entity concludes that an adjustment is necessary because a reported NAV is not calculated consistently with the measurement principles of FASB ASC 946, how does a reporting entity estimate the adjustment? (Refer to the inquiry in section 2220.21 for applicable FASB literature.)

Reply—Although it is not possible to state all the reasons why a reported NAV may not be consistent with the measurement principles of FASB ASC 946 (that is, it is not fair value based), the reporting entity would need to consider and understand the following:

- The reasons why NAV has not been based upon fair value. In some cases investees may appear to function similarly to investment companies, but do not meet the definition of an *investment company* provided in FASB ASC 946-10-15-2 and it is not industry practice for the investee to issue financial statements using the measurement principles in FASB ASC 946. (In those cases, the practical expedient is unavailable and the entity should be valued using the general measurement principles of FASB ASC 820.)
- Whether a fair value based NAV can be obtained from the investee manager.
- Whether the specific data needed to adjust the reported NAV can be obtained and properly utilized to estimate a fair value based NAV.

Examples of circumstances in which the reporting entity may be able to obtain data to estimate an adjustment include, but are not be limited to the following:

- Reported NAV is on a cash basis. The reporting entity could estimate the fair value of each underlying investment as of the measurement date by obtaining additional information from the investee manager.
- Reported NAV utilizes blockage discounts taken on securities valued using level 1 inputs, which is not consistent with FASB ASC 820. The reporting entity could estimate the adjustment to reported NAV required to remove the blockage discount based on additional information from the financial statements or from the investee manager.
- Reported NAV has not been adjusted for the impact of unrealized carried interest or incentive fees. The reporting entity could estimate the impact of carried interest or incentive fees and adjust reported NAV.

If the reporting entity finds that it is not practicable to calculate an adjusted NAV (for example, because sufficient information is not available or it is not in a position to reasonably evaluate the information available and estimate values consistent with FASB ASC 946), then the practical expedient is not available. The reporting entity may also elect not to utilize the practical expedient. In those instances, the reporting entity should apply the general measurement principles of FASB ASC 820 instead (see section 2220.27).

[Issue Date: December 2009]

.24 Disclosures—Ability to Redeem Versus Actual Redemption Request

Inquiry—FASB ASC 820-10-35-54B(c) states the following:

If a reporting entity cannot redeem its investment with the investee at net asset value per share (or its equivalent) at the measurement date but the investment may be redeemable with the investee at a future date (for example, investments subject to a lockup or gate or investments whose redemption period does not coincide with the measurement date), the reporting entity shall take into account the length of time until the investment will become redeemable in determining whether the fair value measurement of the investment shall be categorized within Level 2 or Level 3 of the fair value hierarchy. For example, if the reporting entity does not know when it will have the ability to redeem the investment or it does not have the ability to redeem the investment in the near term at net asset value per share (or its equivalent), the fair value measurement of the investment shall be categorized within Level 3 of the fair value hierarchy.

In most cases, redemptions from alternative investment funds that redeem at NAV are only permitted with advance notice, ranging from 30 to 120 days. In order to classify the investment within level 2 of the fair value hierarchy, must the investor have submitted a previous redemption request effective as of the measurement date or is it sufficient for an investor to have had the ability to redeem on the measurement date, even though it may not have exercised this ability?

Reply—Determining the appropriate level within the fair value hierarchy is a matter of professional judgment. Even though a redemption notice may not have been submitted effective on the measurement date, so long as the reporting entity has the ability to redeem at NAV in the near term (for example, it has the contractual and practical ability to redeem) at the measurement date, then consistent with FASB ASC 820-10-35-54B(a), the investment may be classified within level 2 of the fair value hierarchy.

[Issue Date: December 2009; Revised, September 2013, to reflect conforming changes necessary due to the issuance of FASB ASU No. 2011-04.]

.25 Impact of “Near Term” on Classification Within Fair Value Hierarchy

Inquiry—What is considered “near term” for purposes of determining whether the investment would be classified as level 2 or level 3? (Refer to the inquiry in section 2220.24 for applicable FASB literature.)

Reply—What is viewed as near term is a matter of professional judgment and depends on the specific facts and circumstances. A redemption period of 90 days or less generally would be considered near term, because any potential discount relative to the time value of money to the next redemption date would be unlikely to be considered a significant unobservable input in accordance with FASB ASC 820. However, other factors (for example, likelihood or actual imposition of gates) may influence the determination of whether the investment will be redeemable in the near term.

[Issue Date: December 2009]

.26 Categorization of Investments for Disclosure Purposes

Inquiry—The sample disclosure provided in FASB ASC 820-10-55-107 appears to apply to an institutional investor with a diversified portfolio of hedge, private equity, and real estate funds. Certain entities, however, specialize in one particular investment category or have a significant investment in one such category, such as private equity or venture capital. Should these reporting entities use a different categorization than that appearing in the sample disclosure?

Reply—Yes. FASB ASC 820-10-55-107 indicates that “the major categories presented ... are provided as examples only and are not intended to be treated as a template. The major categories disclosed should be tailored to the nature and risks of the reporting entity’s investments.”

Accordingly, the disclosure should be tailored to address the concentrations of risk that are specifically attributable to the investments. For example, a private equity fund of funds should not simply categorize its investments as “private equity” as this categorization is not specific enough to address the nature and risks of the investee funds. In this example, more specific categorization, perhaps relating to industry, geography, vintage year, or the strategy of the investees (venture, buyout, mezzanine, and so on), may be more appropriate and more useful to the reader. Such categorization is a matter of judgment and should only be made after careful consideration of the specific risks and attributes of the portfolio investments has been made.

[Issue Date: December 2009; Revised, October 2013, to reflect conforming changes necessary due to the issuance of FASB ASU No. 2011-04.]

.27 Determining Fair Value of Investments When the Practical Expedient Is Not Used or Is Not Available

Inquiry—For entities that do not elect to use NAV as a practical expedient to estimate fair value or are unable to adjust the most recently reported NAV to estimate a NAV that is calculated in a manner consistent with the measurement principles of FASB ASC 946 as of the reporting entity’s measurement date, what inputs or investment features should be considered in estimating fair value?

Reply—Section 2220 distinguishes between redeemable and nonredeemable types of alternative investments, which are defined as follows:

- **Investments with redeemable interests.** Typically consist of hedge funds (based both in the United States and offshore) and some bank common/collective trust funds. These investment funds permit holders periodic opportunities to subscribe for or redeem interests at frequencies that can run from daily to annually. Certain funds may impose lock-up periods after an initial investment, under which an investor agrees that it may not redeem its investment for a specified period of time (in some cases, an early redemption may be permitted upon payment of an early redemption fee).
- **Investments with nonredeemable interests.** Typically consist of private equity, venture capital, and real estate funds. Generally, these investments have an initial subscription period, under which each investor makes a commitment to contribute a specified amount of capital as called for by the investment manager, typically as investments are identified and money is needed to acquire them. Due to the inherent illiquidity of the underlying investments, redemptions are not permitted during the fund’s life; however, typically, as investments are sold or experience another liquidity event (for example, an initial public offering), the proceeds of the sale, less any incentives due to the

fund sponsor, are often distributed back to the investors in the fund immediately following the sale or liquidity event.

Investment Inputs

A reporting entity might first consider the other market participants to whom it could sell the asset. In accordance with FASB ASC 820-10-35-9, “[t]he fair value of the asset ... shall be determined based on the assumptions that market participants would use in pricing the asset ...” Based on guidance in FASB ASC 820-10-35-53, in the absence of relevant observable inputs, a reporting entity uses “unobservable inputs [that] shall reflect the reporting entity’s own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk).” In accordance with FASB ASC 820-10-35-55, “[i]n developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. However, the reporting entity shall not ignore information about market participant assumptions that is reasonably available without undue cost and effort.” When doing so, the reporting entity is reminded that the FASB ASC glossary defines *market participants* as “knowledgeable, having a reasonable understanding about the asset or liability and the transaction based on all available information, including information that might be obtained through due diligence efforts that are usual and customary.” Thus, it can be presumed that a market participant would be aware of, and may be willing to accept, limitations on conversion to cash inherent to alternative investments. However, in some cases, those types of limitations may also affect the fair value measurement (see “Investment Features”).⁶ It also can be presumed that market participants may consider other factors such as the investment manager’s track record and potentially limited access to desirable investment opportunities. Finally, it should be acknowledged that market participant assumptions normally result in a range of values. According to FASB ASC 820-10-35-24, “[a] fair value measurement is the point within that range that is most representative of fair value in the circumstances.” See FASB ASC 820-10-35-9 for further guidance. The reporting entity should also consider the guidance in paragraphs 51A–51H of FASB ASC 820-10-35.

Alternative investments may lend themselves to valuation techniques consistent with the income or market approaches. If both of these approaches are used to measure fair value, the results should be evaluated and weighted as discussed in FASB ASC 820-10-35-24. When NAV is not used as a practical expedient, examples of factors that might be used when estimating fair value (depending on the valuation technique(s) and facts and circumstances) are as follows:

- NAV (as one valuation factor)
- Transactions in principal-to-principal or brokered markets (external markets) and overall market conditions
- Features of the alternative investment
- Expected future cash flows appropriately discounted (detailed description is beyond the scope of this document; however, for many funds with nonredeemable interests, expected future cash flows from the

⁶ Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820-10-35-15 states that “the effect on a fair value measurement of a restriction on the sale or use of an asset by a reporting entity will differ depending on whether the restriction would be considered by market participants in pricing the asset.”

interests might typically coincide with the expected future cash flows from the underlying investments)

- Factors used to determine whether there has been a significant decrease in the volume and level of activity for the asset when compared with normal market activity for the asset (FASB ASC 820-10-35-51A)

The preceding examples are not listed in any order of importance. Rather, the reporting entity might determine the relative weighting and importance of these inputs based on its view of what market participants might consider in estimating fair value.

Investment Features⁷

A valuation technique used to measure the fair value of an asset or a liability should reflect assumptions a market participant might use to price the asset or liability, including assumptions about liquidity and risk, based on the best information available. The following discussion provides a detailed description of features of alternative investments that normally might be expected to be considered by market participants in the estimation of the fair value of an alternative investment. When considering the potential impact of the features of an alternative investment on its fair value, it is important that all relevant features be considered in the aggregate because that is how a market participant might be likely to evaluate them in determining how much it might be willing to pay for an alternative investment.

Other factors that may be considered include observed subscriptions and redemptions in redeemable interests; external market transactions in non-redeemable interests; expected future cash flows; and features of the alternative investment. Additionally, a market participant might normally be expected to compare the performance of the alternative investment to publicly available data (for example, benchmarks, indexes, expected returns, and returns of comparable vehicles), and the cash returns of the investment to NAVs reported by the alternative investment during the year. A conclusion may ultimately be reached that the reported NAV is equivalent to fair value, either because no conditions exist to suggest an adjustment is necessary or because factors indicating a discount to the reported NAV may be offset by other factors that might justify a premium. In other cases, however, the investment may be valued at a discount or premium to the reported NAV because factors indicate that the fair value of the investment is less than, or more than, the reported NAV. Regardless of whether or not NAV is determined to be equivalent to fair value, the reporting entity needs to evaluate the relevant individual factors and their potential impact on fair value, and consider the level of documentation in its evaluation.

Among the factors that market participants might be expected to consider are the various terms and features of the alternative investment. Such features generally fall into one of two categories: initial due diligence features or ongoing

⁷ The “Investment Features” section contains important information related to features of alternative investments that a reporting entity may consider in determining fair value when the option to utilize the practical expedient is unavailable or not elected. The list of features highlighted in this section is intended to provide some examples to better explain the types of scenarios that could impact fair values. Because individual investments may have additional terms and features, the examples included in the “Investment Features” section should not be viewed as an all-inclusive “checklist.” Professional judgment should be applied in evaluating the assumptions appropriate to any individual investment. The actual computation of fair value requires management’s professional judgment and is beyond the scope of this Technical Questions and Answers section.

monitoring features. The magnitude of any adjustment resulting from consideration of ongoing monitoring features is a matter of judgment and should be evaluated based on the facts and circumstances specific to each investee fund.

Initial Due Diligence Features. Generally, *initial due diligence features* are inherent characteristics that may have been considered by the reporting entity as part of its due diligence when making its initial investment in the particular investee fund. The following provides examples of initial due diligence features of an alternative investment. Not every feature may be relevant to every alternative investment, nor does this list necessarily include all assumptions that market participants may apply in any specific situation.

Lock-up periods and redemption fees. (Typically applies only to redeemable interests)

Lock-up period refers to the initial amount of time a reporting entity is contractually required to invest before having the ability to redeem. Typically, when the lock-up period expires, the reporting entity may redeem its interests on any scheduled liquidity date, subject to the other liquidity terms described in the investee fund's governing documents. The length of the lock-up period often depends on the quality and reputation of the fund manager as well as the expected liquidity of the underlying investment portfolio. In some instances, alternative investments may offer reduced fees if an investor agrees to a longer lock-up period. Also, some funds may permit investors to redeem during a lock-up period upon payment of a redemption fee. Such fees are typically imposed on the amount to be redeemed and generally range from 1 percent to 3 percent of the gross redemption amount.

Related to the concept of lock-up periods is the general frequency in which an investor is allowed to redeem or withdraw from a fund. In the absence of a lock-up period, investors with redeemable interests typically may only redeem at prescribed liquidity dates (generally monthly, quarterly, or annually).

Notice periods. (Typically applies only to redeemable interests)

Following the expiration of any applicable lock-up period, a reporting entity may, upon specified prior written notice (generally 45–120 days) to the general partner or manager (redemption notice), elect to redeem all or a portion of its interest as of the last day of a calendar month, quarter, or year (redemption date).

Holdbacks. (Typically applies only to redeemable interests)

When the general partner or investment manager receives a redemption notice, the fund will redeem the interests of an investor as specified in the redemption notice, at the redemption price (as discussed subsequently) as of the applicable redemption date. The fund will distribute all or a substantial portion (for example, 90 percent) of the redemption price with respect to the interests being redeemed within a specified number of business days (for example, 30 days) following the applicable redemption date. Any balance (for example, the remaining 10 percent) is distributed within a specific time frame, often following the release of the fund's audited financial statements for the year in which the redemption date falls. Holdback amounts protect the general partner or investment manager from adjustments reducing the NAV of the fund during an audit of the financial statements.

Suspension of redemptions (“gates”). (Typically applies only to redeemable interests)

Pursuant to the fund’s governing documents, the general partner or investment manager can suspend or restrict the right of any investor to redeem his or her interests (whether in whole or in part). The general partner or investment manager can implement this restriction for certain reasons, including the aggregate amount of redemption requests, certain adverse regulatory or tax consequences, reduced liquidity of portfolio holdings, and other reasons that may render the manager unable to promptly and accurately calculate the fund’s NAV. The most common example is the use of a “gate,” whereby certain redemption requests are deferred, in whole or in part, because the aggregate amount of redemption requests as of a particular redemption date exceeds a specified level, generally ranging from 15 percent to 25 percent of the fund’s net assets. The mere presence of a provision allowing the imposition of a gate might not normally be expected to have an effect on fair value, in the absence of any evidence suggesting that the provision actually may be exercised (see “Ongoing Monitoring Features,” which follows).

Lack of redemption option. (Nonredeemable interests and instances where all or a portion of otherwise redeemable interests have been declared nonredeemable)

As discussed earlier, funds investing in private equity, venture capital, or real estate investments generally do not permit withdrawals or redemptions, primarily to match the liquidity provisions of the fund with the liquidity of the investment portfolio. When the fund sells any of its portfolio holdings, it often distributes the proceeds received on the sale to the investors in the fund.

Fund sponsor approval to transfer. (Redeemable and nonredeemable interests)

As discussed earlier, in virtually all cases, transfers of interests in alternative investments are not permitted under the governing documents of the fund without the written consent of the fund sponsor or general partner, for regulatory or tax reasons or both, and thus, are inherent to the category of investments. Past experiences, as well as the current operating environment, are both considerations in assessing the likelihood of such approval being granted.

In some private equity, venture capital and real estate funds that require investors to make commitments to invest over time and periodically call on the commitments as needed, the fund sponsor or general partner may allow an investor to withdraw or redeem from the fund and, thus, be absolved of future commitments, but the investor may forfeit its existing interest if no other investors (including the fund sponsor or general partner) are willing to assume the withdrawn partner’s interest, including future commitments. If forfeiture occurs (which, in practice, is rare), the investor’s interest is generally reallocated to the remaining investors in the fund. (The balance of the withdrawing partner’s commitment may also be reallocated to the other investors, or the total size of the fund may be reduced).

Use of “side pockets.” (Typically applies only to redeemable interests)

As noted earlier, certain funds issuing redeemable interests may be allowed to invest a portion of their assets in illiquid securities. In such cases, a common mechanism used is a “side pocket,” whereby, at the time of an investment in an illiquid security, a proportionate share of an investor’s

capital account, relative to the entire interest of the fund, is assigned to a separate memorandum capital account or designated account. Typically, the investor loses its redemption rights to the designated account, and even a full redemption request is fulfilled only with that capital ascribed to his or her basic capital account (that is, the nondesignated capital account), while the investor continues to hold its proportionate interest in the designated account. Only when the security is sold (or otherwise deemed liquid) by the fund is the amount moved back to each applicable investor's basic capital account (and otherwise withdrawn investors can redeem the designated account balance). This designated account generally does not pay a performance fee⁸ (although one may be levied) until the illiquid investment is sold or otherwise deemed liquid. Designated accounts are often referred to as "side pocket accounts" or as "special investment accounts." Similar to "gates," the mere existence of contractual provisions permitting the use of side pockets typically does not have a material effect on estimating the fair value unless those provisions are actually exercised and access to a portion of the investment is actually limited (see "Ongoing Monitoring Features," which follows).

As previously noted, these examples of initial due diligence features are common characteristics of alternative investment funds and, as such, are generally considered and accepted by investors when making investment decisions in these investments. Accordingly, a market participant may or may not require an adjustment to the reported NAV in a transfer of an investment interest in an alternative investment solely due to the existence of these items. However, it is necessary to consider these features in conjunction with other inputs available to the reporting entity. For example, if the reporting entity is valuing redeemable interests and observes that other investors are subscribing for interests at the reported NAV under the same terms as the reporting entity's agreement, that fact may provide evidence that no adjustment to the reported NAV is necessary. However, if other investors are subscribing to the fund at the reported NAV under terms that, in aggregate, are less favorable than those in the reporting entity's agreement (for example, higher fees, greater restrictions on redemption), that fact may provide evidence that the reporting entity's holdings may trade at a premium to the reported NAV. Similarly, if other investors are receiving more favorable terms in aggregate than those in the reporting entity's agreement (for example, lower fees, fewer restrictions on redemption), that fact may provide evidence that the reporting entity's holding may trade at a discount to the reported NAV. An investor may also typically consider whether the fund's terms are more or less restrictive than those prevailing in the current market. For example, terms that are more restrictive may suggest a discount. Alternatively, the quality of the investment manager may command a premium.

In short, if market participants would be expected to place a discount or premium on the reported NAV because of features, risk, or other factors relating to the interest, then the fair value measurement of the interest would need to be adjusted for that risk or opportunity.⁹ However, if market participants might accept the same features, risk, and other factors relating to the interest and

⁸ Consistent with the definition in the AICPA Audit and Accounting Guide *Investment Companies*, a *performance fee* (also referred to as an *incentive fee*) is a fee paid to an investment adviser based upon the fund's performance for the period. It may be an absolute share of the fund's performance or a share of the performance in excess of a specified benchmark.

⁹ This is consistent with FASB ASC 820-10-35-54, which states, "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."

might transact at the reported NAV without a premium or discount, that fact may suggest that no adjustment is needed for the factors discussed previously to estimate fair value.

Ongoing Monitoring Features. *Ongoing monitoring features* are characteristics related to activity in an investee fund subsequent to a reporting entity's initial investment. Because ongoing monitoring features often include specific events relating to the investee fund, the fund sponsor, the industry or the asset class, they are more likely to result in consideration of a discount or premium to the reported NAV than initial due diligence features. The following provides some examples of ongoing monitoring features for an alternative investment.

As with initial due diligence features, not every feature may be relevant to a particular investment, nor does this list necessarily include all assumptions that market participants may apply in any specific situation. Also, changes in market conditions may affect the investor's assumptions relating to the significance of any particular feature.

Imposition of a gate. (Typically applies only to redeemable interests)

Though an investee fund manager's mere ability to impose a gate on redemption requests is a common initial due diligence feature (as noted previously), the actual imposition of a gate by an investee fund manager may warrant further consideration of whether a discount should be applied to the reported NAV. The act of imposing the gate generally implies that the investee fund manager is experiencing liquidity concerns, either related to specific investments or its portfolio as a whole, which the reporting entity and a market participant normally would be expected to consider in estimating fair value of the interest in the investee fund. Further, the imposition of a gate increases the uncertainty of the ultimate timing of receipt of cash upon redemption, sometimes significantly, and, thus, may impose an additional risk premium on the investment.

Redemptions from an investee fund. (Typically applies only to redeemable interests)

Even in the absence of the actual imposition of a gate, when an investee fund experiences material redemption requests this may suggest comparable liquidity issues that could result in a discount from the reported NAV, particularly in situations when the investee fund is leveraged.

Notification of redemption triggers the assessment of redemption fee. (Typically applies only to redeemable interests)

Though, as noted previously, an investee fund manager may have the ability to charge redeeming investors a redemption fee, the mere existence of this feature is generally considered to be an initial due diligence feature which, in many instances, may not cause the reported NAV to exceed the fair value of the investment interest. However, if a reporting entity irrevocably agrees to redeem some or all of its interest, the redemption fee normally would be expected to cause the reported NAV to exceed the fair value of the investment interest.

Significant changes in key terms of the investee fund. (Redeemable and nonredeemable interests)

The initial due diligence features, as previously noted, represent standard or common characteristics of an alternative investment. They are generally known and accepted by the reporting entity at the time of making an initial investment at the reported NAV. As such, a market participant with full

knowledge of these features may also likely transact at the reported NAV, so long as the terms remain within the range prevailing in the market.

If, however, the investee fund makes significant changes to the terms (for example, fees, lock-up periods, notification periods, gates) subsequent to the initial investment, the reporting entity normally would be expected to consider these changes when evaluating whether the reported NAV should be adjusted to arrive at fair value. In some cases, changes may be deemed to have little impact on the investment decisions of a market participant, whereas in other cases, changes to key terms may create a distinct difference between the existing interest and other interests (either in the specific alternative investment or comparable investments), which may result in either a discount or premium to the reported NAV.

Closure of fund to new subscriptions. (Redeemable interests)

Some funds may cease accepting subscriptions from new investors because doing so might cause them to exceed the maximum number of investors they can accept without requiring public filings of financial information under securities laws. In other cases, funds may voluntarily suspend the acceptance of subscriptions from new investors, and even in some cases additional subscriptions from existing investors, because of the adviser's view that opportunities to make further investments under the fund's investment strategy may be limited given the size of the markets involved or that they might not bring acceptable returns, or both. Such an event may suggest that existing interests in the fund could trade at a premium because prospective investors may have no other means of investing in the fund. Further, a large number of investors or the intent not to "dilute" the fund's returns by accepting additional investment funds, or both, may provide evidence that the fund may trade at a premium to the reported NAV.

Ability of fund to identify and make acceptable investments. (Nonredeemable interests)

Venture capital, private equity, and real estate funds typically offer interests on the basis of committed capital, which is only called from investors as investments are identified. Investors agree to commit capital under implicit or explicit understandings that committed capital will be called during an initial investment period, often from one to five years. Depending on the market environment, managers may find that they are unable to identify sufficient investments to utilize committed capital on a timely basis. Such funds often are smaller and less diversified than expected at the time of inception of the fund, which may negatively influence fair value. Further, certain vintages (that is, years when funds were organized) may be identified over time as having represented exceptionally good or poor investment opportunities for the particular investment style, and interests in funds organized in those years may be more likely to incur premiums or discounts, respectively. The fund's potential inability to identify and make acceptable investments will often result in unfunded capital commitments, which may need to be considered when estimating the fair value of an investment interest in the fund.

Allegations of fraud against the investee fund manager. (Redeemable and nonredeemable interests)

If the reporting entity is aware of allegations of fraud, noncompliance with laws and regulations, or other improprieties against the investee fund manager or its affiliates, the reporting entity should consider the potential impact of these allegations on the value of its interest in the investee fund.

In many cases, such allegations may result in the unexpected inability to obtain any cash proceeds from the investee fund pending the resolution of the investigation or from a general lack of liquidity resulting from historical misrepresentation of the net assets of the fund. In other cases, the ongoing ability of the investee fund manager to manage the fund may be brought into question.

Change in financial strength or key personnel of investment manager.
(Redeemable and nonredeemable interests)

In some cases, a key consideration for investment in certain funds is the reputation, and prior investment record, of the investment manager, or specific individuals expected to manage the investee fund's portfolio. In some situations, the desirability of the investment manager or individuals, or both, may influence the nature of the fee, lock-up, and similar terms investors are willing to accept in making an initial investment. If those key personnel no longer provide services to the alternative investment, investors may not be willing to continue to accept those terms. Further, if the advisory organization experiences financial deterioration, it may be less able to retain key personnel or, for certain private equity, venture capital, or real estate funds, to repay previously-received incentive fees to the fund under contractual clawback provisions (if the fund experiences subsequent losses). Those uncertainties may increase the risk of the investment.

[Issue Date: December 2009; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[The next page is 1361.]

Section 2230

Noncurrent Receivables

[.01] Reserved

.02 Balance Sheet Classification of Deposit on Equipment to Be Purchased

Inquiry—What is the appropriate balance sheet classification of a deposit on machinery which is to be purchased within one year?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 210-10-45-4 states, in part:

The concept of the nature of current assets contemplates the exclusion from that classification of such resources as the following:

- a* Cash and claims to cash that are restricted as to withdrawal or use for other than current operations, are designated for expenditure in the acquisition or construction of noncurrent assets, or are segregated for the liquidation of long-term debts.

Accordingly, the deposit on equipment should be classified as a noncurrent asset even though the equipment will be purchased within one year.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[The next page is 1391.]

Section 2240

Cash Surrender Value of Life Insurance

.01 Balance Sheet Classification of Life Insurance Policy Loan

Inquiry—A company has secured a short-term loan from an insurance company against the cash surrender value of its life insurance policies.

In Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 210-10-45-4(d), cash surrender value of life insurance policies is excluded from the classification of a current asset. This reference does not appear to recommend a different classification if the cash value may have been fully borrowed from the insurance company.

Is it proper to classify a readily liquid asset as noncurrent and simultaneously show the related borrowings as a current liability?

Reply—FASB ASC 210-10-45-4 states, in part:

This concept of the nature of current assets contemplates the exclusion from that classification of such resources as . . . (d) cash surrender value of life insurance policies.

FASB ASC 210-10-45-9(d) states, in part:

Loans accompanied by pledge of life insurance policies would be classified as current liabilities if, by their terms or by intent, they are to be repaid within 12 months. The pledging of life insurance policies does not affect the classification of the asset any more than does the pledging of receivables, inventories, real estate, or other assets as collateral for a short-term loan. However, when a loan on a life insurance policy is obtained from the insurance entity with the intent that it will not be paid but will be liquidated by deduction from the proceeds of the policy upon maturity or cancellation, the obligation shall be excluded from current liabilities.

FASB ASC 210-20-05-1 states, in part:

It is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except if a right of setoff exists.

Therefore, if a company takes out policy loans from the insurance company on life insurance policies which it owns and if there is no intention to repay the loan during the ensuing operating cycle of the business, such loan may be excluded from current liabilities. Furthermore, as the owner of a policy normally has the right to offset the loan against the proceeds received on maturity or cancellation of the policy, it is appropriate to apply the amount of the loan in reduction of the cash surrender value, with disclosure of the amount so offset.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.02 Disclosure of Life Insurance on Principal Stockholders

Inquiry—A client corporation, which is a nonpublic entity, maintains life insurance policies on its principal stockholders that will provide for the repurchase of the stock in the event of a stockholder's death. The cash surrender value of these policies appears on the balance sheet. Is further disclosure necessary?

Reply—The rule of informative disclosure requires that the essential facts respecting firm commitments for purchase of a corporation's own stock pursuant to a buy-sell agreement be set forth in a footnote to the financial statements.

The following is an example of a footnote describing such a situation that might appear on the balance sheet in reference to the cash surrender value account:

The company is the owner and beneficiary of key-man life insurance policies carried on the lives of X, Y, and Z, bearing face value amounts of \$500,000, \$500,000, and \$450,000, respectively. No loans are outstanding against the policies, but there is no restriction in the policy regarding loans.

The life insurance contracts are accompanied by mandatory stock purchase agreements to the amount of the proceeds of the life insurance. In the event of the insured's death, the "fair market value" of the stock will, by previous action, be established by the X Appraisal Company. The insured's estate will be obligated to sell, and the company will be obligated to purchase, the insured's stock up to the appraisal value of the stock or the proceeds of insurance, whichever is the lesser. The purpose is to protect the company against an abrupt change in ownership or management.

[Revised, April 2010.]

.03 Omission of Cash Surrender Value of Life Insurance from Assets

Inquiry—Clearly, cash surrender values of life insurance may be included among the assets in the balance sheet of an enterprise. Is this mandatory, or may management elect to omit this item from the assets on the theory that its inclusion will be misleading since the insurance is carried for the purpose of covering the loss it is anticipated will be sustained as a result of the death of a key official?

Reply—If the enterprise retains all valuable contract rights incident to ownership of the life insurance policy, then it is mandatory from the standpoint of full accountability to reflect the asset status of the cash surrender value of the policy. Not to reflect the cash surrender value would be tantamount to creating a hidden reserve which would be contrary to generally accepted accounting principles.

.04 Corporation's Policy on Life of Debtor Corporation's Officer

Inquiry—A client took out a straight life insurance policy on the life of an officer of another corporation which is indebted to the client. The client corporation hopes to receive the proceeds of the insurance policy tax free and has not deducted the yearly premium payments as expenses. The officer is over 65 years old, and, therefore, there is a great possibility he or she will die prior to the full payment of the outstanding balance of the corporation's debt. The prior CPA reported the accumulated premium payments on the Balance Sheet as "Investment in Life Insurance."

Is it proper to show total premiums paid as an investment under these circumstances?

Reply—Where a corporation takes out a life insurance policy on the life of a debtor corporation's officer (assuming that there is an insurable interest), the manner of accounting for the premiums should not differ from the manner of accounting for premiums paid on the life of the corporation's own officer. The premiums should be broken down between the expense and the cash surrender value elements. Accordingly, the accumulated premiums account should be

analyzed to determine the cash surrender value as at the balance sheet date, the expense portion for the period under audit, and the remaining portion which should be treated as a correction of prior period earnings. See Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 250, *Accounting Changes and Error Corrections*, for a discussion of correction of an error.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.05] Reserved

.06 Measurement of Cash Value Life Insurance Policy

Inquiry—How should a company measure and record a cash value life insurance policy that it purchases for itself on the company's balance sheet?

Reply—In accordance with FASB ASC 325-30-25-1, “an investment in a life insurance contract shall be reported as an asset.”

FASB ASC 325-30-35-1 states

An asset representing an investment in a life insurance contract shall be measured subsequently at the amount that could be realized under the insurance contract as of the date of the statement of financial position. It is not appropriate for the purchaser of life insurance to recognize income from death benefits on an actuarially expected basis. The death benefit shall not be realized before the actual death of the insured, and recognizing death benefits on a projected basis is not an appropriate measure of the asset.

FASB ASC 325-30-35-3 states

FASB ASC 325-30-30-1 states that a policyholder shall consider any additional amounts included in the contractual terms of the policy in determining the amount that could be realized under the life insurance contract. When it is probable that contractual terms would limit the amount that could be realized under the life insurance contract, these contractual limitations shall be considered when determining the realizable amounts. Those amounts that are recoverable by the policyholder at the discretion of the insurance entity shall be excluded from the amount that could be realized under the life insurance contract.

FASB ASC 325-30-35-4 states that “amounts that are recoverable by the policyholder in periods beyond one year from the surrender of the policy shall be discounted in accordance with Topic 835.”

FASB ASC 325-30-35-5 states

A policyholder shall determine the amount that could be realized under the life insurance contract assuming the surrender of an individual-life by individual-life policy (or certificate by certificate in a group policy). Any amount that ultimately would be realized by the policyholder upon the assumed surrender of the final policy (or final certificate in a group policy) shall be included in the amount that could be realized under the insurance contract. See Example 1 (paragraph 325-30-55-1) for an illustration of this guidance.

FASB ASC 325-30-35-6 states

A policyholder shall not discount the cash surrender value component of the amount that could be realized under the insurance contract when contractual restrictions on the ability to surrender a policy exist, as long

as the holder of the policy continues to participate in the changes in the cash surrender value as it had done before the surrender request. If, however, the contractual restrictions prevent the policyholder from participating in changes to the cash surrender value component, then the amount that could be realized under the insurance contract at a future date shall be discounted in accordance with Topic 835.

FASB ASC 325-30-35-7 states “if a group of individual-life policies or a group policy only allows for the surrender of all of the individual-life policies or certificates as a group, then the policyholder shall determine the amount that could be realized under the insurance contract on a group basis.”

[Issue Date: May 2010.]

[The next page is 1451.]

Section 2250

Intangible Assets

[.01] Reserved

[.02] Reserved

[.03] Reserved

[.04] Reserved

[.05] Reserved

.06 Accounting Treatment of Agreements Not to Compete

Inquiry—A company enters into an agreement with an outgoing officer whereby the company will make future periodic payments to the officer in return for the officer's agreement not to compete with the company for the period coinciding with the payments.

Would it be appropriate for the company to record a liability for the total future payments to the former officer and a corresponding intangible asset for the covenant?

Reply—The authoritative literature does not provide specific guidance for the treatment of executory contracts, which require future consideration upon the occurrence of certain events.

FASB Concept No. 6, *Elements of Financial Statements—a replacement of FASB Concepts Statement No. 3 (incorporating an amendment of FASB Concepts Statement No. 2)*, paragraph 36 specifies that a characteristic of a liability is that “the transaction or other event obligating the entity has already happened.” Because the event that gives rise to the company's obligation is the former officer's forbearance from competition, many accountants believe that the transaction should be recorded prospectively, as the payments are “earned” by the former officer. They would disclose the contractual obligation as a commitment in the company's notes to its financial statements.

FASB Concept No. 6 paragraph 26 provides that a characteristic of an asset is that “it embodies a probable future benefit.” Accordingly, the company would only record an intangible asset if the payment to the former officer preceded the period of forbearance.

[.07] Reserved

[The next page is 1501.]

Section 2260

Other Assets

[.01] Reserved

[.02] Reserved

.03 Legal Expenses Incurred to Defend Patent Infringement Suit

Inquiry—A company is sued for patent infringement. Should the cost to defend the patent be capitalized or expensed?

Reply—The choice of capitalizing or expensing depends on the outcome of the lawsuit. FASB Concept No. 6, *Elements of Financial Statements—a replacement of FASB Concepts Statement No. 3 (incorporating an amendment of FASB Concepts Statement No. 2)*, paragraph 247 states “. . . the legal and other costs of successfully defending a patent from infringement are ‘deferred legal costs’ only in the sense that they are part of the cost of retaining and obtaining the future economic benefit of the patent.”

If defense of the patent lawsuit is successful, costs may be capitalized to the extent of an evident increase in the value of the patent. Legal costs which relate to an unsuccessful outcome should be expensed.

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TIS Section 3000

LIABILITIES AND DEFERRED CREDITS

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Section 3100

Current Liabilities

.01 Estimated Liability for Unemployment Claims

Inquiry—Under state law, a corporation has a choice of the method to pay unemployment insurance contributions. The corporation may pay a percentage of gross wages or may reimburse the state employment commission directly for actual unemployment claims. A client chose to reimburse the state for the actual claims which may arise. If no claims against the client are filed, may the client record an expense and a liability for unemployment claims?

Reply—The estimated unemployment insurance costs should be accrued currently based on the client's estimated or past history of unemployment. Unemployment insurance cost should be related to the period worked by the employees. Not recording unemployment costs until claims are actually filed would result in a mismatching of revenues and expenses. Such an approach would be unacceptable under generally accepted accounting principles.

[.02] Reserved

.03 Accounting for Possible Refunds of Leasing Fees

Inquiry—A company franchises distributorships for home and office oxygen inhalator units. The licensees lease the units from the company and pay an initial leasing fee for each unit before receipt of the unit. As stipulated in the franchise agreement, the licensee is entitled to a refund, upon termination of the franchise agreement and return of the units, of a specified amount of the initial leasing fee depending on the period of time that the units are leased out. When units are returned they can usually be redistributed with little or no repair. Is there a liability for the return of a portion of the initial leasing fees?

Reply—The returned units can usually be redistributed with little or no repair. Therefore, accounting for these units would be similar to accounting for returnable containers. Because the licensee pays the initial leasing fee prior to delivery of the units, there is no receivable to be offset by an "allowance account" for the estimated refunds, and so the amounts for estimated refunds should be shown as a liability.

.04 Date for Accrual of Tax Penalties

Inquiry—A company has received certain billings from the federal government for interest and penalties for late filing of federal withholding taxes. Some of these notices were received prior to the balance sheet date, while other notices were received after the balance sheet date, but in either case they apply to periods prior to the balance sheet date. Should liabilities for the interest and penalties be shown on the balance sheet?

Reply—Paragraph .02 of AU-C section 560, *Subsequent Events and Subsequently Discovered Facts* (AICPA, *Professional Standards*), states, in part:

Financial statements may be affected by certain events that occur after the date of the financial statements ... financial reporting frameworks ordinarily identify two types of events:

- a. Those that provide evidence of conditions that existed at the date of the financial statements

- b. Those that provide evidence of conditions that arose after the date of the financial statements

The auditor's objective is to determine whether events occurring between the date of the financial statements and the date of auditor's report that require adjustment of, or disclosure in, the financial statements have been identified and are appropriately reflected in the financial statements. Therefore, provision should be made for any billings received for penalties on late filing of federal withholding taxes which were required to be filed prior to the balance sheet date. Similarly, any such interest should be provided for up to the balance sheet date. Interest accrued subsequent thereto would be an expense of the following period.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[.05] Reserved

[.06] Reserved

[.07] Reserved

[.08] Reserved

.09 Accrual for Employer Co-Insurance Arrangements

Inquiry—A company pays for the medical expenses of its active employees but purchased “stop-gap” or “excess of loss” insurance to cover medical expenses exceeding \$10,000, lifetime benefit, per employee. What amount, if any, should the company accrue to cover its liability?

Reply—Although Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 450, *Contingencies*, excludes employment-related costs, that accounting guidance may be appropriate for this situation. FASB ASC 450-20-25-2 states that an accrual for a loss contingency is required if the loss is probable and the amount of the loss can be reasonably estimated. Medical expenses incurred by the employee during the reporting period should be accrued. This includes expenses incurred during the reporting period but submitted after the balance sheet date. The accrual should be based on all relevant data (including statistical data), the company's historical experience, and its expectations of the future. Some of this data may be available from insurance administrators or actuaries.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.10 Compensated Absences

Inquiry—A company with a June 30 year end has a sick pay policy that states that an employee employed for at least three months is entitled to ten sick days annually. The employee is entitled to these days as of January 1 and any unused sick days as of December 31, are paid to these workers. Should the company accrue a liability as of June 30 for the unused sick days of these workers?

Reply—Yes. Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 710, *Compensation—General*, indicates that sick pay that is customarily paid even though the absence from work is not actually the result of an illness, should not be considered sick pay in applying the provisions of paragraphs 6–7 of FASB ASC 710-10-25. In considering necessity for making an accrual, the four criteria in FASB ASC 710-10-25-1 should be considered.

In determining the amount of the accrual, the guidance in FASB ASC 450, *Contingencies*, concerning the probability of future payment should be considered. Specifically, the company should consider its payment history and employee turnover in calculating the accrual.

In this example, if an employee had taken three days through June 30, the remaining accrual would be seven days. If this example were modified, and the days were earned on a pro rata basis throughout the year, the company would record a liability for the expected payment to be made to the employee for only the accumulated right through June 30. With the same three days taken through June 30, the company would have an accrual for the remaining two days in the June 30 financial statements.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[The next page is 2021.]

Section 3200

Long-Term Debt

[.01] Reserved

[.02] Reserved

[.03] Reserved

[.04] Reserved

[.05] Reserved

.06 Amortization Period for Placement Fee When Mortgage Refinanced

Inquiry—A company paid a \$100,000 mortgage placement fee for an eighteen year mortgage. Ten months later, it became apparent that a refinancing of a significantly larger mortgage would be needed. The company negotiated a commitment with a bank for a larger mortgage to be placed one year from the date of this agreement. At the time of the commitment, in accordance with Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 350, *Intangibles—Goodwill and Other*, which deals with intangible assets, the company reduced the amortization period of the placement fee to the expected remaining period of the original mortgage.

Two months before the closing date of the original mortgage, at which time almost the entire prepaid mortgage fee had been amortized, the bank was unable to make the loan and exercised an option to extend the closing date of the old mortgage and the placement date of the new mortgage for six more months.

Should the amortization period now be extended to the new settlement date?

Reply—The mortgage placement fee should not be viewed as an intangible asset but as a deferred charge under FASB ASC 835, *Interest*. It is an amortizable cost incurred to secure the mortgage.

The unamortized amount of the fee at the time when the bank exercises the option should be amortized over the remaining six month period. The reasons for the exercise of the option do not change the fact that the period benefited has been extended. The change should be treated as a change in accounting estimate, in accordance with FASB ASC 250, *Accounting Changes and Error Corrections*. If the new mortgage is placed before the end of the six month option period, any balance of the fee should then be written off in accordance with FASB ASC 470-50 and FASB ASC 470-50-45-1, which deal with early extinguishment of debt.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.07] Reserved

[.08] Reserved

.09 Financial Statement Presentation of “Pay Any Day” Loans

Inquiry—Corporation A finances its purchases of equipment through “pay any day” loans. Under this type of financing arrangement, the borrower signs

a note and security agreement which sets forth the amount financed, the finance charge, and the amount of monthly payment. This instrument differs from a conditional sales contract or “add-on” loan. The “add-on” loan is a contract calling for a specified number of payments, including interest, and therefore the liability is the total amount to be repaid over the life of the contract; whereas, the “pay any day” loan, or note and security agreement is a simple interest loan and the agreement shows the finance charge in order to disclose the amount of interest that will be paid if each installment payment is made on its exact due date.

What is the appropriate financial statement presentation of “pay any day” loans?

Reply—A “pay any day” loan can be recorded and reported in the financial statements at its face amount plus accrued interest because it is in effect a term loan with interest charged at the current rate. The amount of the loan, if any, expected to be paid within one year would be shown as a current liability.

.10 Determining the Allocation for Lease Payments for a Lease Capitalized at Fair Market Value

Inquiry—According to Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 840-30-30-1, a lessee accounting for a capital lease, records an asset and an obligation equal to the present value of the minimum lease payments at the beginning of the lease term, excluding any portion of the payments which represent executory costs (such as insurance and taxes) which will be paid by the lessor. However, if this amount is greater than the fair market value of the leased property, the amount recorded as the asset and obligation should be fair market value. When the asset and obligation are recorded at the fair market value, since the interest rate is not known, how should the amount for the lease payments be recorded?

Reply—FASB ASC 840-30-35-6 states that during the lease term, each minimum lease payment shall be allocated between a reduction of the obligation and interest expense so as to produce a constant periodic rate of interest on the remaining balance of the obligation. This is the “interest” method described in paragraphs 2–3 of FASB ASC 835-30-35.

When the asset to be recorded based on the present value of the minimum lease payments exceeds the fair market value of the asset, it is usually because the incremental borrowing rate used to determine present value is lower than the interest rate implicit in the lease.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.11 Effect of Sales Taxes on the Determination of Present Value of Minimum Lease Payments

Inquiry—A company leases a machine for \$14,000 a month for 72 months. The monthly invoice received from the lessor includes the stipulated monthly rent plus a charge for state sales taxes. The lease does not meet the 90 percent criterion of a capital lease (i.e., the present value of the minimum lease payments excluding executory costs equals or exceeds 90 percent of the fair value of the leased property) if sales taxes are excluded from minimum lease payments. The criterion is met if both the rent and sales taxes are included as minimum lease payments.

Should the minimum lease payments include sales taxes?

Reply—Practice in this area varies. Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 840-10-25 describes, in part,

minimum lease payments as the payments that the lessee is obligated to make or can be required to make in connection with the leased property. However, the lessee's obligation to pay (apart from rental payments) executory costs such as insurance, maintenance, and taxes in connection with leased property are excluded. Many accountants interpret this to mean that all taxes, including sales taxes, levied on lease payments are considered executory costs since the lessor is merely acting as a collection agent for the taxing authority.

Other accountants believe that only taxes other than sales taxes (such as property taxes) should be excluded from the minimum lease payments because sales taxes are often capitalized as part of the cost of purchased assets. FASB ASC 840-10-10-1 states that the criteria are derived from the concept that a lease that transfers substantially all of the benefits and risks incident to ownership should be accounted for as the acquisition of an asset and the incurrence of an obligation.

Because the authoritative pronouncements do not specifically address whether sales taxes should be included as part of minimum lease payments, practice varies and should be determined by the company's general policy for accounting for sales taxes on purchased assets.

Regardless of which approach is used, in order to properly apply the 90 percent test referred to in FASB ASC 840-10-25-1(d), the components of the numerator and denominator should be the same. For example, if the sales taxes are included as part of the minimum lease payments (the numerator) then the sales taxes should be included in the fair value of the leased asset (the denominator).

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.12 Balance Sheet Classification of Revolving Line of Credit

Inquiry—A company has a revolving line of credit with a bank. The company is only required to make monthly interest payments. No principal payments are required. In the event the credit line is terminated, the principal is due 12 months after the date of termination.

Should the principal amount be classified as current or long-term in a classified balance sheet?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 210-10-45-9 states that liabilities whose regular and ordinary liquidation is expected to occur within a relatively short period of time, usually 12 months, are intended for inclusion in the current liability classification. If the line of credit has not been terminated at the balance sheet date, the principal amount should be classified as long-term, unless the company intends to repay the outstanding debt within 12 months.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.13 Uncertainty Arising From Violation of Debt Agreement

Inquiry—At the end of 20X1, a company was in violation of its long-term debt covenant and was unable to obtain a waiver from the bank. It therefore reclassified its debt to current and appropriate footnote disclosures were made. During 20X2, the violation was cured. What is the proper classification of the debt in the company's 20X2 comparative financial statements?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) ASC 470-10-45-11 states that:

Current liabilities shall include long-term obligations that are or will be callable by the creditor either because the debtor's violation of a provision of the debt agreement at the balance sheet date makes the obligation callable or because the violation, if not cured within a specified grace period, will make the obligation callable. Accordingly, such callable obligations shall be classified as current liabilities unless either of the following conditions is met:

- a. The creditor has waived or subsequently lost (for example, the debtor has cured the violation after the balance sheet date and the obligation is not callable at the time the financial statements are issued) the right to demand repayment for more than one year (or operating cycle, if longer) from the balance sheet date. If the obligation is callable because of violations of certain provisions of the debt agreement, the creditor needs to waive its right with regard only to those violations.
- b. For long-term obligations containing a grace period within which the debtor may cure the violation, it is probable that the violation will be cured within that period, thus preventing the obligation from becoming callable.

Since the violation was cured in 20X2, the debt should be classified as long-term in the 20X2 financial statements. The debt should not be reclassified to long term in the 20X1 financial statements because it was a current liability based on the facts existing at the 20X1 balance sheet date.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.14] Reserved

.15 Disclosure of Five-Year Maturities on Long-Term Debt

Inquiry—A company entered into a 10-year loan agreement with a lender. The mortgage note contains a variable interest rate based on prime plus one percent. In accordance with Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 440, *Commitments*, the company will disclose the maturities on the debt for each of the next five succeeding years. Should the disclosure include principal and interest?

Reply—No. The required disclosure of the amount of scheduled repayments for each of the five succeeding fiscal years relates only to principal repayments and should not include interest. Disclosure is also called for when interest rates vary with the prime rate.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.16 Amortization of Premium or Discount in Investment Securities With an Early Call Date

Inquiry—Investment securities may be acquired at par value, at a premium, or at a discount. If the investment securities have an earlier call date, how should the amortization of premium or accretion of discount be recorded?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 310-20 applies to the accounting for discounts, premiums, and commitment fees associated with the purchase of loans and other debt securities such as corporate bonds. In accordance with FASB ASC 310-20-35-26, “the calculation of the constant effective yield necessary to apply the interest method shall use the payment terms required by the loan contract,

and prepayments of principal shall not be anticipated to shorten the loan term.” Accordingly, the period of amortization or accretion is from the purchase date to the maturity date. As provided by FASB ASC 310-20-35-26, in order to amortize the premium or accrete the discount to an early call date, the enterprise must hold a large number of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.17 Disclosure of Covenant Violation and Subsequent Bank Waiver

Inquiry—At the balance-sheet date, an entity was in violation of certain provisions of the loan covenant associated with its long-term debt. Under the terms of the loan agreement, the obligation is now callable by the creditor. Subsequent to the balance-sheet date, the bank waived its right to demand repayment for more than one year from the balance-sheet date. Therefore, the loan remained classified as long-term, per Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 470-10-45-12. Does the covenant violation and subsequent bank waiver need to be disclosed in the financial statements?

Reply—The authoritative literature applicable to nonpublic entities does not address disclosure of debt covenant violations existing at the balance-sheet date that have been waived by the creditor for a stated period of time. Nevertheless, disclosure of the existing violation(s) and the waiver period should be considered for reasons of adequate disclosure. If the covenant violation resulted from nonpayment of principal or interest on the debt, inability to maintain required financial ratios, or other such financial covenants, that information may be vital to users of the financial statements even though the debt is not callable. If the lender has waived the right for greater than one year but retained the future covenant requirements (i.e., covenant requirements will have to be met at interim dates during the next 12 months), the accounting and disclosure provisions of FASB ASC 470, *Debt*, apply.

For SEC registrants, Regulations S-X, Article 4, Section 210-4-08(c), requires disclosure of the amount of the obligation and the period of waiver whenever a creditor has waived its right to call the debt for a stated period of time.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[The next page is 2471.]

Section 3400

Contingent Liabilities

.01 Contested Liability

Inquiry—A company acquired the entire outstanding stock of another company several years ago. The acquired company was reorganized under IRS Code Section 334(b)(2) causing its building and equipment to be written up in value. Inventory was later written down.

An unpaid portion of the original purchase price is claimed by the former owners of the acquired company, but this is contested by the acquiring company on the grounds that the value of the acquired company's stock was misrepresented.

The acquired company's shareholders intend to sue the acquiring company for the unpaid balance, but a suit has not yet been filed. How should the amount due under the original purchase contract and the possible suit be reflected on the acquiring company's financial statements?

Reply—Because the possibility of a suit exists, footnote disclosure describing the entire dispute should be made, including legal counsel's comment that no suit is pending at this time. The amount due under the original purchase contract, plus accrued interest, should still be reported as a liability. No adjustments should be made in the acquiring company's financial records until the dispute is settled or legal counsel advises that a statute of limitations effectively bars filing of the suit in question and the company is not legally liable to pay the debt.

[.02] Reserved

[.03] Reserved

.04 Accounting for Issuance of Cents Off Coupons

Inquiry—A client includes with its consumer product a coupon for cents off on the next purchase of the product. Should the coupon be accounted for as a reduction of the selling price when the second product is sold?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 450-20-05-10 would consider the possible future coupon claims as a loss contingency to be evaluated as a future event. More than likely, the redemption of some or all of the coupons would be considered a *probable* event as defined in FASB ASC glossary. The amount to be accrued and charged to earnings at the time the first product is sold should be based on a reasonable estimate of the amount of coupons expected to be presented for redemption. This estimate could be based on experience in previous promotions.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.05] Reserved

[.06] Reserved

[The next page is 2571.]

Section 3500

Commitments

.01 Accounting for Contract to Cut Timber

Inquiry—A corporation is engaged in the forest products industry and purchases timber under both “pay as cut” (specifies a rate the buyer will pay per unit of volume cut) and “lump sum” (buyer pays a fixed amount for the right to cut timber on a specific tract of land). The corporation agrees to purchase timber on land which is identified in the contract. The exact amount of timber purchased can vary in total footage as well as species due to the nature of the goods. Is it proper to recognize the transactions as assets and liabilities on the balance sheet?

Reply—It would be improper to recognize a contract to cut timber as an asset and a liability unless the contract, at the time it was entered into, resulted in the purchase of the timber.

A distinction must be made between a contract that is executory in nature and one in which a sale and a purchase of lumber has occurred. Evidence of a purchase would be the transfer of title to the lumber at the time the contract is signed. Such a transfer usually occurs with lump sum contracts and may occur under pay as cut contracts if they include performance guarantees or risk of monetary damages if not performed. Therefore, those contracts would generally be recognized as assets and liabilities.

Receiving title at the time the timber is cut rather than at the time the contract is signed makes the contract executory. It is generally accepted practice to adequately disclose the nature and amounts of commitments relating to executory contracts in the notes to financial statements. Therefore, pay as cut contracts without performance guarantees or risk of monetary damages would generally not be recognized as assets and liabilities until performance occurs.

.02 Liability Under Foreign Bank's Letter of Payment Guarantee

Inquiry—A client, an import-export firm, agreed to purchase goods from a foreign manufacturer. The agreement calls for advance payment with the goods being delivered over the twelve-month period following the date of the agreement. The client arranged to make this advance payment through a letter of credit issued by a U.S. bank. The U.S. bank has received a letter of payment guarantee issued by a bank in the foreign country. If the supplier fails to make shipments under the terms of the agreement, the U.S. bank will look to the foreign bank for any unpaid advances owed to the U.S. bank by the client. The U.S. bank will look to the client for payment of all amounts represented by shipments to the client under the terms of the agreement.

Is the client directly liable for the amount advanced by the U.S. bank through its letter of credit, or does the client become liable only as the goods are received and payment is due the U.S. bank?

Reply—The client is directly liable for the amount advanced to the foreign supplier. It appears from the description of the transactions that the foreign bank is contingently liable if the supplier does not perform under the agreement. The offsetting asset would be classified as an “Advance to Suppliers.” Additional footnote disclosure of the financial arrangements would also be required.

[.03] Reserved**.04 Recognition of Losses on Purchase Commitments**

Inquiry—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 330-10-35-17 states: “A net loss on firm purchase commitments for goods for inventory, measured in the same way as are inventory losses, shall be recognized in the accounts”. FASB ASC 330-10-50-5 further states: “The amounts of net losses on firm purchase commitments accrued under paragraph 330-10-35-17 shall be disclosed separately in the income statement.”

Does this statement mean that the measurement of losses cannot be done on an item by item basis but must only be done if there is an overall net loss on purchase commitments?

Reply—Net losses apply to specific purchase commitments and contracts, and not necessarily to components of major categories of inventories, as discussed in FASB ASC 330-10-35-8.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.05 Letters of Credit

Inquiry—Should a company report its outstanding letters of credit as a liability in the financial statements?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 440-10-50-1 requires disclosure of unused letters of credit. They are commitments and should not be reported as a liability in the financial statements.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.06 Covenants Imposed by Loan Agreements

Inquiry—Restrictive covenants under certain loan agreements of Company A require the Company to maintain a special level of working capital, reduce the amount of its debts, and restrict the amount of retained earnings available for dividend payments. Should the restrictive covenants be disclosed?

Reply—FASB ASC 440-10-50-1 requires the disclosure of restrictive covenants.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.07 Disclosure of Unused Lines of Credit

Inquiry—Should nonpublic companies disclose the existence of unused lines of credit that are available as of the balance sheet date?

Reply—Although public companies are required [pursuant to SEC Regulation S-X, section 210.5-02.19(b)] to disclose significant unused lines of credit for short-term financing in the notes, there is no such explicit requirement for nonpublic companies under generally accepted accounting principles. However, under certain circumstances, disclosure by nonpublic companies may be advisable based on the general principle of adequate disclosure.

The notes, as well as the financial statements, should be informative of matters that may affect their use, understanding, and interpretation.

[Amended, June 1995; Revised, October 2009, to reflect conforming changes necessary due to the withdrawal of SAS No. 69; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[The next page is 2671.]

Section 3600

Deferred Credits

.01 Balance Sheet Presentation of Unearned Revenue

Inquiry—A client, a motor club with an insurance company subsidiary, has annually contended that unearned insurance premiums and membership dues should be presented on the consolidated balance sheet as deferred income immediately preceding the members' equity and should not be included in the amount for total liabilities. The client recognizes the revenues on the insurance premiums and membership dues on a pro rata basis over the period covered by the insurance policy and the memberships, therefore, the auditors have maintained that the unearned portion of the insurance premiums and membership dues represent a liability on the part of the client to render services in the future.

Is it appropriate to show these unearned premiums and dues outside the liability section of the balance sheet?

Reply—FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, paragraph 84, indicates that amounts received for goods or services in advance are not treated as revenue of the period in which they are received but as revenue of the period or periods in which they are earned. These amounts are carried as “unearned revenue”—that is, liabilities to transfer goods or render services in the future—until the earnings process is complete. Therefore, the unearned portions of the insurance premiums and membership dues represent liabilities to provide services in the future. While the description of the liabilities might vary, to present the unearned premiums and membership dues outside of the liability section of the balance sheet would be inappropriate.

[.02] Reserved

[.03] Reserved

[The next page is 3001.]

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Section 4110

Issuance of Capital Stock

.01 Expenses Incurred in Public Sale of Capital Stock

Inquiry—A closely held corporation is issuing stock for the first time to the public.

How would costs, such as legal and accounting fees, incurred as a result of this issue, be handled in the accounting records?

Reply—Direct costs of obtaining capital by issuing stock should be deducted from the related proceeds, and the net amount recorded as contributed stockholders' equity. Assuming no legal prohibitions, issue costs should be deducted from capital stock or capital in excess of par or stated value.

Such costs should be limited to the direct cost of issuing the security. Thus, there should be no allocation of officers' salaries, and care should be taken that legal and accounting fees do not include any fees that would have been incurred in the absence of such issuance.

.02 Stock Issued for No Consideration

Inquiry—A corporation issued stock without receiving any consideration and set up goodwill to offset the credit to capital stock. Was this transaction properly recorded?

Reply—This is primarily a legal rather than an accounting question, and it would be advisable to obtain legal advice as to the effect of such issuance. If such stock were legally issued, the appropriate entry would be to show the offset as discount on capital stock issued. Goodwill should only be recognized when acquired, in accordance with Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 350, *Intangibles—Goodwill and Other*.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.03 Stock Issued for Accounting and Management Services

Inquiry—A newly formed corporation is going public and wishes to issue shares of stock for certain services, such as accounting, legal, underwriting, printing, etc.

How should the value for these services be set up on the books of the corporation?

Reply—It would be appropriate to record the stock issued at the fair value of the stock or services rendered, whichever is the more clearly evident. The recipients should be able to furnish evidence as to such fair value. Since the amounts the Securities and Exchange Commission might consider to be fair value cannot be predicted, a consultation with the staff of the Commission might be advisable before formal submission of the financial statements.

[.04] Reserved

[.05] Reserved

[.06] Reserved

.07 Expenses Incurred in Withdrawn Public Offering

Inquiry—What is the proper accounting for the costs of a public offering that was withdrawn?

Reply—Accounting Research Study No. 15, *Stockholders' Equity*, page 23, discusses accounting for stock issue costs. The Study states that such costs are usually deducted from contributed portions of equity, that is, capital stock or capital in excess of stated or par value, as a reduction in the proceeds from the sale of securities.

Since there were no proceeds from a sale of securities to offset the costs, the costs should be charged to current year's income, but not as an extraordinary item.

[.08] Reserved

.09 Costs Incurred to Acquire Treasury Stock

Inquiry—A company has incurred legal and accounting costs arising from the acquisition of treasury stock. How should the costs be classified in the company's financial statements?

Reply—There is no authoritative literature on this particular subject. Some accountants believe that costs associated with the acquisition of treasury stock should be treated in a manner similar to stock issue costs. Stock issue costs are usually accounted for as a deduction from the gross proceeds of the sale of stock. Costs associated with the acquisition of treasury stock may be added to the cost of the treasury stock.

.10 Costs Incurred in Shelf Registration

Inquiry—A public company incurs legal and other fees in connection with an SEC filing for a stock issue it plans to offer under a shelf registration. How should the company account for these costs?

Reply—The costs should be capitalized as a prepaid expense. When securities are taken off the shelf and sold, a portion of the costs attributable to the securities sold should be charged against paid in capital. Any subsequent costs incurred to keep the filing "alive" should be charged to expense as incurred. If the filing is withdrawn, the related capitalized costs should be charged to expense.

.11 Default on Stock Subscribed

Inquiry—A company entered into a stock subscription agreement to sell its stock. The agreement called for three monthly payments of \$10,000 after which the stock would be issued. Although the first payment was received by the company, the subscriber subsequently defaulted on the remaining two payments. According to the agreement, any payments made by the subscriber towards the stock subscription are not refundable. How should the company account for the retention of the first \$10,000 payment?

Reply—The payment should be recorded as an addition to shareholders' equity (i.e., a credit to paid-in capital). According to Financial Accounting

Standards Board (FASB) *Accounting Standards Codification* (ASC) 505-10-25-2, capital transactions shall be excluded from the determination of net income or the results of operations.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[The next page is 3121.]

Section 4120

Reacquisition of Capital Stock

[.01] Reserved

[.02] Reserved

.03 Repurchase of Stock in Excess of Retained Earnings and Additional Paid-in Capital

Inquiry—A corporation has contracted to repurchase, over a period, some of its own stock. The corporation does not have sufficient retained earnings and additional paid-in capital from which to charge the excess of amounts paid over par value. How should this repurchase be reflected in the company's financial statements?

Reply—In many states, it would not be legal for a corporation to repurchase shares of its own stock at a cost greater than the amount of retained earnings of the corporation. Competent legal advice as to the effect of the agreement should be obtained. This may be an executory contract, with only amounts currently being paid for considered as repurchases. If this be the case, only amounts disbursed are to be recognized in the accounts, with an offset to treasury stock. There should of course be disclosure in a note to the financial statements of the date, number of shares, and amounts of future payments under the contract. Such future payments would thus include the interest factor, which would be an additional cost of the stock, rather than being interest expense.

However, if legal counsel advises that this is in fact a completed contract and enforceable, the full amount should be shown (excluding interest) as treasury stock, with an offsetting liability. Again, there should be footnote disclosure of the nature of the liability and of the interest rate and maturity dates. Under these circumstances, the interest would be included as a current expense.

[.04] Reserved

.05 Purchase of Treasury Shares for an Amount in Excess of Market Price

Inquiry—A corporation enters into an agreement to purchase a major block of its shares from one of its shareholders at a price in excess of its current market price. These shares represent the controlling interest in the corporation. The purchase price of the treasury stock does not include any other rights or privileges. At what value should the corporation record the treasury stock?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 505-30-30-4 states that transactions do arise in which an acquisition of an enterprise's stock may take place at prices different from routine transactions in the open market. A block of shares representing a controlling interest will generally trade at a price in excess of market, and a large block of shares may trade at a price above or below the current market price depending on whether the buyer or seller initiates the transaction. A company's acquisition of its shares in those circumstances is solely a treasury stock transaction and is properly accounted for at the purchase price of the treasury shares.

In this situation, since the purchase price does not include amounts attributable to items other than the shares purchased, the entire purchase price should be accounted for as the cost of treasury shares.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[The next page is 3201.]

Section 4130

Warrants

[.01] Reserved

[.02] Reserved

.03 Warrants Recquired

Inquiry—Company A issued, in a prior year, stock warrants with a subordinated note. The value of the warrants as determined at the date of issuance was added to capital in excess of par value and recorded as deferred loan costs to be amortized over the term of the loan. Company A plans to reacquire the warrants for \$110,000. Should the \$110,000 be:

- (a) accounted for as additional cost of the loan and amortized over the remaining term of the loan, or
- (b) accounted for as a capital transaction and deducted from capital in excess of par value, or
- (c) accounted for in some other manner?

Reply—The purchase price of the warrants should be deducted from either capital in excess of par value or retained earnings.

[The next page is 3341.]

Section 4150

Stock Dividends and Stock Splits

[.01] Reserved

.02 Stock Dividend Affecting Market Price of Stock

Inquiry—A company issued a 10 percent stock dividend. May the dividend be treated as a stock split if the dividend resulted in a drop in the market price of the stock?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 505-20-25-3 states, in part: “except for a few instances, the issuance of additional shares of less than 20 or 25 percent of the number of previously outstanding shares would call for treatment as a stock dividend as described in paragraph 505-20-30-3.” FASB ASC 505-20-30-3 requires a transfer from retained earnings to the category of permanent capitalization in an amount equal to the fair value of the additional shares issued.

In order to treat the 10 percent “stock dividend” as a “split-up effected in the form of a dividend,” the company would have to demonstrate that the additional shares issued is “large enough to materially influence the unit market price of the stock” as indicated in FASB ASC 505-20-25-3.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.03] Reserved

[The next page is 3401.]

Section 4160

Contributed Capital

.01 Payment of Corporate Debt by Stockholders

Inquiry—Three shareholders own stock in Corporations A and B. They agree to personally pay a debt of Corporation A by giving the creditor stock in Corporation B. How should this transaction be recorded on the books of Corporation A?

Reply—The payments by the three stockholders of Corporation A's debt would represent an additional contribution by the stockholders to Corporation A. This can be recorded as a credit to "additional capital."

[.02] Reserved

[The next page is 3501.]

Section 4200

Retained Earnings

.01 Foreign Currency Translation—Retained Earnings

Inquiry—A parent company is translating a foreign subsidiary's financial statements for consolidation purposes. It is the second year of operation for the subsidiary. How should retained earnings be translated?

Reply—For assets and liabilities, Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 830-30-45-3 requires the use of the exchange rate at the balance sheet date. For revenues, expenses, gains, and losses, the exchange rate at the dates on which those elements are recognized shall be used. However, an appropriately weighted average exchange rate for the period may be used to translate the income statement.

In year two, net income or loss would be translated at the weighted average exchange rate for the current year and accumulated with the historical opening translated retained earnings. It should be noted there may be a number of other transactions that may affect the subsidiary's retained earnings including the declaration of dividends.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[The next page is 3551.]

Section 4210

Dividends

.01 Write-Off of Liquidating Dividends

Inquiry—Quite a few years ago, cash dividends were distributed to stockholders in excess of earnings. The company would now like to “clean up” the stockholders’ equity section of the balance sheet by removing the account “Prior Years’ Liquidation Dividends” which is shown as a reduction of the capital stock account. Can the liquidating dividends account be written off against “retained earnings” or “paid in capital in excess of par value”?

Reply—Essentially, this question is a legal one as to whether cash distribution to stockholders in excess of earnings in prior years may be charged to earnings in subsequent years. When liquidating dividends are declared, the charge is made to accounts such as “capital repayment,” “capital returned,” or “liquidating dividends” which appear on the balance sheet as offsets to paid-in capital. By this treatment, the amount of capital returned as well as the amount of capital originally paid in can be disclosed. Perhaps the wisest thing to do under the circumstances is to consult legal counsel to determine whether the write-off proposed is legal under the corporate statutes of the state. Perhaps it is legally permissible, under the laws of incorporation, to reduce the par or stated value of the corporation’s stock, thereby creating a reduction surplus which may then be used retroactively to absorb the original deficit, on the ground that the excess payments were dividends in partial liquidation.

[.02] Reserved

[.03] Reserved

.04 Accrual of Preferred Dividends

Inquiry—A corporation has cumulative preferred stock. It has not paid any dividends on this stock in the last three years. Should the corporation accrue the preferred dividends in arrears?

Reply—Generally, preferred stock contains a cumulative provision whereby dividends omitted in previous years must be paid prior to the payment of dividends on other outstanding shares. Since dividends do not become a corporate liability until declared, no accrual is needed. Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 505-10-50-5 requires entities to disclose within its financial statements (either on the face of the statement of financial position or in the notes thereto) the aggregate and per-share amounts of arrearages in cumulative preferred dividends. Furthermore, FASB ASC 260-10-45-11 states that dividends accumulated for the period on cumulative preferred stock (whether or not earned) should be deducted from income from continuing operations and also from net income when computing earnings per share. If there is a loss from continuing operations or a net loss, the amount of the loss should be increased by those preferred dividends. Preferred dividends that are cumulative only if earned should be deducted only to the extent that they are earned.

If preferred dividends are not cumulative, only the dividends declared should be deducted. In all cases, the effect that has been given to preferred

dividends in arriving at income available to common stockholders in computing basic earnings per share should be disclosed for every period for which an income statement is presented.

[Amended, September 1997; Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[The next page is 3631.]

Section 4230

Capital Transactions

[.01] Reserved

.02 Exchange of No Par Common Shares for Par Value Preferred Shares

Inquiry—The shareholders of Corporation A exchanged their no par common shares for preferred shares with a par value to “freeze” the value of stock ownership for estate tax purposes. How should the difference between the carrying basis of the preferred shares and the carrying basis of the common shares be accounted for?

Reply—The difference should be charged or credited to additional paid-in capital. If there is no additional paid-in capital, any “debit” balance should first be charged to retained earnings and any remaining “debit” balance should be described in the financial statements as a discount on preferred stock. However, in many states the law requires that issued stock must be fully paid and nonassessable and therefore, if the par value of the preferred shares exceeds the market value of the common shares this exchange may have legal implications that should be considered.

.03 Use of Stockholder’s Assets to Repay Corporate Loan

Inquiry—The sole owner of a corporation agreed to collateralize the company’s bank loan with personal assets. As a result of financial difficulties, the company’s bank loan was called and its owner agreed to sell his personal assets collateralizing the company’s loan, to repay the bank debt. What is the appropriate accounting of this transaction?

Reply—The monies used to repay the bank loan are in substance a further capital infusion by the individual, which increases his investment in the company. The company would eliminate its liability to the bank and credit paid-in capital.

[The next page is 3901.]

TIS Section 5000

REVENUE AND EXPENSE

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[The next page is 3921.]

Section 5100

Revenue Recognition

.01 Equipment Sales Net of Trade-Ins

Inquiry—A Client who deals in heavy equipment records all sales at net of trade-ins. Is this an acceptable accounting practice?

Reply—Support for the accounting treatment for trade-ins which this client follows could not be found. Sales should be credited with the nominal or stated contract price, and the difference between (a) the trade-in allowance and (b) the amount determined by pricing the trade-in at net realizable value minus normal profit margin should be treated as a sales allowance or discount. The traded-in equipment should be set up in inventory at an amount which, when reconditioning costs are added, will allow a margin approximating a normal profit when the sale is made.

.02 Rights to Broadcast Time Received for Services

Inquiry—An advertising agency creates and sells jingles and station identifications to radio and television stations. The agency receives broadcast time credit as part payment. This broadcast time is then resold by the agency to its clients. Should this broadcast time be recognized by the advertising agency:

1. when the agency bills the radio or television station, or
2. when it is subsequently sold to advertisers?

Reply—The broadcast time credit should be recognized as income when the services are billed to the station. It may be necessary to estimate the value of the credits. A corresponding asset account should be charged. This asset would be relieved as the broadcast time is sold by the advertising agency.

[.03] Reserved

.04 Discounts on Prepaid Funeral Arrangement Plans

Inquiry—An incorporated mortuary sells pre-need funeral plans in addition to rendering current mortuary services. These pre-need funeral plans are sold at a discount in order to be attractive to the public. All monies received from the sale of these plans are placed in a trust fund which has been set up at a local bank. The bank is the trustee of the trust and makes investments as it sees fit. The pre-need funeral plan agreements stipulate that all income earned by the trust belong to the mortuary, and withdrawals of such income from the trust may be made by the mortuary periodically. In return for the feature of the agreements calling for the mortuary's entitlement to the trust fund income, purchasers of the pre-need plans are permitted to buy the plans at a substantial discount. The agreements also provide for fully-covered funeral benefits in certain cases, although the plans may not be fully paid at time of death. Another advantage to the purchasers is that the costs of their funerals will not be influenced by increases in the cost of living index.

Certain expenses are met by the mortuary in the selling of its pre-need funeral plans; these are recorded monthly in a separate expense account in its general ledger. Trust fund income earned is also recorded monthly in the mortuary's general ledger, in a separate income account. As pre-need plans are utilized by persons who had purchased them earlier, the special discounts mentioned in the preceding paragraph are recorded in a separate expense

account in the mortuary's general ledger. It should be emphasized here that such discounts are not reflected as an expense in the mortuary's operations until such time the plans are actually used, whereas the expenses of the sales of the plans and the income earned by the trust affect operations currently, with no dependency whatsoever on the deaths of the purchasers or holders of the plans.

In order to achieve a better matching of expenses with revenues accruing from the sales of plans, could the trust fund income or the excess of trust fund income over the expenses of selling the plans be deferred until the plans are utilized? Or could the special discounts be charged to income at some date prior to the utilization of the plans?

Reply—It would be more acceptable to currently accrue or recognize selling expenses, fees and commissions, and trust fund income rather than use the “completed contract” or deferral accounting approach. If it is a fact that costs of furnishing services commonly exceed the trust funds expended at time of utilizing a plan, current provision should be made on an estimated basis for the potential or possible losses (more accurately, estimated excess of future servicing costs over monies to be released from trust to defray same) on plans not utilized as yet at the balance sheet date.

The special discounts are more in the nature of sales adjustments rather than costs or expenses.

[.05] Reserved

[.06] Reserved

.07 One-Cent Sales

Inquiry—A client in the fast food business has a “one-cent sale” once a week. For example, the sale might be two cheeseburgers for the price of one (60¢) plus one cent. The company would record the transaction as follows:

Cash (.60 + .01)	\$.61	
Advertisement Expense59	
Sales (.60 x 2)		\$1.20

The company makes this entry so that their “food costs” are not distorted, but should an adjustment be made at the end of the year for financial reporting purposes eliminating this advertising expense against sales?

Reply—The practice of crediting sales and charging advertising expense for the difference between the normal sales price and the “bargain day” sales price of merchandise is not acceptable for financial reporting. Realization of the full sales price cannot properly be imputed under such conditions. To do so would seem to imply that the same quantities would have been sold if the price had not been reduced.

It might however be appropriate to adjust the cost of sales and charge advertising for the cost of the one-cent hamburger. Such cost of sales should include only out-of-pocket expenses.

.08 Life Membership Fees in a Club

Inquiry—A company is engaged in a service club enterprise. What is the proper accounting for life membership fees?

Reply—The life membership fees should be allocated over the time the individual may be expected to require the services of the club.

[.09] Reserved

.10 Members of Country Club Assessed for Debt Retirement

Inquiry—A country club has voted to impose a special yearly assessment on its membership for ten years. The proceeds are to be used to retire a first mortgage on the property of the club.

The assessment is being imposed on all members including voting certificate holders and nonvoting associate members.

Is the proper accounting treatment of this transaction a contribution to capital, or are dues to be reflected in the annual income statement?

Reply—When billing the assessments each year, the receivables from the members can be shown as an asset with a credit to income for the special assessment. Such amounts might then be appropriated to a special membership equity, perhaps entitled “appropriation for retirement of debt.” The financial statements should disclose that the directors had voted a special assessment for ten years and the amount of assessment per year. The first or the last year for the assessment, or both, should also be disclosed.

.11 Excise Tax on Club Dues

Inquiry—The members of certain private clubs must pay a federal excise tax in addition to their annual dues. Should the clubs record, as revenues, the dues net of the excise tax, or should revenues include both dues and taxes?

Reply—A club, in collecting excise taxes on dues, is acting as no more than an agent or conduit for the federal government. The amounts paid to the club by members to be turned over as excise taxes should not be construed as dues, and to show them as such on the income statement is erroneous.

[.12] Reserved

[.13] Reserved

.14 Recognition of Fees Earned on Construction Mortgage Placements

Inquiry—A client is in the business of bringing lenders and borrowers together for a fee. When a construction mortgage has been arranged and agreed to, it would appear that the client has earned its fee. However, because of the terms of the fee arrangement, there is some doubt as to when the income should be recognized.

The following is a summary of the types of transactions involved:

1. Negotiable Note

The company receives a negotiable note in payment of its fees. Generally the note is unsecured and non-interest-bearing and is payable over the same period as the construction draws on the related mortgage are to be made.

2. Nonnegotiable Note

The terms of the nonnegotiable note are comparable to the negotiable note.

3. Commitment Letter, Not Contingent on Future Events

The company receives a letter from the borrower indicating that the lender and the borrower have agreed on the terms of the

mortgage. In addition, the letter states that the borrower agrees to pay the company a fixed fee by a specified date for services rendered in arranging the loan.

4. Commitment Letter, Contingent on Future Draws

The company receives commitment letters from the borrower as described in No. 3 in the preceding. However, the commitment letters state that a certain amount of the fee will not be paid unless or until certain construction draws are received from the lender.

When should revenue be recognized as earned by the client?

Reply—Revenue recognition is discussed in Financial Accounting Standards Board (FASB) Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, paragraphs 83 and 84.

Applying the guidelines of Concepts No. 5, paragraphs 83 and 84, to the specific situations, revenue would be recognized as follows:

1. Negotiable Note

Income would be recognized when the services have been performed and billed which may be prior to receipt of the negotiable note.

2. Nonnegotiable Note

The terms of the nonnegotiable note are comparable to the negotiable note, and revenue would be recognized in a similar manner.

3. Commitment Letter, Not Contingent on Future Events

Such a letter would be evidence that the services have been rendered and are now “billable”; therefore, the fee has been earned and income should be recognized.

4. Commitment Letter, Contingent on Future Draws

From the description, it appears that the agreement between the client, borrower, and lender in this case is such that the parties do not consider all the services rendered until actual borrowings take place even though the client need not physically do anything else. In such a situation, a portion of the fees should be deferred until the stipulated draw provisions have been met.

[.15] Reserved

.16 Rental Revenue Based on Percentage of Sales

Inquiry—A supermarket built an addition to its store to house a liquor store. The rent to the liquor store is to be a percent of its sales. On its income statement, would it be proper for the supermarket to include the liquor store sales as though they were their own sales? The rent would then appear as a gross margin.

Reply—No. In accordance with the FASB *Accounting Standards Codification* (ASC) glossary, this transaction meets the definition of a *lease*, which is “... the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time.”

The revenue received from the liquor store represents rental income to the supermarket and it would be inappropriate for the supermarket to include as its sales the sales of the liquor store. However, it would be appropriate for the supermarket to include the rental income as part of its gross revenues.

[Amended June 1995; Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.17] **Reserved**

[.18] **Reserved**

[.19] **Reserved**

.20 Payment for Termination of License Agreement

Inquiry—A research and development company holds numerous patents. The company derives its income from the sale of products which utilize its patents as well as from the licensing of the patents, for which it receives royalties, and also from the sale of patent rights, for which it receives a single payment for the term of the license.

A licensee desired to terminate its license, since it was no longer using the technology contained in the company's patent, and paid to the company a lump sum termination payment. This payment approximated the amount the company would have earned during the remaining years of the license agreement. How should the termination payment be reflected in the company's financial statements?

Reply—The transaction is similar to sale of a license for the remaining life of a patent and should be accounted for in the same manner. If this is the sole license for a patent, any remaining unamortized cost of such patent should be written off at this time. If the license represents only a portion of the use of the patent, an appropriate portion of the remaining unamortized cost should be written off. The proceeds should be included in this year's current operations, and there should be disclosure that a major source of income from licensing agreements is being terminated.

[.21] **Reserved**

[.22] **Reserved**

[.23] **Reserved**

[.24] **Reserved**

.25 Finished Parts Held by Manufacturer for Customers

Inquiry—Corporation A, a subcontractor, manufactures precision parts to customers' specifications. Parts produced by Corporation A are inspected by a customer's quality control representative and then held in a secured area in Corporation A's plant. Corporation A is entitled to full contract payment on parts inspected and held in the secured area. Historically, there has been a short time span between completion date and scheduled shipment date, but recently production efficiency has improved to the extent that contracts are completed significantly in advance of scheduled shipment dates. Based on the recent experience of Corporation A, what is the proper date for revenue recognition?

Reply—FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, paragraph 83, states in part:

“Revenues are not recognized until earned. An entity’s revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations, and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues”

Revenue should be recognized at the time of inspection and delivery to the secured areas, since the realization criteria have been met. Corporation A should disclose the method followed for income recognition as part of its disclosure of accounting policies.

[.26] **Reserved**

[.27] **Reserved**

.28 Revenue From Private Label Sales

Inquiry—Corporation A produces certain products that are sold under Corporation B’s label. Corporation B reimburses Corporation A for all direct costs of raw material, ingredients, and packaging plus 10 cents per pound processing fee. Corporation A prepares an invoice for each shipment which itemizes the various direct costs plus 10 cents per pound processing fee. Should Corporation A record the total invoice amount as a sale or should it record the processing fee as revenue and the reimbursed direct costs as a reduction of expenses?

Reply—Corporation A should probably record the total invoice amount as a sale. Accounting for contracts of this type would be treated similar to cost-plus-fixed-fee contracts discussed in FASB ASC 912-605.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.29] **Reserved**

[.30] **Reserved**

.31 Accounting for Zero Coupon Bonds

Inquiry—A client purchased a 20-year zero coupon treasury bond for \$189, with a maturity value of \$1,000, at an 8 1/2 percent yield to maturity.

- (1) What authoritative pronouncement would provide guidance for this transaction?
- (2) How is the interest income computed for financial reporting purposes?

Reply—(1)FASB ASC 835-30-15-2 states that, “The guidance in this Subtopic applies to receivables and payables that represent contractual rights to receive money or contractual obligations to pay money on fixed or determinable dates, whether or not there is any stated provision for interest Some examples are secured and unsecured notes, debentures, bonds”

(2)FASB ASC 835-30-35-2 states that, “the difference between the present value and the face amount shall be treated as discount or premium and amortized as interest expense or income over the life of the note in such a way as to result in a constant rate of interest when applied to the amount outstanding at the beginning of any given period.” This is the “interest” method described in paragraphs 2–3 of FASB ASC 835-30-35. However, other methods of amortization may be used if the results obtained are not materially different from those which would result from the “interest” method.

The following is an example of the application of the interest method. To calculate the semi-annual amount, multiply the purchase price by 4 1/4 percent (half of 8 1/2 percent) to arrive at the adjusted cost basis for the first six-month period. Then repeat this calculation for the next six-month period using the adjusted cost basis. The total amount of income (accrual) in the first year will be \$16.40. Each year the cost basis is increased by the amount of income (accrual) reported in the previous year, as indicated in the following example:

<i>Semi-Annual Period</i>	<i>Your Purchase Price or Adjusted Cost Basis</i>	<i>1/2 Purchase YTM</i>	<i>Accrual During Period</i>	<i>Adjusted Coast Basis at End of Period</i>
1	\$189.00	4.25%	\$8.03	\$197.03
2	197.03	4.25%	8.37	205.40
3	205.40	4.25%	8.73	214.13
4	214.13	4.25%	9.10	223.23

The interest income would be reported annually for financial reporting purposes. If the bond is held to maturity, there will be no gain or loss. If sold prior to maturity any gain or loss is determined by the difference between the adjusted cost basis and the selling price.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.32] Reserved

.33 Operating Lease With Rental Payments Rebated Against Purchase Price

Inquiry—A lessor corporation leases construction equipment for periods of six to eighteen months under short-term cancellable leases. The leases provide that during the first six months, 100 percent of the rentals paid may be applied toward the purchase price of the equipment if the lessee decides to purchase the equipment; during the next three months the percentage drops to 80 percent, and after nine months 60 percent may be applied toward the purchase price. The leases do not qualify as capital leases. How should the lessor account for the leases and the respective rebates?

Reply—The authoritative literature does not address this matter. The lessor should record rental income until the lessee decides to purchase the equipment. The lessor should then record the sale of the equipment net of the applicable rebate. The amount recorded as rental income should not be reclassified as sales proceeds.

[.34] Reserved

.35 Involuntary Conversion—Recognition of Gain

Inquiry—A tornado virtually destroys a company's building on June 12, 20X0. The company has insurance and expects to be reimbursed for costs incurred to refurbish the building. The company's fiscal year-end is June 30, 20X0. On August 15, 20X0, prior to the issuance of the financial statements, the company receives a check in excess of the carrying amount of the building. Should the company recognize the gain on the involuntary conversion in the June 30, 20X0 financial statements?

Reply—No. Since the company was reimbursed for an amount in excess of the carrying amount of the building there was no loss to record on June 30, 20X0. The gain, which was received on August 15, 20X0, was a gain contingency

on June 30, 20X0. Per FASB ASC 450-30-25-1, contingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.36 Sales of Investment to Minority Stockholder

Inquiry—A corporation enters into an agreement to sell an investment accounted for on the equity method to a minority stockholder in return for his shares in the corporation. The fair value of the investment exceeds its book value. Would the corporation recognize a gain on this transaction or would the excess be credited to equity?

Reply—FASB ASC 845-10-30-1 states that a transfer of a nonmonetary asset to a stockholder or to another entity in a nonreciprocal transfer should be recorded at the fair value of the asset transferred, and that a gain or loss should be recognized on the disposition of the asset. FASB ASC 845-10-30-2 also indicates that the fair value of an entity's own stock reacquired may be a more clearly evident measure of the fair value of the asset distributed in a nonreciprocal transfer if the transaction involves acquiring stock for the treasury or retirement.

The corporation should recognize as a gain, in the year in which the transaction occurs, the excess of the fair value of the investment transferred over its carrying amount.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.37 Sales Price Based on Future Revenue

Inquiry—A company sold one of its direct-mail catalog offices for cash plus a percentage of revenue to be earned over the next five years. The sales agreement limits the percentage of revenue to a stipulated maximum. Management believes the maximum will be earned within the five-year period. When should revenue from this transaction be recorded?

Reply—According to FASB ASC 450-30-25-1, “A contingency that might result in a gain usually should not be reflected in the financial statements because to do so might be to recognize revenue before its realization.”

Unless it is assured that adequate revenue will be earned to cause payment of the contingent portion of the sales price, the contingent portion of the sales price should only be accrued as earned. The accuracy and reasonableness of management's projections must be ascertained. If realization is assured, which would be relatively infrequent, revenue should be recorded as of the date of the sale using the present value of the projected cash receipts in accordance with FASB ASC 835, *Interest*.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

- [.38] Reserved
- [.39] Reserved
- [.40] Reserved
- [.41] Reserved
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[.74] Reserved

[.75] Reserved

[.76] Reserved

[The next page is 4121.]

Section 5210

Depreciation and Depletion

[.01] Reserved

.02 Disclosure of Depreciation Expense

Inquiry—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 360-10-50-1 states that the financial statements should disclose depreciation *expense* for a period. Does *expense* mean the total amount of depreciation accrued (that is, credited to the allowance for depreciation account) for the period or the amount actually expensed after allowing for depreciation included in overhead apportioned to inventories?

Reply—In concerns such as public utilities and trading or commercial enterprises, determination of the total provision for depreciation is usually simple since the amounts of depreciation are generally identified in the expense accounts. In manufacturing concerns, however, there are difficulties in determining the amount of depreciation to be disclosed. Depreciation is usually included in overhead which in turn is distributed over a number of departments and products and finds its way ultimately into cost of sales through inventory accounts. To determine the amount of depreciation which is included as a part of the cost of merchandise sold may require an extensive and usually impracticable, if not impossible, analysis of cost accounts. The auditor usually solves the problem by suggesting that the amount of depreciation charged to manufacturing costs and to expense accounts be taken as representing the amount charged to income. Obviously, this method does not correctly state the depreciation charge which was recovered through sale of goods in which depreciation was an element of cost. From a practical standpoint, in view of the indicated difficulty, if not impossibility, of determining the exact amount of depreciation included in cost of sales, it has become recognized practice to report the amount of depreciation charged in the statement of income as that which has been charged to manufacturing costs and to expense accounts, even when amounts of depreciation included in inventories at the beginning and end of the period vary sufficiently to affect depreciation included in cost of sales. Such practice also is acceptable to the Securities and Exchange Commission.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.03] Reserved

.04 Depreciation of Clothing Rented to Individuals

Inquiry—Company A maintains a stock of tuxedos, shoes and related items which are rented to individuals. Management estimates that this stock will have a useful life of approximately two years. Additional stock will be purchased from time to time as required. At the end of each fiscal year, a complete physical inventory is taken of all items on hand. What is the most appropriate accounting treatment for the stock of rental clothing?

Reply—The clothing represents a fixed asset to be depreciated over its estimated life. The estimated life should be adjusted periodically to reflect experience and should not exceed two years. The depreciation charge should be computed monthly based on inventory at the beginning of the period plus additions during the current year.

Logically it seems that loss and retirement of clothing will relate to that clothing first purchased. Accordingly the first-in first-out basis would appropriately account for such loss and retirement.

.05 Classification of Costs of Constructing a Golf Course

Inquiry—How should the costs of constructing a golf course be broken down into depreciable and nondepreciable classifications?

Reply—For the costs incurred in constructing a golf course, those expenditures made to change the land itself, exclusive of buildings, should be treated as permanent improvements to the land and are not, therefore, depreciable. These costs would include clearing the land, building fairways, changing the contour of the earth by moving and filling, building sand traps, and creating water hazards. If trees are planted, and their lives can be estimated, it would appear to be proper to depreciate these over such lives. In the absence of any reasonable estimate, trees and shrubs should be carried at cost. Any structures such as buildings, shacks or stands should be depreciated along with the costs of any vehicles such as trucks or carts, and any equipment used. A watering system should be depreciated as it is made of material that will not last indefinitely.

[.06] Reserved

[.07] Reserved

.08 Additional First Year Depreciation

Inquiry—A corporation reports depreciation expense on its financial statements at the same amount that it claims on its income tax return. If that amount included the maximum \$10,000 deduction for additional first year depreciation (election to expense recovery property) allowed for tax purposes, whereas, normal depreciation was \$18,000, would the financial statements be in accordance with generally accepted accounting principles?

Reply—FASB ASC 360-10-35-4 states, in part: “. . . depreciation accounting, a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit . . . in a systematic and rational manner . . .” Accordingly, if any arbitrary additional first year depreciation amount is included in the financial statements and it is material, it would be a departure from generally accepted accounting principles. Refer to paragraph .A5 of AU-C section 705, *Modifications to the Opinion in the Independent Auditor’s Report* (AICPA, *Professional Standards*), and paragraph .06 of AU-C section 320, *Materiality in Planning and Performing an Audit* (AICPA, *Professional Standards*), for guidance on materiality.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.09 Amortization of Leasehold Improvement

Inquiry—A zoological society leases property in the city zoo for concession stands. The society plans to construct a new building, which will house several concession stands, on the leased property. When construction is complete the title to the building will be turned over to the city. The lease is not a service concession arrangement within the scope of FASB ASC 853, *Service Concession Arrangements*. How should the building be accounted for by the zoological society?

Reply—The construction of a building on leased property is considered a leasehold improvement. A leasehold improvement is a permanent improvement or betterment that increases the usefulness of the leased property and will revert to the lessor at the end of the lease term. The costs of such improvements are normally amortized either over the life of the improvement or the lease term, whichever is shorter.

[Revised, April 2014, to reflect conforming changes necessary due to revisions to FASB ASC.]

[.10] Reserved

[The next page is 4201.]

Section 5220

Interest Expense

.01 Deferral of Payment of Interest

Inquiry—A client experienced problems in meeting its current obligations and reached an agreement with its primary creditor concerning several mortgage loans. Under the agreement, the interest rate on these loans will, for the present, be reduced from 10 percent to 8 percent, but the lender has the option in the future of increasing the interest rate to 11 percent to recover the foregone interest. At the maturity date, any unpaid interest calculated at the original 10 percent rate will be due.

How should the interest expense be recorded on the client's financial statements?

Reply—Interest should be accrued at the rate of 10 percent, the original rate under the mortgage loans. This debit would represent the interest expense charged to income. The credit would be segregated between current liabilities (an amount representing the 8 percent rate) and noncurrent liabilities (an amount representing the *deferred interest*).

[.02] Reserved

.03 Computation of Interest Expense on Long-Term Redeemable Bonds

Inquiry—A bank has issued four year nonnegotiable savings bonds with interest of 7 percent for the first year, 7 1/2 percent for the second year, 8 percent for the third year and 8 1/2 percent for the fourth year. The depositor has the option to request that he or she be paid his interest on a semiannual or annual basis, but few do so, and the normal procedure is that the interest will be compounded and left on deposit for the four years.

If a bond is redeemed prior to maturity, interest is paid to the bondholder at the rate of 5 percent per annum for the period that the bond was held, less 90 days. Few instances of bond redemption prior to maturity are anticipated.

Which of the following methods of accounting for interest expense is appropriate?

(1) Accrue interest at 7 percent for the first year, 7 1/2 percent for the second year (plus the compounding factor), 8 percent for the third year (plus the compounding factor), and 8 1/2 percent for the fourth year (plus the compounding factor), making a debit to the interest expense and a credit to the accrued interest payable on four year bonds.

(2) Determine the total amount of interest that will be due to the holder upon the maturity of the bond and accrue a pro rata share of this amount for each month of the four year period that the bond is in effect.

Reply—A rate of interest should be used which reflects the bank's liabilities and assumes that the bondholders will not redeem their bonds and not withdraw the interest prior to maturity. This is essentially the second approach in the preceding.

[.04] Reserved**.05 Amortization of Prepaid Interest on Discounted Notes**

Inquiry—An equipment leasing company will use as of the beginning of the year the interest method to amortize prepaid interest on new discounted notes. But it will continue to use the straight-line method to amortize prepaid interest on notes discounted earlier. Is the adoption of the interest method on a prospective basis a change in accounting principle?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 835-30-35 states that the interest method of amortization should be used but that other methods of amortization may be used if the results obtained are not materially different from those which would result from the interest method.

If the results in earlier periods would not have differed materially by using the interest method, the interest method may be adopted for the new notes, disclosed, and not be reported as a change in accounting principle.

If the results in earlier periods would have been materially different by using the interest method, the interest method should be adopted for the old and new notes, and be reported as a correction of an error.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.06 Imputed Interest on Shareholder Loans

Inquiry—A section of the Internal Revenue Code requires, under certain circumstances, that a company impute interest on demand loans made to a shareholder of the company. Would this also be required under generally accepted accounting principles? If not, must it be disclosed and would there be an effect on the deferred income tax accounts?

Reply—No. FASB ASC 835-30-15-2 states that the guidance in FASB ASC 835-30 applies to receivables and payables which represent contractual rights to receive money or contractual obligations to pay money on fixed or determinable dates. Imputed interest would not be required on demand loans since they have no fixed or determinable due date.

However, disclosure of this transaction would be required under FASB ASC 850, *Related Party Disclosures*.

There would be no effect on the deferred income tax accounts since this would be considered a permanent difference.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.07 Imputed Interest on Note Exchanged for Cash Only

Inquiry—If an enterprise receives cash in exchange for a non-interest bearing long-term note payable with a stated amount equal to the cash received, must interest be imputed on the note in accordance with FASB ASC 835, *Interest*?

Reply—If there are rights or privileges other than cash attendant to the exchange, the value of such rights or privileges should be given accounting recognition pursuant to FASB ASC 835-30-25-6. If the note is issued solely for cash (that is, the cash received is equivalent to the face amount of the note) and no other right or privilege is exchanged, it is presumed to have a present value at issuance measured by the cash proceeds exchanged.

[Amended, June 1995; Revised, June 2009, to reflect conforming changes
necessary due to the issuance of FASB ASC.]

[The next page is 4281.]

Section 5230

Employee Benefit Plans

[.01] Reserved

[.02] Reserved

[.03] Reserved

[.04] Reserved

[.05] Reserved

.06 Deferred Compensation Payable To Surviving Spouse

Inquiry—Corporation A and its president entered into an employment contract. The contract stipulated that if the president died while employed by Corporation A, Corporation A would pay \$500 a month to the president's widow for the rest of her life. Shortly after the contract was signed, the president died. The present value of the estimated future payments by Corporation A to the president's widow is \$X. Should Corporation A accrue the \$X?

Reply—Under Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 710-10-25-11, the estimated amounts to be paid under a compensation contract would normally be accrued over the period of active employment. The president's death accelerates recognition of a liability that is reasonably determinable from actuarial tables. Accordingly, the present value of the estimated future payments not previously recognized should be accrued and recognized as an expense.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.07] Reserved

[.08] Reserved

.09 Deferred Compensation Arrangement Funded by Life Insurance Contracts

Inquiry—A company has a deferred compensation contract with one of its employees. In accordance with FASB ASC 710-10-25-11, the estimated amount of future payments was accrued over the period of active employment. The company purchases a life insurance policy on the employee, naming the company as beneficiary. May the cash surrender value earned on the policy be offset against the liability for the deferred compensation arrangement?

Reply—No. Paragraphs 1–2 of FASB ASC 325-30-35 specify that the cash surrender value on a life insurance contract should be reported on the balance sheet as an asset with any changes in that value reflected as an adjustment of insurance expense for the period. No right of offset or other deviations from the preceding accounting would be appropriate regardless of the funding objective pertaining to the purchase of the insurance contract, as stated in paragraphs 2–3 of FASB ASC 325-30-15.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[The next page is 4381.]

Section 5240

Cost Allocation

[.01] Reserved

[.02] Reserved

[.03] Reserved

[.04] Reserved

[.05] Reserved

[.06] Reserved

[.07] Reserved

[.08] Reserved

[.09] Reserved

.10 Sale of Research and Development Technology

Inquiry—A company has incurred material research and development costs in the current year. Subsequent to the balance sheet date but prior to issuance of the financial statements, the company commenced negotiations and sold the research and development technology to an unrelated company. May the company capitalize the incurred research and development costs in its annual financial statements in light of the subsequent sale?

Reply—No. Financial Accounting Standards Board *Accounting Standards Codification* 730-10-25 states that research and development costs should be expensed when incurred. There is no justification for capitalizing the costs because the technology will be sold. The company should disclose the subsequent sale of the research and development technology in the footnotes to its financial statements if the amount is material.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.11] Reserved

[The next page is 4401.]

Section 5250

Tax Allocation

[.01–.13] Reserved

- .14 Application of Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (codified in FASB *Accounting Standards Codification* (ASC) 740-10) to Taxes Other Than Income Taxes**

Inquiry—Does FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, (codified in FASB ASC 740-10) apply to federal or state income taxes only, or does it apply to sales, payroll, and other taxes as well?

Reply—The scope of FASB Interpretation No. 48 or FASB ASC 740-10 applies to income taxes only. Entities should follow FASB ASC 450, *Contingencies*, to account for uncertainties related to payroll, sales, and other taxes.

[Issue Date: May 2010.]

- .15 Application of Certain FASB Interpretation No. 48 (codified in FASB ASC 740-10) Disclosure Requirements to Nonpublic Entities That Do Not Have Uncertain Tax Positions**

Inquiry—FASB released Accounting Standards Update (ASU) No. 2009-06, *Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities*. The ASU retains the disclosure requirements in FASB ASC 740-10-50-15(e), which requires a description of tax years that remain subject to examination. Is this disclosure requirement applicable to a nonpublic entity even if the entity has no uncertain tax positions?

Reply—Yes. ASU No. 2009-06 modifies the FASB ASC to eliminate the disclosure requirements in FASB ASC 740-10-50-15(a)–(b) for nonpublic entities, including pass-through and not-for-profit entities, but the disclosure requirements in paragraphs 15(c)–(e) remain in effect (if applicable), regardless of whether the entity has any uncertain tax positions.

[Issue Date: May 2010.]

[The next page is 4501.]

Section 5260

Estimated Losses

.01 Recognition of Estimated Losses on Uncompleted Contracts

Inquiry—An engineering firm manufactures and sells telemetry components on the basis of bids previously submitted to customers. In some cases, engineering time is required to modify a component to customer specifications. Since the amount of required engineering time is not known at the time a bid is submitted, costs to complete a particular job may exceed the bid price. The firm completes all jobs.

Presently all costs that accumulate on a particular job (direct materials, labor, and applied manufacturing and engineering overhead) are charged to that job and treated as work in process, even though the costs may exceed the selling price. Once the job is completed, it is taken out of work in process inventory and treated as costs of completion in the month that the job is shipped. Therefore, a loss on a job is recognized only when the job is shipped. When cost to complete a job is expected to exceed the bid price, what disclosure should be made on the balance sheet?

Reply—The problem faced by the firm is not primarily one of disclosure but rather that of satisfying the generally accepted accounting principle of “providing for losses which are reasonably certain to occur.”

It is assumed that the firm is accounting on the completed-contract basis. With regard to construction companies using this method of accounting, Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 605-35-25-89 states, “Although the completed-contract method does not permit the recording of any income prior to completion, provision shall be made for expected losses. See paragraphs 605-35-25-45 through 25-47.” The same concept applies to companies accounting under the percentage-of-completion method (paragraphs 5 and 46 of FASB ASC 605-35-25).

A possible journal entry to recognize the loss would be a charge to “Estimated Loss on Uncompleted Contracts” while crediting “Estimated Liability for Loss on Uncompleted Contracts.” This estimated liability could then be deducted from any excess of accumulated costs over related billings (or added to any liability arising from billings in excess of accumulated costs) for balance sheet purposes. If the loss is not deductible for tax purposes, part of the income tax paid should be set up as a deferred charge.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[The next page is 4551.]

Section 5290

Other Expenses

[.01] Reserved

.02 Classification of Expenses Which Are Taxable to Employees

Inquiry—An amendment to the Internal Revenue Code requires, under certain circumstances, that an employer include as income, the fair value for the use of a company automobile, in the employee's wage and tax statement (Form W-2).

Should this be reported in the company's statement of income as compensation to employees?

Reply—No. The fair value is the amount the employee would have paid to use the car if the employee had owned it. The employer should report, as automobile expenses, the amount of actual expenses it incurred as owner of the car.

[.03] Reserved

[.04] Reserved

.05 Accrual of Audit Fee

Inquiry—A CPA has been engaged to audit the financial statements of a client company. The audit is being conducted after year end. Is it proper to accrue the audit fee as an expense of the year under audit?

Reply—According to FASB Concepts Statement No. 6, *Elements of Financial Statements*, paragraph 145, "The goal of accrual accounting is to account in the periods in which they occur for the effects on an entity of transactions and other events and circumstances, to the extent that those financial effects are recognizable and measurable." The audit fee expense was incurred in the period subsequent to year end. Therefore, it is properly recorded as an expense in the subsequent period. However, fees incurred in connection with planning the audit, together with preliminary procedures (for example, confirmation work) would be accruable for the year under audit.

.06 Accounting for a Lease Trial Period

Inquiry—A lease agreement allows a prospective lessee the free use of newly introduced specialized equipment for 30 days prior to entering into a long-term lease agreement for the equipment. The prospective lessee is not committed to enter into a long-term lease agreement at the beginning or during the 30-day trial period and there is no economic penalty to the lessee if the lessee does not enter into that agreement. How should the prospective lessee account for the 30-day trial period?

Reply—The 30-day trial period is part of the lessor’s marketing strategy. Therefore, the lessee should not report any lease expense during the 30-day trial period. If the lessee subsequently enters into the lease arrangement, the date of inception should begin on the first day of the lease with no accounting recognition given to the trial period.

[The next page is 4801.]

Section 5400

Extraordinary and Unusual Items

[.01] Reserved

.02 Sale of Cotton Futures Commitment Contracts

Inquiry—A textile manufacturer entered into firm purchase commitments for cotton at a very favorable price. At the present time, the corporation has an unusually long position of purchase commitments at a low fixed price. Some of these contracts may be sold at a tremendous profit which is extremely material in relation to normal operating income. This results from the tremendous increase in cost of raw cotton during recent months. The corporation has not sold such commitment contracts in the past; nor does it anticipate selling such contracts in the future.

Will the sale of cotton futures commitment contracts be considered an extraordinary item?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 225-20-45 discusses the criteria for extraordinary items. In order to be classified as an extraordinary item, an event or transaction would have to be both unusual in nature and infrequent in occurrence. The transaction would not meet the “unusual nature” test. Making a commitment for future delivery of cotton to insure a source of supply would be part of the normal operations of a textile manufacturer. Any resulting gain or loss would therefore be considered ordinary. Although the corporation has not sold such commitment contracts in the past; nor does the corporation anticipate selling such contracts in the future, any gain realized on the sale of such a contract should not be considered an extraordinary item under FASB ASC 225-20-45. However, it should be shown as a separate line item in the income statement in accordance with FASB ASC 225-20-45-16.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.03] Reserved

.04 Reporting the Proceeds From Life Insurance on an Officer

Inquiry—A company received the life insurance proceeds on the death of its president before the end of its fiscal year and intends to report the amount in its income statement as an extraordinary item. Would this be in accordance with generally accepted accounting principles?

Reply—No. FASB ASC 225-20-45-2 states that “extraordinary items are events and transactions that are distinguished by their unusual nature and by the infrequency of their occurrence.” The receipt of insurance proceeds from an officer’s life insurance policy is an infrequent occurrence, but it is not unusual in nature. Since it does not meet *both* the criteria of unusual and infrequent it does not qualify as an extraordinary item.

FASB ASC 225-20-45-16 states that “a material event or transaction that is unusual in nature or occurs infrequently but not both, and therefore does not meet both criteria for classification as an extraordinary item, shall be reported as a separate component of income from continuing operations.”

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.05 Accounting and Disclosures Guidance for Losses From Natural Disasters—Nongovernmental Entities

(This section identifies certain issues that may arise in accounting for losses from natural disasters, and lists relevant accounting literature for nongovernmental entities to consider in addressing those financial reporting issues.)

Inquiry—A natural disaster (such as a hurricane, tornado, fire, or earthquake) strikes and causes substantial damages. Though extreme in the loss of life and financial harm caused, the nature and location of the disaster may be such that one might reasonably expect that type of activity of nature to strike again in greater or lesser magnitude of damage. What are some of the accounting issues that arise and which accounting literature provides guidance for recognizing, measuring, and disclosing losses from natural disasters?

Reply—The following questions may arise in accounting for losses incurred as a result of a natural disaster:

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 non-impairment 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?

Issue 1—How should losses from a natural disaster of a type that is reasonably expected to reoccur be classified in the statement of operations?

FASB ASC 225-20-45-2 describes an extraordinary item as an item that is both unusual in nature *and* nonrecurring. A natural disaster of a type that is reasonably expected to reoccur would not meet both conditions. The magnitude of loss from a particular natural disaster does not cause that disaster to be unusual in nature or unlikely to reoccur. If losses from such natural disasters meet the criteria for disclosure of unusual or infrequently occurring items in FASB ASC 225-20-45-16, they should be reported as a separate component of income from continuing operations either on the face of the statement of operations or in the notes to the financial statements.

Issue 2—When should an asset impairment loss related to a natural disaster be recognized?

FASB ASC 360, *Property, Plant, and Equipment*, provides guidance on recognition and measurement of impairment losses on long-lived assets. That literature should be used to determine when an impairment loss on long-lived assets resulting from a natural disaster should be recognized and how that impairment loss should be measured.

FASB ASC 310, *Receivables*, provides guidance on recognition and measurement of impairment losses on loans. The FASB ASC glossary defines *loan* as “a contractual right to receive money on demand or on fixed or determinable dates that is recognized as an asset in the creditor’s statement of financial position.” According to FASB ASC 310-10-35-16, a loan is impaired when, “based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement.” In measuring impairment losses on loans, creditors should follow FASB ASC 310-10-35-22, which states

When a loan is impaired as defined in paragraphs 310-10-35-16 through 35-17, a creditor shall measure impairment based on the present value of expected future cash flows discounted at the loan’s effective interest rate, except that as a practical expedient, a creditor may measure impairment based on a loan’s observable market price, or the fair value of the collateral if the loan is a collateral-dependent loan.

FASB ASC 350, *Intangibles—Goodwill and Other*, provides guidance on recognition and measurement of impairment losses on intangible assets and goodwill.

FASB ASC 450, *Contingencies*, provides guidance on recognition and measurement of impairment losses on assets not covered by specific other literature.

Issue 3—When should a liability for non-impairment losses and costs related to a natural disaster be recognized?

FASB ASC 450-20-25-2 requires a loss accrual by a charge to income, if it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements and the amount of loss can be reasonably estimated.

Paragraph 63 of FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, provides that liabilities should be recognized when

- a. the item meets the definition of a liability. Paragraph 35 of Concepts Statement 6 defines liabilities as “probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events” (footnote references omitted).
- b. the liability can be measured with sufficient reliability.
- c. the information about the liability is capable of making a difference in user decisions.
- d. the information about the liability is representationally faithful, verifiable, and neutral.

Other authoritative literature to consider includes FASB ASC 420, *Exit or Disposal Cost Obligations*, and FASB ASC 450-20.

Issue 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?

In accounting for insurance payments to cover losses, entities should follow the guidance in FASB ASC 210-20; FASB ASC 225-20; FASB ASC 410-30; FASB ASC 605-40; and FASB ASC 815, *Derivatives and Hedging*.

FASB ASC 605-40 clarifies the accounting for involuntary conversions of nonmonetary assets (such as property or equipment) to monetary assets (such as insurance proceeds). It requires that a gain or loss be recognized when a nonmonetary asset is involuntarily converted to monetary assets even though an enterprise reinvests or is obligated to reinvest the monetary assets in replacement nonmonetary assets. FASB ASC 605-40-45-1 states

Gain or loss resulting from an involuntary conversion of a nonmonetary asset to monetary assets shall be classified in accordance with the provisions of Subtopic 225-20.

Entities should follow the guidance in FASB ASC 605-40-25-4 (for recoveries in connection with property and casualty losses), or paragraphs 8–11 of FASB ASC 410-30-35 (for recoveries in connection with environmental obligations), as applicable. That guidance generally requires that an asset relating to the insurance recovery should be recognized only when realization of the claim for recovery of a loss recognized in the financial statements is deemed probable (as that term is used in FASB ASC 450). In addition, under FASB ASC 450-30-25-1, a gain (that is, a recovery of a loss not yet recognized in the financial statements or an amount recovered in excess of a loss recognized in the financial statements) should not be recognized until any contingencies relating to the insurance claim have been resolved. It is important to note that in some circumstances, losses and costs might be recognized in the statement of operations in a different (earlier) period than the related recovery.

An additional consideration relates to FASB ASC 225-30, which indicates that entities may choose how to classify such recoveries in the statement of operations, provided that classification does not conflict with existing GAAP requirements.

Issue 5—What are the required disclosures regarding the impact of a natural disaster?

In disclosing the impact of a natural disaster in the financial statements, entities should follow the guidance in FASB ASC 225-20-45-16 pertaining to presentation and disclosure of a material event or transaction that is unusual in nature or occurs infrequently.

As it relates to the issues covered in this section, entities also should consider the disclosure requirements of FASB ASC 275, *Risks and Uncertainties*; FASB ASC 310; FASB ASC 350; FASB ASC 360; FASB ASC 410, *Asset Retirement and Environmental Obligations*; FASB ASC 420; and FASB ASC 450.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[The next page is 4851.]

Section 5500

Earnings per Share

[.01] Reserved

.02 Earnings Per Share of Wholly-Owned Subsidiaries

Inquiry—The annual report of a holding company with five wholly owned subsidiaries shows the consolidated net income and earnings per share of the companies. If the report also includes the individual income statements of the five subsidiaries, is it necessary to include individual earnings per share figures?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 260-10-15-3 does not require presentation of earnings per share in statements of wholly owned subsidiaries.

Therefore, it is not necessary to show earnings per share figures for the subsidiaries.

[Amended, September 1997; Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.03 Weighted Average Shares Outstanding for an Interim Period

Inquiry—A company retired some of its common stock during the first quarter of its fiscal year. Should earnings per share for the interim period be based on annualized weighted average shares outstanding or the weighted average shares outstanding during the period?

Reply—The earnings per share computation should be based on the weighted average shares outstanding during the interim period, and not on an annualized weighted average.

[Amended, September 1997; Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.04] Reserved

[.05] Reserved

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[.12] Reserved

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[.14] Reserved

.15 Stock Dividend Declared But Not Paid at Balance-Sheet Date

Inquiry—A client declared a percent stock dividend to shareholders of record in December 20X4, payable in 20X5. In calculating the weighted average number of shares outstanding for determining the earnings per share for 20X4, how should this stock dividend apply?

Reply—FASB ASC 260-10-55-12 requires the computations of basic and diluted earnings per share to be adjusted retroactively for all periods presented to reflect a change in capital structure resulting from a stock dividend. Therefore, the 5 percent stock dividend should be considered as being outstanding for every month of 20X4, as well as for every month of every preceding period presented.

[Amended, September 1997; Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.16] Reserved

[The next page is 4891.]

Section 5600

Leases

[.01] Reserved

[.02] Reserved

[.03] Reserved

.04 Accounting for Subleases

Inquiry—A corporation leased a building and, ultimately, subleased half of the space to a third party with the lease agreement between the two original parties remaining in effect. Management believed that a fairer presentation was made by netting the rental income from the sublease against its own minimum lease payments. Is the corporation properly accounting for its leased property and sublease income?

Reply—No. Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 840-30-35-12 states that the original lessee, as sublessor, shall continue to account for the obligation related to the original lease as before. The sublease shall be accounted for in accordance with paragraphs 1, 29–31, and 41–44 of FASB ASC 840-10-25, depending upon which of the criteria the original lease met. If the original lease is an operating lease, the original lessee shall account for both it and the new lease as operating leases.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.05] Reserved

[.06] Reserved

.07 Determining a Lease Term for Accounting Purposes

Inquiry—How should a lessee and lessor determine, for accounting purposes, the lease term of a lease, which is fundamental to determining the appropriate accounting for that lease?

Reply—FASB ASC glossary provides a definition of *lease term* as follows:

The fixed noncancelable lease term plus all of the following, except as noted in the following paragraph:

- a. All periods, if any, covered by bargain renewal options
- b. All periods, if any, for which failure to renew the lease imposes a penalty on the lessee in such amount that a renewal appears, at lease inception, to be reasonably assured
- c. All periods, if any, covered by ordinary renewal options during which any of the following conditions exist:
 1. A guarantee by the lessee of the lessor's debt directly or indirectly related to the leased property is expected to be in effect
 2. A loan from the lessee to the lessor directly or indirectly related to the leased property is expected to be outstanding
- d. All periods, if any, covered by ordinary renewal options preceding the date as of which a bargain purchase option is exercisable

- e. All periods, if any, representing renewals or extensions of the lease at the lessor's option

The lease term shall not be assumed to extend beyond the date a bargain purchase option becomes exercisable.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.08 Lease Term for Accounting Purposes Differs From Term Stated in Lease (Part 1)

Inquiry—Can a lease term for accounting purposes begin before an initial fixed noncancelable term stated in a lease agreement?

Reply—Yes. FASB ASC 840 provides that a lease term for accounting purposes includes all periods in which a lessee has access to and control over leased space, even if those periods precede the fixed noncancelable term stated in the lease agreement. For example, a lease agreement is signed on January 1 but the initial fixed noncancelable term begins on April 1. The lease allows the lessee to make improvements to the leased space at any time starting after January 1. In this situation, the lease term for accounting purposes starts on January 1.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.09 Lease Term for Accounting Purposes Differs From Term Stated in Lease (Part 2)

Inquiry—Can a lease term for accounting purposes extend beyond an initial fixed noncancelable term stated in a lease agreement?

Reply—Yes. FASB ASC glossary term *lease term* identifies situations in which the lease term for accounting purposes extends beyond the fixed noncancelable term stated in a lease agreement. Section 5600.07 identifies those situations. For example, the lease term for accounting purposes would include renewal periods that at lease inception appear reasonably assured because failure to exercise renewal periods would impose a penalty on the lessee.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.10 Rent Expense and Rent Revenue in an Operating Lease—General

Inquiry—In an operating lease, how should a lessee accrue rent expense and a lessor recognize rent revenue?

Reply—FASB ASC 840-20-25-1 says that the lessee should accrue rent expense on a straight line basis over the lease term unless another systematic and rational basis is more representative of the time pattern use of the property.

Paragraphs 1–2 of FASB ASC 840-20-25 say that the lessor should recognize rent revenue on a straight line basis over the lease term unless another systematic and rational basis is more representative of the time pattern use of the property.

Also see section 5600.11, “Rent Expense and Rent Revenue in an Operating Lease—Scheduled Increase in Rental Space.”

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.11 Rent Expense and Rent Revenue in an Operating Lease—Scheduled Increase in Rental Space

Inquiry—Related to sections 5600.08 and 5600.10 assume a lessee has access to and use of one floor of a building as of the beginning of a lease agreement in year 1. In accordance with the agreement and at the start of year 3, the lessee will have access to and the ability to occupy a second floor in addition to the first floor, and will pay an additional rental fee starting at that time. In this situation, how should the lessee accrue rent expense and the lessor recognize rent revenue before the lessee is allowed to occupy the second floor?

Reply—FASB ASC 840 is the applicable guidance. In years 1 and 2, the lessee should accrue rent expense on a straight line basis (unless another systematic and rational basis is more representative of the time pattern use of the property) for the one floor and not include the rental of the second floor in its accrual because the lessee does not have access to and control over the second floor until the start of year 3. Starting in year 3, the lessee should accrue rent expense on a straight line basis for both floors.

The lessor's accounting for revenue is parallel to that of the lessee for expense in this fact pattern.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.12 Rent Expense and Rent Revenue in an Operating Lease—Rent Holiday

Inquiry—A lessee has a 120 month lease for \$10,000 per month on space owned by a lessor. The lease term for accounting purposes is 120 months. As an incentive to sign the lessee to the lease agreement, the first 6 of those months are rent free. In an operating lease, if a lease term includes a period of free or reduced rent (rent holiday), how does the rent holiday factor into the lessee's recognition of rent expense and the lessor's recognition of rent revenue?

Reply—FASB ASC 840-20-25-2 provides that the lessee should recognize rent expense of \$9,500 per month ($\$10,000 \times 114 \text{ months} / 120 \text{ month lease term}$) for 120 months, which is on a straight line basis. Likewise, the lessor should recognize rent revenue of \$9,500 per month.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.13 Rent Expense and Rent Revenue in an Operating Lease—Scheduled Rent Increases

Inquiry—In an operating lease, how should a lessee accrue rent expense and a lessor recognize rent revenue using the straight line method (see section 5600.10) when the lease agreement contains scheduled rent increases over the lease term?

Reply—FASB ASC 840-20-25-2 provides that the lessee and lessor should add up all rental payments over the lease term and divide that number by the number of periods in the lease term to arrive at the expense/revenue amounts to be accrued/recognized on a straight line basis.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.14 Amortization/Depreciation of Leasehold Improvements in an Operating Lease (Part 1)

Inquiry—A lessee enters into an operating lease in which the lease term for accounting purposes is 10 years. Upon signing the lease, the lessee acquires

leasehold improvements that have a useful life of 15 years. Over what period should the lessee amortize or depreciate the leasehold improvements?

Reply—For leasehold improvements contemplated at or near the beginning of an initial lease term, the lessee should amortize or depreciate the leasehold improvements over the shorter of the (a) useful life of the improvements or (b) remaining lease term, which is 10 years in this inquiry. If the leasehold improvements are acquired and placed in service significantly after the inception of a lease, FASB ASC 840-10-35-6 requires that the lessee amortize or depreciate leasehold improvements over the shorter of the useful life of the leasehold assets or a term that includes required lease periods and renewals that are deemed to be reasonably assured at the date the leasehold improvements are acquired. Note that FASB ASC 840-10-35-6 does not apply to preexisting leasehold improvements.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.15 Leasehold Improvements and Lease Term in an Operating Lease (Part 2)

Inquiry—A lessee enters into an operating lease in which the initial fixed noncancelable term within the lease agreement is 10 years and the agreement includes three 5-year renewal periods. Upon signing the lease, the lessee plans to acquire leasehold improvements that have a useful life of 15 years. Is the lessee's plan to acquire the leasehold improvements a factor in determining the lease term for accounting purposes?

Reply—Yes, the lessee should consider the impact on the lease term for accounting purposes, if any, of the plan to acquire leasehold improvements. If the leasehold improvements are expected to have a significant value at the end of the initial 10 year term such that the lessee would not be willing to abandon these assets (that is, effectively incur a penalty) resulting in a renewal option being reasonably assured of being exercised, that renewal period would be added to the initial fixed noncancelable term in determining the appropriate lease term for accounting purposes.

.16 Landlord Incentive Allowance in an Operating Lease

Inquiry—A lessee enters into an operating lease in which the landlord offers an incentive allowance towards the cost of the lessee making leasehold improvements. The leasehold improvements are the lessee's assets and cost \$1 million, and the incentive allowance totals \$500,000. Should the lessee net the \$500,000 allowance received from the landlord against the \$1 million leasehold improvement asset?

Reply—No. In accordance with FASB ASC 840-20-55-3, the \$500,000 allowance should be reported by the lessee as a liability and amortized straight line over the lease term as a reduction of rent expense. Therefore, the lessee's amortization/depreciation calculation is based on the \$1 million leasehold improvements.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.17 Cash Flows Statement Presentation of Landlord Incentive Allowance in an Operating Lease

Inquiry—Related to section 5600.16, how should a lessee categorize expenditures for leasehold improvements and a related cash incentive allowance received from a landlord in the statement of cash flows?

Reply—In accordance with FASB ASC 230, *Statement of Cash Flows*, a lessee should report expenditures for leasehold improvements in the investing section of a statement of cash flows. Cash allowances received from the landlord should be presented in the lessee's operating activities section of its statement of cash flows. The cash allowances from the lessor are treated for accounting purposes as adjustments of rent. FASB ASC 230 does not identify rent payments on operating leases as investing or financing activities.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[The next page is 4901.]

Section 5700

Contributions Made

.01 Income Tax Accounting for Contributions to Certain Not-for-Profit Scholarship Funding Entities

Inquiry—A state's corporate income taxpayers are allowed a credit against their state corporate income tax of 100 percent of eligible contributions made during the year to a not-for-profit scholarship funding entity. Unused credits may be carried forward up to 3 years. The taxpayer may not convey, assign, or transfer the credit to another entity unless all of the assets of the taxpayer are conveyed, assigned, or transferred in the same transaction.

Should corporate income taxpayers report contributions that qualify for the tax credit as contributions or as income tax expense in income statements prepared in accordance with generally accepted accounting principles?

Reply—Corporate income taxpayers should report such contributions as contributions in their income statements in accordance with Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 720-25.

Such contributions meet the definition of a *contribution* in the FASB ASC glossary. Just as the federal government offering a tax deduction for such a contribution does not change the nonreciprocal nature of the gift, the fact that the state provides a dollar-for-dollar tax credit to the donor for its remittance to the scholarship funding entity does not change the nonreciprocal nature of the gift. Nor does having only the alternative of paying a corresponding, higher tax make the contribution involuntary.

FASB ASC 740, *Income Taxes*, provides that total income tax expense or benefit for the year is the sum of deferred tax expense or benefit and income taxes currently payable or refundable.

Example

Assumptions:

\$100 contribution to qualified scholarship funding entity

\$5,000 federal taxable income (includes \$100 charitable contribution deduction)

Tax rate—5.5 percent

State Tax Computation:

Federal taxable income	\$5,000
Contribution	<u>100</u>
State taxable income	5,100
Tax rate	<u>0.055</u>
Pre-credit state income tax	275
Tax credit	<u>(100)</u>
State income taxes payable	\$175

Journal Entries:

Journal entries made during the year should achieve the following result:

Dr. Contributions	100
Cr. Cash	100

To record contribution to scholarship fund

Dr. Income tax expense	175
Cr. State income taxes payable	175

To record state income tax expense

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

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Section 6130

Finance Companies

.01 Amortization of Discount on Receivables of Consumer Finance Companies

Inquiry—A client in the consumer finance business loans money for short periods of time. What method should be used to amortize discounts on such loans?

Reply—In determining income from loans receivable which have been issued at a discount, the required method of income recognition for any such discount is the interest method, as described in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 310-20.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.02 Method of Recognizing Revenue From Finance Charges

Inquiry—A finance company would like to establish a policy of recognizing 15 percent of the finance charges on discount loans as revenues in the first month of the loan and recognizing the balance of such charges as yield adjustments as the receivables are liquidated. Is this an acceptable method of recognizing revenues from finance charges?

Reply—No. In accordance with FASB ASC 310-20, the interest (actuarial) method should be used to account for interest income. In addition, FASB ASC 310-20-35-2 requires that certain direct loan acquisition costs be deferred and treated as yield adjustments in applying the interest method.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.03 Method of Recognizing Revenue From Service Charges

Inquiry—A company finances insurance premiums of individuals through various insurance agents. The company's policy is to receive completed premium finance agreements directly from the insurance agents. The amount financed includes a finance charge and a nonreturnable service charge. The finance charge is recognized in income by the interest method.

How should the service charge be recognized on the records of the company?

Reply—In accordance with FASB ASC 310-20, the service charge should also be recognized in income over the life of the related loan as an adjustment of yield using the interest method.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.04 Method of Recognizing Revenue From Commissions on Loan Insurance

Inquiry—A finance company receives commissions for loan insurance. How should the company recognize commission revenues?

Reply—FASB ASC 942-605-25-1 states that the insurance commissions received from independent insurers should be deferred and systematically amortized to income over the life of the related insurance contracts because the insurance and lending activities are integral parts of the same transactions. The method of commission amortization should be consistent with the method

of premium income recognition for that type of policy in accordance with FASB ASC 944, *Financial Services—Insurance*.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.05 Disclosure of Contractual Maturities of Direct Cash Loans

Inquiry—FASB ASC 944-805-50-4 states

Disclosures that typically would be required by the preceding paragraph for the various specific elements included in the closed block need not be made separately for the closed block if the nature of the information for the closed block would not differ significantly from that already included for the reporting entity as a whole. For example, it is not necessary to show a separate schedule of contractual maturities of closed block fixed maturity securities if the relative composition of contractual maturities is similar to those of the reporting entity taken as a whole. However, if the relative maturities of the closed block fixed maturity securities differ from those of the reporting entity taken as a whole, separate disclosures shall be made.

At December 31, 20X1, a company has only three loans outstanding of \$36,000 each, payable monthly as follows: 12 installments of \$3,000 each; 24 installments of \$1,500 each; and 36 installments of \$1,000 each. How would these contractual maturities properly be shown?

Reply—Appropriate disclosure of the amounts to be received would be: 20X2, \$66,000; 20X3, \$30,000; and 20X4, \$12,000. Refer to FASB ASC 944-805-55 for implementation guidance and illustrations.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.06 Balance Sheet Presentation of Subordinated Debt

Inquiry—A consumer finance company, whose financial statements are used only by the company and its banks, would like to include subordinated debt in its balance sheet with the caption “Total Subordinated Notes and Shareholders’ Equity.” The company believes that presentation would show more clearly the position of the banks with respect to other creditors. Would the presentation be acceptable if the statements were clearly labeled, “For the Use of Banks and Bankers Only”?

Reply—No. Although the total of subordinated long-term debt and stockholders’ equity is important to creditors of finance companies, the prominent presentation of this total in balance sheets causes many users of financial statements to interpret this amount as total stockholders’ equity, and, for this reason, its use is not acceptable.

The proposed balance sheet presentation would not be in accordance with generally accepted accounting principles even if the financial statements are clearly and conspicuously labeled, “For the Use of Banks and Bankers Only.”

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[.07] Reserved

[The next page is 5371.]

Section 6140

Not-For-Profit Entities

.01 Inventory Valuation for a Not-for-Profit Scientific Entity

Inquiry—A not-for-profit scientific entity produces products that are sold at a price less than cost. The difference between cost and sale proceeds is covered by contributions. The not-for-profit entity reports inventories in its financial statements at an arbitrary amount and discloses that fact on the face of the financial statements. Is this accounting appropriate?

Reply—No. Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 330-10-35-1 states

A departure from the cost basis of pricing the inventory is required when the utility of the goods is no longer as great as their cost. Where there is evidence that the utility of goods, in their disposal in the ordinary course of business, will be less than cost, whether due to physical deterioration, obsolescence, changes in price levels, or other causes, the difference shall be recognized as a loss of the current period. This is generally accomplished by stating such goods at a lower level commonly designated as *market*.

Accordingly, inventories should be valued at lower of cost or market and not at an arbitrary amount. The fact that the difference between the sales proceeds and the costs is covered by contributions does not change the application of the requirements of FASB ASC 330-10.

[Amended, June 1995; Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.02 Income Recognition of Membership Dues by Not-for-Profit Entity

Inquiry—A local not-for-profit entity collects membership dues and does not provide any services to its members in return for the dues. It records the dues as contributions and recognizes them as revenue in the period they are received. The entity provides services, such as seminars, group insurance, and so on., to its members at an extra cost.

Is this the appropriate accounting method?

Reply—Yes. This entity qualifies as a *not-for-profit entity* under the FASB ASC glossary definition. Accordingly, FASB ASC 958-605-25-2 would require that the dues be recognized as contributions revenue when received since the members receive no benefits from the dues. In accordance with FASB ASC 958-605-25-1, if the member did receive benefits from those dues, dues revenue would be recognized over the period of membership.

[Amended, June 1995; Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.03 Lapsing of Time Restrictions on Receivables That Are Uncollected at Their Due Date

Inquiry—FASB ASC 958-605-45-5 provides that “receipts of unconditional promises to give with payments due in future periods shall be reported as restricted support unless explicit donor stipulations or circumstances surrounding the receipt of a promise make clear that the donor intended it to be used to support activities of the current period. It is reasonable to assume that by specifying future payment dates donors indicate that their gift is to support

activities in each period in which a payment is scheduled. For example, receipts of unconditional promises to give cash in future years generally increase temporarily restricted net assets.”

Do time restrictions on contributions receivable lapse when the receivable is due or when it is collected?

Reply—Time restrictions on contributions receivable lapse when the receivable is due. (In some cases, the due date may be explicitly stated. In other cases, circumstances surrounding receipt of the contribution may make clear the implicit due date. In yet other cases, the due date may be unclear. NPEs should consider the facts and circumstances surrounding the promise to give to determine the due date, if any.)

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.04 Lapsing of Restrictions on Receivables if Purpose Restrictions Pertaining to Long-Lived Assets Are Met Before the Receivables Are Due

Inquiry—FASB ASC 958-605-45-4 provides, in part, that “a restriction on a not-for-profit entity’s use of the assets contributed results either from a donor’s explicit stipulation or from circumstances surrounding the receipt of the contribution that make clear the donor’s implicit restriction on use.” These are purpose restrictions. FASB ASC 958-605-45-5 provides that “receipts of unconditional promises to give with payments due in future periods shall be reported as restricted support unless explicit donor stipulations or circumstances surrounding the receipt of a promise make clear that the donor intended it to be used to support activities of the current period. It is reasonable to assume that by specifying future payment dates donors indicate that their gift is to support activities in each period in which a payment is scheduled. For example, receipts of unconditional promises to give cash in future years generally increase temporarily restricted net assets.” These are time restrictions. FASB ASC 958-205-45-9 provides, in part, as follows:

If two or more temporary restrictions are imposed on a contribution, the effect of the expiration of those restrictions shall be recognized in the period in which the last remaining restriction has expired.

FASB ASC 958-205-45-11 further provides, in part

Temporarily restricted net assets with time restrictions are not available to support expenses until the time restrictions have expired.

FASB ASC 958-205-45-12 further provides

Time restrictions implied on gifts of long-lived assets pursuant to paragraph 958-605-45-6 expire as the economic benefits of the acquired assets are used up; that is, over their estimated useful lives. In the absence of donor stipulations specifying how long donated assets must be used or a not-for-profit entity’s policy of implying time restrictions, restrictions on long-lived assets, if any, or cash to acquire long-lived assets expire when the assets are placed in service.

NPEs may receive promises to give contributions that are restricted by donors for investment in long-lived assets. In some circumstances, the assets may be placed in service, and the purpose restrictions met, prior to the due date of the contribution. For example, an NPE may have a capital campaign, asking for commitments to contribute over the next five years so the entity can build a new facility. A donor may promise to give \$100,000 in five years in response to that request.

Are the restrictions met when the assets are placed in service or when the receivable is due?

Reply—NPEs should consider the facts and circumstances surrounding the promise to give and whether those facts and circumstances indicate that the donor intended the contribution to be used to support activities of the current period, with constructing the building or placing it in service considered activities of the current period. If circumstances indicate that the donor intended to support activities of the current period, there is no time restriction and the preceding guidance in paragraphs 9 and 11–12 of FASB ASC 958-205-45 would not be applicable, unless a restriction was placed on the contribution other than constructing the building. If circumstances indicate that the donor's intent is not to support activities of the current period, there are both a time restriction and a purpose restriction. In accordance with FASB ASC 958-205-45-11, the effect of the expiration of restrictions is recognized in the period in which the last remaining restriction has expired.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.05] Reserved

.06 Functional Category of Cost of Sales of Contributed Inventory

Inquiry—How should the cost of sales of contributed inventory be reported? For example, should it be reported as a separate supporting service, as program, or as fund-raising?

Reply—Cost of sales of contributed inventory should be reported as the cost of a separate supporting service, unless the item sold is related to a program activity, in which case, cost of sales is reported as a cost of a program activity. Cost of sales of contributed inventory should not be reported as fund-raising.

.07 Functional Category of Costs of Special Events

Inquiry—FASB ASC 958-720-25-4 provides that “fundraising costs, including the cost of special fundraising events, are incurred to persuade potential donors to make contributions to a not-for-profit entity and shall be expensed as incurred.” The FASB ASC glossary defines the term fundraising activities as “activities undertaken to induce potential donors to contribute money, securities, services, materials, facilities, other assets, or time.” Chapter 13 of the AICPA Audit and Accounting Guide *Not-for-Profit Entities* provides guidance on accounting for special events and provides that not-for-profit entities may report the gross revenues of special events and other fund-raising activities with the cost of direct benefits to donors (for example, meals and facilities rental) displayed either (1) as a line item deducted from the special event revenues or (2) in the same section of the statement of activities as are other programs or supporting services and allocated, if necessary, among those various functions.

Should all costs of special fund-raising events, such as costs of direct donor benefits that are provided in exchange transactions, be reported as fund-raising?

Reply—The discussion of special fund-raising events in FASB ASC 958-720-25 and 958-720-45 provide that some, but not necessarily all, costs of special fund-raising events should be reported as fund-raising. Certain costs of special fund-raising events, such as costs of direct donor benefits that are provided in exchange transactions, should be reported in categories other than fund-raising.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.08 Functional Category of the Costs of Direct Donor Benefits

Inquiry—NPEs may hold special events that provide donor benefits. For example, an entity may hold a special event and provide a meal to donors, which would be a direct donor benefit. Paragraphs 10–15 of FASB ASC 958-720-55 provide guidance on reporting the costs of special events, including the costs of direct donor benefits. Paragraphs 20–22 of FASB ASC 958-720-45 provide that, if cost of sales relates to an item that is program related, cost of sales should be reported as program expense. Otherwise, cost of sales could be reported as a separate supporting service. Also, FASB ASC 958-720-45-19 provides that the cost of premiums provided that are greater than nominal in value should be reported as cost of sales. However, FASB ASC 958 provides no guidance concerning the functional category in which the costs of direct donor benefits should be reported in circumstances in which the benefits are not program related, beyond providing that they should be reported as a supporting service.

In which functional category should the costs of direct donor benefits that are not program related be reported?

Reply—The costs of donor benefits that are not program related and that are provided in exchange transactions should be reported as a separate supporting category, such as cost of sales, and should not be reported as fund-raising.

The costs of donor benefits that are not program related and that are provided in transactions that are other than exchange transactions, such as a fund-raising dinner for which there is no charge to attend, should be reported as fund-raising.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.09 Reporting Bad Debt Losses

Inquiry—FASB ASC 958-225-45-7 provides that expenses should be reported as decreases in unrestricted net assets.

FASB ASC 958-225-45-15 provides that “a statement of activities may report gains and losses as net amounts if they result from peripheral or incidental transactions or from other events and circumstances that may be largely beyond the control of the not-for-profit entity and its management.”

FASB ASC 958-310-35-7 provides that, if the fair value of contributions arising from unconditional promises to give cash or noncash assets decreases subsequent to initial measurement because of changes in the quantity or nature of assets expected to be received, the decrease should be recognized as expenses or losses (bad debt) in the period(s) in which the expectation changes.¹

May bad debt losses be netted against contribution revenue?

Reply—Bad debt losses are prohibited from being netted against contribution revenue under FASB ASC 958-225-45-15 because losses are permitted to be netted only against gains, and not against revenues.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

¹ The provision that certain decreases in the fair value of contributions arising from unconditional promises to give should be accounted for as losses, rather than as expenses, is an accounting convention. This convention provides that, in circumstances in which the net assets related to receivables are represented as restricted net assets, decreases in net assets should be reported as decreases in restricted net assets, rather than as decreases in unrestricted net assets.

.10 Consolidation of Political Action Committee

Inquiry—Some not-for-profit entities are related to other not-for-profit entities that perform political activities that the reporting entity does not wish to perform, perhaps because performing those activities may threaten the reporting entity's tax exempt status, the reporting entity is precluded from conducting such activities, or for other reasons. For example, a membership entity may establish and sponsor a political action committee (PAC) whose mission is to further the interests of the membership entity. The resources held by the PAC are used for the purposes of the membership entity and the governing board of the PAC is appointed by the board of the membership entity.

Does FASB ASC 958-810 require consolidation of PACs in the circumstances previously described?

Reply—FASB ASC 958-810 requires consolidating PACs in the circumstances described in the preceding. Under FASB ASC 958-810, the threshold issues pertaining to the circumstances previously described are whether there is (1) control through a majority voting interest in the board of the PAC and (2) an economic interest. In the circumstances described in the preceding, both are present. Control through a majority voting interest in the board of the PAC exists because the governing board of the PAC is appointed by the board of the membership entity. An economic interest exists because the PAC holds significant resources that must be used for the purposes of the membership entity.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.11 Costs of Soliciting Contributed Services and Time That Do Not Meet the Recognition Criteria in FASB ASC 958

Inquiry—Questions have arisen about the classification of costs of soliciting contributed services and time. The issue focuses on whether those costs should be reported as fundraising in all cases or whether, in circumstances in which the services or time do not meet the recognition criteria in FASB ASC 958-605-25-16, those costs should be reported in the functional category to which the solicited services or time pertain.

According to FASB ASC 958-720-45-9, fundraising activities include the following:

- a. Publicizing and conducting fundraising campaigns
- b. Maintaining donor mailing lists
- c. Conducting special fundraising events
- d. Preparing and distributing fundraising manuals, instructions, and other materials
- e. Conducting other activities involved with soliciting contributions from individuals, foundations, government agencies, and others.

The FASB ASC glossary defines *contribution* and provides as follows:

An unconditional transfer of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner. Those characteristics distinguish contributions from exchange transactions, which are reciprocal transfers in which each party receives and sacrifices approximately equal value; from investments by owners and distributions to owners, which are nonreciprocal transfers between an entity and its owners; and from other nonreciprocal transfers, such as impositions of taxes or fines and thefts, which are not voluntary transfers. In a contribution transaction, the value,

if any, returned to the resource provider is incidental to potential public benefits. In an exchange transaction, the potential public benefits are secondary to the potential proprietary benefits to the resource provider. The term contribution revenue is used to apply to transactions that are part of the entity's ongoing major or central activities (revenues), or are peripheral or incidental to the entity (gains).

The FASB ASC glossary defines the term *fundraising activities* as follows:

Activities undertaken to induce potential donors to contribute money, securities, services, materials, facilities, other assets, or time.

FASB ASC 958-605-25-16 discusses recognition criteria for contributed services and provides, in part, as follows:

Contributions of services shall be recognized if the services received meet any of the following criteria:

- a. They create or enhance nonfinancial assets
- b. They require specialized skills, are provided by individuals possessing those skills, and would typically need to be purchased if not provided by donation.

Contributed services that do not meet these criteria are prohibited from being recognized.

As previously mentioned, questions have arisen about the classification of the costs of soliciting contributed services and time that do not meet the recognition criteria in FASB ASC 958-605-25-16.

How should the costs of soliciting contributed services that do not meet the recognition criteria in FASB ASC 958-605-25-16 be reported?

Reply—FASB ASC 958-720-45-10 provides that fundraising activities include soliciting contributions of services from individuals, regardless of whether those services meet the recognition criteria for contributions in paragraphs 2–20 of FASB ASC 958-605-25.² For example, costs of soliciting contributed services to be used in program functions should be reported as fundraising, even if the services do not meet the recognition criteria. Similarly, costs of soliciting management and general services should be reported as fundraising, even if the management and general services do not meet the recognition criteria.

Certain contributed services are prohibited from being recognized for practical, rather than conceptual, reasons. Those services are nevertheless contributions, regardless of whether or not they are recognized. Therefore, soliciting those contributions meets the definition of *fundraising* in the FASB ASC glossary.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.12 Nondiscretionary Assistance Programs

Inquiry—FASB ASC 958 provides guidance for transactions in which an entity—the *donor*—makes a contribution by transferring assets to a not-for-profit entity—the *recipient entity*, as defined in the FASB ASC glossary—that accepts the assets from the donor and agrees to use those assets on behalf of or transfer those assets, the return on investment of those assets, or both to another entity—the *beneficiary*—that is specified by the donor. It also provides

² NPEs frequently incur other costs in connection with contributed services, such as costs of training and managing volunteers. Costs of training and managing volunteers should not be reported as fund-raising, unless those volunteers are performing fundraising functions.

guidance for transactions that take place in a similar manner but are not contributions because the transfers are revocable, repayable, or reciprocal. FASB ASC 958 provides that a recipient entity that (a) accepts assets from a donor without variance power and (b) agrees to use those assets on behalf of or transfer those assets, the return on investment of those assets, or both to a specified beneficiary that is not financially interrelated is not a donee. The recipient entity should recognize its liability to the specified beneficiary concurrent with its recognition of cash or other financial assets³ received from the donor. Further, FASB ASC 958 provides that a nondonee recipient entity that receives nonfinancial assets is permitted, but not required, to recognize its liability and those assets provided that the entity reports consistently from period to period and discloses its accounting policy.

FASB ASC 958-605-55-71 discusses transfers that are not contributions and provides as follows:

Receipts of resources as an agent, trustee, or intermediary of a donor are not contributions received to the agent because the recipient of assets who is an agent or trustee has little or no discretion in determining how the assets transferred will be used. For the same reason, deliveries of resources as an agent, trustee, or intermediary of a donor are not contributions made by the agent. Similarly, contributions of services (time, skills, or expertise) between donors and donees that are facilitated by an intermediary are not contributions received or contributions made by the intermediary.

Some NPEs participate in activities wherein the resource provider (donor) determines the eligibility requirements for the ultimate beneficiaries and the NPE must disburse to any who meet guidelines specified by the resource provider or return the assets. In some of those programs, the NPE receives assets, such as food, food vouchers, public transportation vouchers, and cash and distributes the assets on behalf of the resource provider (donor) in exchange for a fee for performing that service.

Should recipient entity NPEs report receipts and disbursements of assets under such programs (other than any fees for performing the service) as revenues and expenses?

Reply—Receipts and disbursements of assets under such programs (other than any fees for performing the service) are agency transactions, and are not contributions to the recipient entity NPE. A recipient entity that receives financial assets, such as cash or vouchers that can be exchanged for cash, should recognize its liability to the beneficiaries concurrent with its recognition of financial assets received from the donor. A recipient entity that receives nonfinancial assets, such as food vouchers or public transportation vouchers that are denominated in either dollar values or in nonfinancial terms, such as pounds of food or bus rides, but that will not be settled in cash, is permitted, but not required, to recognize its liability and those assets provided that the entity reports consistently from period to period and discloses its accounting policy.

³ The Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary defines financial assets as

cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right to do either of the following:

- a. Receive cash or another financial instrument from a second entity
- b. Exchange other financial instruments on potentially favorable terms with the second entity

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.13 Note to Sections 6140.14–.18—Implementation of FASB ASC 958—Classification of a Beneficiary’s Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (in the Beneficiary’s Financial Statements)

Some not-for-profit entities have separate fund-raising foundations (commonly referred to as *institutionally related foundations*) that solicit contributions on their behalf. FASB ASC 958 provides guidance on (among other things) the accounting that should be followed by such institutionally related foundations and their related beneficiary entity(ies) with respect to contributions received by the foundation.

Some institutionally related foundations and their beneficiary entities meet the characteristics of financially interrelated entities provided in FASB ASC 958-20-15-2. If entities are financially interrelated, FASB ASC 958 provides that the balance sheet of the beneficiary entity(ies) should reflect that entity’s interest in the net assets of the foundation, and that interest should be periodically adjusted to reflect the beneficiary’s share of the changes in the net assets of the foundation. This accounting is similar to the equity method of accounting, which is described in FASB ASC 323, *Investments—Equity Method and Joint Ventures*.

FASB ASC 323-10-35-5 requires that the periodic adjustment of the investment be included in the determination of the investor’s net income. The purpose of sections 6140.14–.18 (applicable to NPEs other than health care [HC] entities) and sections 6400.36–.42 (applicable to not-for-profit HC entities) is to clarify that in circumstances in which the recipient and the beneficiary are financially interrelated:

- Beneficiary entities should segregate the adjustment into changes in restricted and unrestricted net assets. (NPE TPA [sections 6140.14–.16]; HC TPA [section 6400.36–37 and .39])
- In circumstances in which the beneficiary can influence the financial decisions of the recipient entity to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient to the beneficiary, the existence of the recipient entity should be transparent in determining the net asset classifications in the beneficiary’s financial statements. In other words, the recipient cannot impose time or purpose restrictions beyond those imposed by the donor. (NPE TPA [sections 6140.14 and .16]; HC TPA [sections 6400.36 and .39])
- In circumstances in which the beneficiary cannot influence the financial decisions of the recipient entity to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient to the beneficiary, the existence of the recipient entity creates an implied time restriction on the beneficiary’s net assets attributable to the beneficiary’s interest in the net assets of the recipient (in addition to any other restrictions that may exist). Accordingly, in recognizing its interest in the net assets of the recipient entity and the changes in that interest, the beneficiary should classify the resulting net assets and changes in those net assets as temporarily restricted (unless donors placed permanent restrictions on their contributions). (NPE TPA [section 6140.15]; HC TPA [section 6400.37])

- In circumstances in which the beneficiary can influence the financial decisions of the recipient entity to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient to the beneficiary and some net assets held by the recipient for the benefit of the beneficiary are subject to purpose restrictions (for example, net assets of the recipient restricted to the beneficiary's purchase of property, plant, and equipment [PPE]), expenditures by the beneficiary that meet those purpose restrictions result in the beneficiary (and recipient) reporting reclassifications from temporarily restricted to unrestricted net assets (assuming that the beneficiary has no other net assets subject to similar purpose restrictions), unless those net assets are subject to time restrictions that have not expired, including time restrictions that are implied on contributed long-lived assets as a result of the beneficiary's accounting policy pursuant to FASB ASC 958-605-45-6. (If those net assets are subject to time restrictions that have not expired and the beneficiary has other net assets with similar purpose restrictions, the restrictions on those other net assets would expire in accordance with FASB ASC 958. These sections do not, however, establish a hierarchy pertaining to which restrictions are released first—restrictions on net assets held by the recipient or purpose restrictions on net assets held by the beneficiary.) (NPE TPA [section 6140.17]; HC TPA [section 6400.40])
- In circumstances in which the beneficiary cannot influence the financial decisions of the recipient entity to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient to the beneficiary and some net assets held by the recipient for the benefit of the beneficiary are subject to purpose restrictions, though not subject to time restrictions other than the implied time restrictions that exist because the beneficiary cannot determine the timing and amount of distributions from the recipient to the beneficiary, expenditures by the beneficiary that are consistent with those purpose restrictions should not result in the beneficiary reporting a reclassification from temporarily restricted to unrestricted net assets, subject to the exceptions in the following sentence. Expenditures by the beneficiary that are consistent with those purpose restrictions should result in the beneficiary reporting a reclassification from temporarily restricted to unrestricted net assets if (a) the recipient has no discretion in deciding whether the purpose restriction is met⁴ or (b) the recipient distributes or obligates itself to distribute to the beneficiary amounts attributable to net assets restricted for the particular purpose, or otherwise indicates that the recipient intends for those net assets to be used to support the particular purpose as an activity of the current period. In all other circumstances, (a) purpose restrictions and (b) implied time restrictions on the net assets attributable to the interest in the recipient entity exist and have not yet expired. (However, if the beneficiary has other net assets with similar purpose

⁴ In some circumstances, the purpose restrictions may be so broad that the recipient entity has discretion in deciding whether expenditures by the beneficiary that are consistent with those purpose restrictions actually meet those purpose restrictions. For example, the recipient's net assets may have arisen from a contribution that was restricted for the beneficiary's purchase of research equipment, with no particular research equipment specified. Purchasing an XYZ microscope, which is consistent with that purpose restriction, may or may not meet that purpose restriction, depending on the decision of the recipient. In contrast, the net assets may have arisen from a contribution that was restricted for an XYZ microscope. Purchasing an XYZ microscope, which also is consistent with that purpose restriction, would result in the recipient having no discretion in determining whether that purpose restriction is met.

restrictions, those restrictions would expire in accordance with FASB ASC 958. These TPAs do not establish a hierarchy pertaining to which restrictions are released first—restrictions on net assets held by the recipient or restrictions on net assets held by the beneficiary.) (NPE TPA [section 6140.18]; HC TPA [section 6400.41])

- *For HC NPEs Only.* In circumstances in which the beneficiary can influence the financial decisions of the recipient to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient to the beneficiary, changes in the beneficiary's interest in the net assets of a recipient entity attributable to unrealized gains and losses on investments should be included or excluded from the performance indicator in accordance with FASB ASC 954-10, FASB ASC 954-205-45, FASB ASC 954-320-45, FASB ASC 954-320-55, and FASB ASC 954-605 in the same manner that they would have been had the beneficiary had the transactions itself. Similarly, in applying this guidance, the determination of whether amounts are included or excluded from the performance measure should comprehend that if the beneficiary cannot influence the financial decisions of the recipient entity to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient to the beneficiary, an implied time restriction exists on the beneficiary's net assets attributable to the beneficiary's interest in the net assets of the recipient (in addition to any other restrictions that may exist). Accordingly, in circumstances in which the beneficiary cannot influence the financial decisions of the recipient entity to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient to the beneficiary, the beneficiary should classify the resulting net assets and changes in those net assets as temporarily restricted (unless donors placed permanent restrictions on their contributions) and therefore exclude those changes from the performance indicator. (HC TPA [section 6400.42])
- *For HC NPEs Only.* In circumstances in which the recipient entity and the beneficiary are both controlled by the same entity, entities should consider the specific facts and circumstances to determine whether the beneficiary can influence the financial decisions of the recipient entity to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient to the beneficiary. (HC TPA [section 6400.38])

**Technical Practice Aids for Not-for-Profit Entities
Implementation of FASB ASC 958—Classification of a Beneficiary’s
Interest in the
Net Assets of a Financially Interrelated Fund-Raising Foundation
(in the Beneficiary’s Financial Statements)**

HC NPEs			
NPEs that are not HC NPEs			
<p>Can the beneficiary determine the timing and amount of distributions from the recipient to the beneficiary? [Not-for-profit health care entities (HC NPEs) under common control consider HC Technical Practice Aid (TPA) section 6400.38]</p>	<p>How does the existence of the recipient affect the beneficiary’s reporting of its interest?</p>	<p>Are any net assets held by the recipient for the benefit of the beneficiary subject to donor-imposed purpose restrictions and has the beneficiary made expenditures that meet those purpose restrictions (in circumstances in which the beneficiary can determine the timing and amount of distributions from the recipient to the beneficiary) or that are consistent with those purpose restrictions (in circumstances in which the beneficiary cannot determine the timing and amount of distributions from the recipient to the beneficiary)?</p>	<p>Are any changes in the beneficiary’s interest in the net assets of the recipient attributable to unrealized gains and losses on investments?</p>

(continued)

HC NPEs			
NPEs that are not HC NPEs			
Yes	Existence of recipient is transparent in determining net asset classifications. (NPE TPA [sections 6140.14 and .16]; HC TPA [sections 6400.36 and .39])	Reclass the applicable net assets from temporarily restricted (TR) to unrestricted (UR) unless those net assets are subject to time restrictions that have not expired. (NPE TPA [section 6140.17]; HC TPA [section 6400.40])	Changes in the beneficiary's interest in the net assets of a recipient entity attributable to unrealized gains and losses on investments should be included or excluded from the performance indicator in accordance with FASB ASC 954-10, FASB ASC 954-205-45, FASB ASC 954-320-45, FASB ASC 954-320-55, and FASB ASC 954-605 in the same manner that they would have been had the beneficiary had the transactions itself. (HC TPA [section 6400.42])
No	Existence of the recipient creates an implied time restriction on the beneficiary's net assets attributable to the beneficiary's interest in the net assets of the recipient. (NPE TPA [section 6140.15]; HC TPA [section 6400.37])	Reclass the applicable net assets from TR to UR only if the purpose restriction and the implied time restriction are met. Whether the purpose restriction is met depends in part on (1) whether the recipient has discretion in determining whether the purpose restriction is met and (2) the recipient's decision in exercising that discretion, if any. (NPE TPA [section 6140.18]; HC TPA [section 6400.41])	An implied time restriction exists on the beneficiary's net assets attributable to the beneficiary's interest in the net assets of the recipient. The beneficiary should classify the resulting net assets and changes in those net assets as temporarily restricted (unless donors placed permanent restrictions on their contributions) and therefore exclude those changes from the performance indicator. (HC TPA [section 6400.42])

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.14 Application of FASB ASC 958—Classification of a Beneficiary’s Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (The beneficiary can influence the operating and financial decisions of the foundation to such an extent that the beneficiary can determine the timing and amount of distributions from the foundation.)

Inquiry—ABC Research Institute, a not-for-profit entity subject to FASB ASC 958⁵ and ABC Foundation are financially interrelated entities as described in FASB ASC 958-20-15-2. ABC Foundation’s bylaws state that it is organized for the purpose of stimulating voluntary financial support from donors for the sole benefit of ABC Research Institute. Assume that ABC Research Institute can influence the operating and financial decisions of ABC Foundation to such an extent that ABC Research Institute can determine the timing and amount of distributions from ABC Foundation to ABC Research Institute.

During its most recent fiscal year, ABC Foundation’s activities resulted in an increase in net assets (before distributions) of \$3,200, comprised of \$2,000 in unrestricted contributions, \$1,000 in temporarily restricted contributions (purpose restrictions), \$500 in unrestricted dividend and interest income, and \$300 in expenses. In addition, ABC Foundation distributed \$2,500 in cash representing unrestricted net assets to ABC Research Institute. How should this activity be reported in ABC Research Institute’s financial statements?

Reply—Because ABC Foundation (the recipient entity) and ABC Research Institute (the beneficiary) are financially interrelated, FASB ASC 958-20-25-2 requires ABC Research Institute to recognize its interest in the net assets of ABC Foundation and periodically adjust that interest for its share of the change in net assets of ABC Foundation. This is similar to the equity method of accounting described in FASB ASC 323.

In recognizing its interest in the net assets of ABC Foundation and the changes in that interest, ABC Research Institute should classify the resulting net assets as if contributions were received by ABC Research Institute directly from the donor, because ABC Research Institute can influence the operating and financial decisions of ABC Foundation to such an extent that ABC Research Institute can determine the timing and amount of distributions from ABC Foundation to ABC Research Institute. In other words, the existence of ABC Foundation should be transparent in determining the net asset classifications in ABC Research Institute’s financial statements because ABC Foundation cannot impose time or purpose restrictions beyond those imposed by the donor. (Any instructions given by ABC Foundation are designations, rather than restrictions.)

In the circumstances described in the preceding, ABC Research Institute would initially increase its asset, “Interest in Net Assets of ABC Foundation” for the change in ABC Foundation’s net assets (\$3,200). ABC Research Institute’s Statement of Activity would include “Change in Unrestricted Interest in ABC Foundation” of \$2,200, which would be reported as an increase in unrestricted net assets, and “Change in Temporarily Restricted Interest in ABC Foundation” of \$1,000 as an increase in temporarily restricted net assets.

The \$2,500 distribution from ABC Foundation to ABC Research Institute would not be reported as an increase in net assets on ABC Research Institute’s

⁵ This section addresses not-for-profit entities subject to FASB ASC 958. Section 6400.36, “Application of FASB ASC 958—Classification of a Beneficiary’s Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (The beneficiary can influence the operating and financial decisions of the foundation to such an extent that the beneficiary can determine the timing and amount of distributions from the foundation.)” addresses a similar issue for not-for-profit health care entities subject to FASB ASC 954, *Health Care Entities*.

Statement of Activity. By analogy to equity method accounting, the \$2,500 would be reported in a manner similar to a distribution from a subsidiary to its parent (for example, a dividend). ABC Research Institute should report the distribution by increasing cash and decreasing its interest in the net assets of ABC Foundation.

If the distribution represented restricted net assets, ABC Research Institute would not reclassify the net assets from temporarily restricted to unrestricted at the time of the distribution. Instead, ABC Research Institute would reclassify the net assets from temporarily restricted to unrestricted when those restrictions were met.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.15 Application of FASB ASC 958—Classification of a Beneficiary’s Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (The beneficiary cannot influence the operating and financial decisions of the foundation to such an extent that the beneficiary can determine the timing and amount of distributions from the foundation.)

Inquiry—ABC Research Institute, a not-for-profit entity subject to FASB ASC 958⁶ and ABC Foundation are financially interrelated entities as described in FASB ASC 958-20-15-2. ABC Foundation’s bylaws state that it is organized for the purpose of stimulating voluntary financial support from donors for the sole benefit of ABC Research Institute. Assume that ABC Research Institute cannot, however, influence the operating and financial decisions of ABC Foundation to such an extent that ABC Research Institute can determine the timing and amount of distributions from ABC Foundation to ABC Research Institute.

During its most recent fiscal year, ABC Foundation’s activities resulted in an increase in net assets (before distributions) of \$3,200, comprised of \$2,000 in unrestricted contributions, \$1,000 in temporarily restricted contributions (purpose restrictions), \$500 in unrestricted dividend and interest income, and \$300 in expenses. In addition, ABC Foundation elected to distribute \$2,500 in cash representing unrestricted net assets to ABC Research Institute. How should this activity be reported in ABC Research Institute’s financial statements?

Reply—Because ABC Foundation (the recipient entity) and ABC Research Institute (the beneficiary) are financially interrelated, FASB ASC 958-20-25-2 requires ABC Research Institute to recognize its interest in the net assets of ABC Foundation and periodically adjust that interest for its share of the change in net assets of ABC Foundation. This is similar to the equity method of accounting described in FASB ASC 323.

ABC Research Institute cannot influence the operating and financial decisions of ABC Foundation to such an extent that ABC Research Institute can determine the timing and amount of distributions from ABC Foundation to ABC Research Institute. Therefore, an implied time restriction exists on ABC Research Institute’s interest in the net assets of ABC Foundation (in addition to any other restrictions that may exist). Accordingly, in recognizing its interest in the net assets of ABC Foundation and the changes in that interest, ABC Research Institute should classify the resulting net assets as changes in

⁶ This section addresses not-for-profit entities subject to FASB ASC 958. Section 6400.37, “Application of FASB ASC 958—Classification of a Beneficiary’s Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (The beneficiary cannot influence the operating and financial decisions of the foundation to such an extent that the beneficiary can determine the timing and amount of distributions from the foundation.),” addresses a similar issue for not-for-profit health care entities subject to FASB ASC 954.

temporarily restricted net assets (unless donors placed permanent restrictions on their contributions).

In the circumstances described in the preceding, ABC Research Institute would initially increase its asset, “Interest in Net Assets of ABC Foundation” for the change in ABC Foundation’s net assets (\$3,200). ABC Research Institute’s Statement of Activity would include “Change in Temporarily Restricted Interest in ABC Foundation” of \$3,200 as an increase in temporarily restricted net assets.

The \$2,500 distribution from ABC Foundation to ABC Research Institute would not be reported as an increase in net assets on ABC Research Institute’s Statement of Activity. By analogy to equity method accounting, the \$2,500 would be treated similar to a distribution from a subsidiary to its parent (for example, a dividend). ABC Research Institute should report the distribution by increasing cash and decreasing its interest in the net assets of ABC Foundation.

ABC Research Institute would reclassify the net assets from temporarily restricted to unrestricted at the time of the distribution, because the time restriction would expire at the time of the distribution. (If those net assets were subject to purpose or time restrictions that remained even after the net assets had been distributed to ABC Research Institute, ABC Research Institute would not reclassify the net assets from temporarily restricted to unrestricted at the time of the distribution. Instead, ABC Research Institute would reclassify the net assets from temporarily restricted to unrestricted when those restrictions were met.)

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.16 Application of FASB ASC 958—Classification of a Beneficiary’s Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (More Than One Beneficiary—Some Contributions Are Designated)

Inquiry—DEF Arts Entity is the parent of three brother-sister not-for-profit entities: Ballet, Orchestra, a not-for-profit entity subject to FASB ASC 958⁷ and Foundation. Foundation is organized for the purpose of raising contributions for the benefit of both Ballet and Orchestra. The four entities are legally separate not-for-profit entities that are financially interrelated pursuant to the guidance in FASB ASC 958-20-15-2. Assume that Orchestra can influence the financial decisions of Foundation to such an extent that Orchestra can determine the timing and amount of distributions from Foundation to Orchestra.

A donor contributes \$5,000 cash to Foundation and stipulates that the contribution is for the benefit of Orchestra. Foundation would record the contribution as temporarily restricted revenue (because Foundation must use the contribution for the benefit of Orchestra). In its separately issued financial statements, Orchestra would recognize its interest in the net assets attributable to that contribution by debiting “Interest in Net Assets of Foundation” for \$5,000. Would the offsetting credit be reported as temporarily restricted revenue (because the net assets attributable to the contribution are restricted on Foundation’s Balance Sheet) or unrestricted revenue (because there are no

⁷ This section addresses not-for-profit entities subject to FASB ASC 958. Section 6400.39, “Application of FASB ASC 958—Classification of a Beneficiary’s Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (More Than One Beneficiary—Some Contributions Are Designated),” addresses a similar issue for not-for-profit health care entities subject to FASB ASC 954.

donor-imposed time restrictions or purpose restrictions on how Orchestra must use the contribution)?

Reply—Orchestra should report the offsetting credit as unrestricted revenue. Because Orchestra can influence the financial decisions of Foundation to such an extent that Orchestra can determine the timing and amount of distributions from Foundation to Orchestra, no implied time restriction exists on Orchestra's net assets attributable to its interest in the net assets of Foundation. Accordingly, in recognizing its interest in the net assets of Foundation and the changes in that interest, Orchestra should classify the resulting net assets as if contributions were received by Orchestra directly from the donor. In other words, the existence of Foundation should be transparent in determining the net asset classifications in Orchestra's separately issued financial statements because Foundation cannot impose time or purpose restrictions beyond those imposed by the donor. (Any instructions given by Foundation are designations, rather than restrictions.)

Because there are no donor-imposed restrictions on how Orchestra must use the contribution, Orchestra should report the change in its interest in the net assets attributable to the contribution as an increase in unrestricted net assets in its separately issued Statement of Activity. When Foundation actually distributes the funds, Orchestra should increase cash and decrease its interest in net assets of Foundation; the distributions would have no effect on Orchestra's Statement of Activity.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.17 Application of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (The beneficiary makes an expenditure that meets a purpose restriction on net assets held for its benefit by the recipient entity—The beneficiary can influence the operating and financial decisions of the recipient to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient.)

Inquiry—ABC Research Institute, a not-for-profit entity subject to FASB ASC 958⁸ and ABC Foundation are financially interrelated entities as described in FASB ASC 958-20-15-2. ABC Foundation's bylaws state that it is organized for the purpose of stimulating voluntary financial support from donors for the sole benefit of ABC Research Institute. Assume that ABC Research Institute can influence the operating and financial decisions of ABC Foundation to such an extent that ABC Research Institute can determine the timing and amount of distributions from ABC Foundation to ABC Research Institute.

ABC Foundation's net assets consist of \$3,000,000 resulting from cash contributions restricted for the purchase of property, plant, and equipment (PPE) by ABC Research Institute. ABC Research Institute has recorded its interest in those net assets by debiting "Interest in net assets of ABC Foundation" and crediting "Change in interest in ABC Foundation," which is reported as an increase in temporarily restricted net assets. ABC Research

⁸ This section addresses not-for-profit entities subject to FASB ASC 958. Section 6400.40,"Application of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (The beneficiary makes an expenditure that meets a purpose restriction on net assets held for its benefit by the recipient organization—The beneficiary can influence the operating and financial decisions of the recipient to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient.)" addresses a similar issue for not-for-profit health care entities subject to FASB ASC 954.

Institute's accounting policy is to not imply a time restriction that expires over the useful life of the donated long-lived assets pursuant to FASB ASC 958-605-45-6 and it has no other net assets restricted for the purchase of PPE.⁹ ABC Research Institute subsequently purchased and placed into service \$3,000,000 of PPE that meets those donor restrictions prior to receiving a distribution from ABC Foundation. Should ABC Research Institute reclassify \$3,000,000 from temporarily-restricted net assets to unrestricted net assets as a result of building and placing into service the \$3,000,000 of PPE?

Reply—Because ABC Foundation (the recipient entity) and ABC Research Institute (the beneficiary) are financially interrelated, FASB ASC 958-20-25-2 requires ABC Research Institute to recognize its interest in the net assets of ABC Foundation and periodically adjust that interest for its share of the change in net assets of ABC Foundation. This is similar to the equity method of accounting described in FASB ASC 323.

In recognizing its interest in the net assets of ABC Foundation and the changes in that interest, ABC Research Institute should classify the resulting net assets as if contributions were received by ABC Research directly from the donor, because ABC Research Institute can influence the operating and financial decisions of ABC Foundation to such an extent that ABC Research Institute can determine the timing and amount of distributions from ABC Foundation to ABC Research Institute. Accordingly, the net assets representing contributions restricted for the purchase of PPE should be reported as temporarily restricted net assets (purpose restricted) in ABC Research Institute's financial statements. Upon purchasing and placing into service the PPE, ABC Research Institute (and ABC Foundation) should reclassify \$3,000,000 from temporarily restricted to unrestricted net assets.¹⁰ In other words, the existence of ABC Foundation should be transparent in determining the net asset classifications in ABC Research Institute's financial statements because ABC Foundation cannot impose time or purpose restrictions beyond those imposed by the donor. (Any instructions given by ABC Foundation are designations, rather than restrictions.)

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

⁹ The assumption that ABC Research Institute has no other net assets restricted for the purchase of PPE is intended to avoid establishing a hierarchy pertaining to which restrictions are released first—restrictions on net assets held by the recipient or restrictions on net assets held by the beneficiary. That issue is not addressed in this TPA.

¹⁰ In this fact pattern, ABC Research Institute's interest in the net assets of ABC Foundation is subject to only purpose restrictions because the net assets arose from cash contributions with no time restrictions. If instead the net assets arose from promises to give rather than from cash contributions, the net assets might be subject to time restrictions in addition to the purpose restrictions. In determining whether net assets that arose from promises to give are subject to time restrictions, NPEs should consider the guidance in section 6140.04, "Lapsing of Restrictions on Receivables if Purpose Restrictions Pertaining to Long-Lived Assets Are Met Before the Receivables Are Due," which discusses whether restrictions on net assets arising from promises to give that are restricted by donors for investments in long-lived assets are met when the assets are placed in service or when the receivables are due.

- .18 Application of FASB ASC 958—Classification of a Beneficiary’s Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (The beneficiary makes an expenditure that is consistent with a purpose restriction on net assets held for its benefit by the recipient entity—The beneficiary cannot influence the operating and financial decisions of the recipient to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient.)**

Inquiry—ABC Research Institute, a not-for-profit entity subject to FASB ASC 958¹¹ and ABC Foundation are financially interrelated entities as described in FASB ASC 958-20-15-2. ABC Foundation’s bylaws state that it is organized for the purpose of stimulating voluntary financial support from donors for the sole benefit of ABC Research Institute. Assume that ABC Research Institute cannot, however, influence the operating and financial decisions of ABC Foundation to such an extent that ABC Research Institute can determine the timing and amount of distributions from ABC Foundation to ABC Research Institute.

ABC Foundation’s net assets consist of \$3,000,000 resulting from cash contributions restricted for the purchase of property, plant, and equipment (PPE) by ABC Research Institute. ABC Research Institute has recorded its interest in those net assets by debiting “Interest in net assets of ABC Foundation” and crediting “Change in interest in ABC Foundation,” which is reported as an increase in temporarily restricted net assets. ABC Research Institute has no other net assets restricted for the purchase of PPE.¹²

ABC Research Institute subsequently built and placed into service the New Modern Wing of the Research Building prior to receiving a distribution from ABC Foundation or any indication that it intends to support building and placing into service the New Modern Wing of the Research Building. Should ABC Research Institute reclassify \$3,000,000 from temporarily-restricted net assets to unrestricted net assets as a result of building and placing into service the \$3,000,000 of PPE?

Reply—From ABC Research Institute’s perspective, its interest in the net assets of ABC Foundation has two restrictions—a purpose restriction (the purchase of the PPE) and an implied time restriction. (ABC Research Institute cannot influence the operating and financial decisions of ABC Foundation to such an extent that ABC Research Institute can determine the timing and amount of distributions from ABC Foundation to ABC Research Institute, including distributions pertaining to expenditures by ABC Research Institute that meet the donor-imposed purpose restrictions. Therefore, an implied time restriction exists on ABC Research Institute’s interest in the net assets of ABC Foundation.) FASB ASC 958-205-45-9 provides, in part, as follows:

If two or more temporary restrictions are imposed on a contribution, the effect of the expiration of those restrictions shall be recognized in the period in which the last remaining restriction has expired.

¹¹ This section addresses not-for-profit entities subject to FASB ASC 958. Section 6400.41, “Application of FASB Statement No. 136—Classification of a Beneficiary’s Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (The beneficiary makes an expenditure that is consistent with a purpose restriction on net assets held for its benefit by the recipient organization—The beneficiary cannot influence the operating and financial decisions of the recipient to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient.),” addresses a similar issue for not-for-profit health care entities subject to FASB ASC 954.

¹² The assumption that ABC Research Institute has no other net assets restricted for the purchase of PPE is intended to avoid establishing a hierarchy pertaining to which restrictions are released first—restrictions on net assets held by the recipient or restrictions on net assets held by the beneficiary. That issue is not addressed in this section.

FASB ASC 958-205-45-11 further provides, in part, as follows:

Temporarily restricted net assets with time restrictions are not available to support expenses until the time restrictions have expired.

In considering whether the purpose restriction on ABC Research Institute's interest in the net assets of ABC Foundation is met, ABC Research Institute should determine whether ABC Foundation has discretion in deciding whether an expenditure by ABC Research Institute that is consistent with the purpose restriction satisfies that purpose restriction. For example, if the restricted net assets arose from a contribution that was restricted for "building projects of ABC Research Institute," with no particular building project specified, purchasing and placing into service the New Modern Wing of the Research Building is consistent with the purpose restriction but may or may not meet it, because ABC Foundation has some discretion in deciding which building project releases the purpose restriction. In other words, ABC Foundation may, at its discretion, either release restricted net assets in support of building the New Modern Wing of the Research Building or not, because the purpose restriction imposed by the donor was broad enough to give ABC Foundation discretion in deciding which building projects meet the purpose restriction. If ABC Foundation has such discretion, a purpose restriction and an implied time restriction on ABC Research Institute's interest in the net assets of ABC Foundation exist. Therefore, ABC Research Institute should not reclassify \$3,000,000 from temporarily-restricted net assets to unrestricted net assets as a result of building and placing into service the New Modern Wing of the Research Building unless ABC Foundation distributes or obligates itself to distribute to ABC Research Institute amounts attributable to net assets restricted for the purchase of PPE by ABC Research Institute, or ABC Foundation otherwise indicates that it intends for those net assets to be used to support the building and placing into service the New Modern Wing of the Research Building as an activity of the current period (assuming that ABC Research Institute had no other net assets that were restricted for the purchase of PPE).^{13 14}

¹³ In this fact pattern, the expenditure is made prior to meeting the purpose restriction and the implied time restriction that exists because ABC Research Institute cannot determine the timing and amount of distributions from ABC Foundation to ABC Research Institute. FASB ASC 958-205-45-11 provides that in circumstances in which both purpose and time restrictions exist, expenditures meeting the purpose restriction must be made simultaneous with or after the time restriction has expired in order to satisfy both the purpose and time restriction and result in a reclassification of net assets from temporarily restricted to unrestricted. In other words, time restrictions, if any, must be met before expenditures can result in purpose restrictions being met. In this fact pattern, however, the time restriction is an implied time restriction that exists because the beneficiary cannot determine the timing and amount of distributions from the recipient to the beneficiary, rather than an implied time restriction that exists because a promise to give is due in a future period or because of an explicit donor stipulation. Accordingly, in this fact pattern, temporarily restricted net assets with implied time restrictions are available to support expenditures made before the expiration of the time restrictions and the net assets should be reclassified from temporarily restricted to unrestricted in the period in which the last remaining restriction has expired. In other words, in this fact pattern, if the expenditure that meets the purpose restriction is made before meeting the implied time restriction that exists because the beneficiary cannot determine the timing and amount of distributions from the recipient to the beneficiary, all the restrictions should be considered met once the implied time restriction is met.

¹⁴ In this fact pattern, ABC Research Institute's interest in the net assets of ABC Foundation is subject to an implied time restriction that exists because ABC Research Institute cannot determine the timing and amount of distributions from ABC Foundation to ABC Research Institute and a purpose restriction. Because the net assets arose from cash contributions with no other donor-imposed time restrictions, no time restrictions other than those imposed by ABC Foundation exist. If instead the net assets arose from promises to give rather than from cash contributions, the net assets might be subject to donor-imposed time restrictions in addition to the time restriction imposed by ABC Foundation and the purpose restriction. In determining whether net assets that arose from promises to give are subject to donor-imposed

In contrast to the example in the previous paragraph, if the restricted net assets arose from a contribution that was restricted for “building and placing into service the New Modern Wing of the Research Building,” ABC Foundation has no discretion in deciding whether that purpose restriction is met by building and placing into service the New Modern Wing of the Research Building. Therefore, if ABC Research Institute builds and places into service the New Modern Wing of the Research Building, the purpose restriction is met (assuming that ABC Research Institute had no other net assets that were restricted for building and placing into service the New Modern Wing). In addition, the implied time restriction is met because ABC Foundation is required to distribute the funds to ABC in order to meet the donor’s stipulations. Therefore, ABC Research Institute (and ABC Foundation) should reclassify \$3,000,000 from temporarily-restricted net assets to unrestricted net assets as a result of building and placing into service the New Modern Wing of the Research Building.

In summary, ABC Research Institute should not reclassify \$3,000,000 from temporarily-restricted net assets to unrestricted net assets as a result of building and placing into service the New Modern Wing of the Research Building until both the purpose restriction and the implied time restriction are met. If both the purpose restriction and the implied time restriction are met, ABC Research Institute should decrease its interest in the net assets of ABC Foundation and increase cash (or a receivable, if the Foundation has merely obligated itself to make the distribution) by the amount of the distribution, and simultaneously reclassify the same amount from temporarily restricted net assets to unrestricted net assets.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.19 Application of FASB ASC 958—Classification of Distributions From a Financially Interrelated Fund-Raising Foundation (Recipient Entity) to a Health Care Beneficiary

Inquiry—How should a fund-raising foundation (recipient), a not-for-profit entity subject to FASB ASC 958 report (in its separately issued financial statements) distributions to a financially interrelated beneficiary that is a health care entity? In other words, should such distributions be reported following (a) the guidance on reporting transfers among affiliated health care entities in FASB ASC 954-10, FASB ASC 954-205, FASB ASC 954-605, and FASB ASC 954-810, or (b) the guidance in FASB ASC 958.

Reply—FASB ASC 958 applies to all not-for-profit entities, except those that are providers of health care services (FASB ASC 958-10-15-3). Therefore, the guidance in FASB ASC 954 generally does not apply to financial statements of recipient entities that are financially interrelated fund-raising foundations. The foundation should follow the accounting and reporting requirements of FASB ASC 958 rather than FASB ASC 954 in the foundation’s separately issued financial statements. The foundation should report distributions to beneficiary

time restrictions in addition to the time restrictions imposed by ABC Foundation, NPEs should consider the guidance in section 6140.04, which discusses whether restrictions on net assets arising from promises to give that are restricted by donors for investments in long-lived assets are met when the assets are placed in service or when the receivables are due. In circumstances in which the net assets are subject to (a) donor-imposed time restrictions in addition to the (b) implied time restrictions that exist because ABC Research Institute cannot determine the timing and amount of distributions from ABC Foundation to ABC Research Institute and (c) purpose restrictions, the last remaining time restriction should be considered in applying the guidance in FASB ASC 958-205-45-11 that provides that temporarily restricted net assets with time restrictions are not available to support expenses until the time restrictions have expired.

entities as expenses or distributions to related entities. The guidance in the previous sentence applies regardless of whether the recipient entity and the beneficiary are under common control or whether one controls the other in a parent-subsidiary relationship.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.20 NPEs Reporting No Fund-Raising Expenses

Inquiry—Some NPEs with contributions report no fund-raising expense. FASB ASC 958-720-50-1 provides that the financial statements should disclose total fund-raising expense. Do circumstances exist in which an NPE could have contributions but minimal or no fund-raising expense?

Reply—It would be unusual for an NPE to have contributions but have minimal or no fund-raising expense. Examples of circumstances in which an NPE could have contributions but minimal or no fund-raising expense typically include those in which (a) because of name recognition or custom, donors contribute to the NPE without the NPE undertaking fund-raising activities,¹⁵ (b) fund-raising activities related to those contributions are conducted entirely or almost entirely by volunteers whose contributed services do not meet the recognition criteria for contributed services in FASB ASC 958-605-25-16 or (c) other entities that the NPE does not control¹⁶ contribute to the NPE with the NPE undertaking minimal or no fund-raising activity or other participation in relation to those contributions.¹⁷ ¹⁸ Examples of circumstances in which an NPE with contributions may have no fund-raising expense or minimal fund-raising expense in relation to contributions include:

- A religious entity 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 entity's behalf (and this volunteer activity does not meet the recognition criteria for contributed services in FASB ASC 958-605-25-16).
- An entity has no paid staff, and most or all contributions arise from uncompensated board members soliciting contributions (and this

¹⁵ Fund-raising activities include, but are not limited to, compensating another entity for raising funds on behalf of the NPE, such as circumstances in which the fund-raising entity retains an administrative fee for raising funds on behalf of the NPE.

¹⁶ The FASB ASC glossary defines *control* as “the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an entity through ownership, by contract, or otherwise.”

¹⁷ As discussed in FASB ASC 958-720-45-27, “Federated fundraising entities solicit and receive designated and undesignated contributions and make grants and awards to other not-for-profit entities. The fundraising activities of federated fundraising entities, including activities related to fundraising on behalf of others, shall be reported as fundraising expenses.”

¹⁸ As discussed in section 6140.22, “In Circumstances in Which the Reporting NPE Undertakes a Transaction in Which Another NPE (Fund-Raising NPE) Raises Contributions on Behalf of the Reporting NPE, and the Reporting NPE Compensates the Fund-Raising NPE for Raising Those Contributions (Compensation Including, But Not Limited to, an Administrative Fee), Should the Reporting NPE Report the Fund-Raising NPE's Compensation Gross as Fund-Raising Expenses, or Net, as a Reduction of Contributions?,” reporting NPEs should report fund-raising expenses for compensation to a fund-raising NPE acting as an agent or intermediary in circumstances in which the fund-raising NPE acting as an agent or intermediary retains an administrative fee that will be deducted from all contributions that are to be transferred to the donor's chosen entity. That fact pattern is an example of a circumstance in which other entities that the NPE does not control contribute to the NPE (through an agent or intermediary) with the NPE undertaking minimal or no fund-raising activity or other participation in relation to those contributions, and the NPE would report fund-raising expense.

board member activity does not meet the recognition criteria for contributed services in FASB ASC 958-605-25-16).

- The reporting entity is a private foundation or is supported by a private foundation, and the reporting entity expends no or minimal resources in soliciting those contributions.
- The reporting entity obtains most or all of its contributions from one or more entities that it does not control (fund-raising NPE), expends minimal resources, and has minimal participation in soliciting those contributions.¹⁹ For example:
 - NPE Relief and Development Entity is one of many entities devoted to cause ABC. NPE Relief and Development Entity receives most or all of its contributions from Relief and Development Entities in the USA, Canada, and the United Kingdom that raise support for cause ABC throughout the world.
 - NPE Religious Entity Denomination International Mission Board receives a substantial portion of its support from the NPE Religious Entity Denomination, which supports various entities and causes, including but not limited to NPE Religious Entity Denomination International Mission Board. NPE Religious Entity Denomination allocates, at its discretion, X percent of its contributions from supporting churches and individuals to NPE Religious Entity Denomination International Mission Board.

The reporting NPE should consider, however, whether it is required to make financial statement disclosures required by FASB ASC 850, *Related Party Disclosures*, and FASB ASC 275, *Risks and Uncertainties*.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.21 Should an NPE Report Amounts Charged to the NPE by a Professional Fund-Raiser Gross, as Fund-Raising Expenses, or Net, as a Reduction of Contributions?

Inquiry—In circumstances in which a professional fund-raiser charges an NPE for soliciting contributions on the NPE's behalf, should the NPE report amounts charged to the NPE by the professional fund-raiser gross, as fund-raising expense, or net, as a reduction of contributions?

Reply—In circumstances in which a professional fund-raiser charges an NPE for soliciting contributions on the NPE's behalf, the NPE should report the amounts charged to the NPE by the professional fund-raiser gross, as fund-raising expense. As discussed in paragraphs 14–15 of FASB ASC 958-225-45, revenues and expenses should be reported gross (except for investment revenues and related expenses, which are permitted to be reported net of related expenses), while gains and losses may be reported net. Accordingly, in circumstances in which an NPE incurs expenses by hiring a professional fund-raiser to solicit contributions on its behalf, the NPE should report those contributions and expenses gross, rather than net. For example, assume NPE A enters into a transaction with Professional Fund-Raiser B, whereby Professional Fund-Raiser B solicits contributions on behalf of NPE A, for a fee of 20 percent of contributions raised. Professional Fund-Raiser B raises \$100,000 and remits

¹⁹ Footnote 18, in referring to section 6140.22, discusses a circumstance in which other entities that the NPE does not control contribute to the NPE (through an agent or intermediary) with the NPE undertaking minimal or no fund-raising activity or other participation in relation to those contributions, and the NPE would report fund-raising expense.

\$80,000 to NPE A after retaining its fee of \$20,000. NPE A should report \$100,000 contribution revenue and \$20,000 fund-raising expense.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.22 In Circumstances in Which the Reporting NPE Undertakes a Transaction in Which Another NPE (Fund-Raising NPE) Raises Contributions on Behalf of the Reporting NPE, and the Reporting NPE Compensates the Fund-Raising NPE for Raising Those Contributions (Compensation Including, But Not Limited to, an Administrative Fee), Should the Reporting NPE Report the Fund-Raising NPE's Compensation Gross, as Fund-Raising Expenses, or Net, as a Reduction of Contributions?

Inquiry—In some circumstances, a federated fund-raising entity (or other NPE) (fund-raising NPE) acts as an agent or intermediary rather than a donee. For example, in circumstances in which the fund-raising NPE receives resources from donors who stipulate that those resources should be transferred to a specified NPE, the fund-raising NPE acts as an agent or intermediary rather than a donee.²⁰ The NPE compensates the fund-raising NPE acting as an agent or intermediary. (Such compensation includes, but is not limited to, the fund-raising NPE retaining an administrative fee that will be deducted from all contributions that are to be transferred to the donor's chosen entity.) Should the reporting NPE report the compensation to the fund-raising NPE acting as an agent or intermediary gross, as fund-raising expenses, or net, as a reduction of contributions?

Reply—The reporting NPE should report fund-raising expenses for the compensation to the fund-raising NPE acting as an agent or intermediary in circumstances in which the reporting NPE compensates the fund-raising NPE acting as an agent or intermediary for raising contributions on behalf of the reporting NPE. (Such compensation includes, but is not limited to, the fund-raising NPE acting as an agent or intermediary retaining an administrative fee that will be deducted from all contributions that are to be transferred to the donor's chosen entity.) Accordingly, the reporting NPE should report the amount retained as compensation by the fund-raising NPE acting as an agent or intermediary gross as fund-raising expenses and report contributions for the gross amount contributed from the donor to the fund-raising NPE acting as an agent or intermediary for the benefit of the reporting NPE.

Paragraphs 84–87 of FASB ASC 958-605-55 discuss, among other matters, circumstances in which a federated fund-raising entity acts as an agent or intermediary, rather than a donee, in raising contributions in which the donor specifies the entity to which the contribution should be transferred. As discussed in FASB ASC 958-605-55-86, in circumstances in which the federated fund-raising entity charges an administrative fee that will be deducted from all contributions that are to be transferred to the donor's chosen entity, the beneficiaries should report the gross amount of the contributions as contribution revenue and the administrative fees withheld by the federated fund-raising entity as expenses. The guidance in paragraphs 84–87 of FASB ASC 958-605-55 would also apply if the fund-raising NPE were other than a federated fund-raising entity. Also, in functionalizing the administrative fees reported as expenses, the reporting NPE beneficiary would classify those expenses as fund-raising.

²⁰ In some circumstances, the fund-raising NPE receives resources from donors without stipulations or with stipulations sufficiently broad such that the fund-raising NPE acts as a donee, rather than as an agent or intermediary.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.23 Changing Net Asset Classifications Reported in a Prior Year

Inquiry—In some circumstances, not-for-profit organizations (NFPs) correct net asset classifications previously reported in prior years' financial statements.

The FASB ASC glossary defines an *error in previously issued financial statements* as follows:

An error in recognition, measurement, presentation, or disclosure in financial statements resulting from mathematical mistakes, mistakes in the application of generally accepted accounting principles (GAAP), or oversight or misuse of facts that existed at the time the financial statements were prepared. A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error.

Are individual net asset classes, rather than net assets in the aggregate (total net assets), relevant in determining whether an NFP's correction of net asset classifications previously reported in prior years' financial statements is an error in previously issued financial statements?

Reply—Individual net asset classes, rather than net assets in the aggregate (total net assets), are relevant in determining whether an NFP's correction of net asset classifications previously reported in prior years' financial statements is an error in previously issued financial statements.

FASB ASC 958-205-45-2, in discussing the financial statement presentation of net asset classes, provides, in part, as follows:

The usefulness of information provided by financial statements of NFPs can be vastly improved if certain basic information is classified in comparable ways. All NFPs shall ... classify and report net assets in three groups—permanently restricted, temporarily restricted, and unrestricted—based on the existence or absence of donor-imposed restrictions and the nature of those restrictions. Information about the nature and amount of restrictions imposed by donors on the use of contributed assets, including their potential effects on specific assets and on liabilities or classes of net assets, is helpful in assessing the financial flexibility of an NFP.

FASB ASC 958-225-45-13, in discussing the circumstances in which net assets should be reclassified, provides as follows:

Reclassifications of net assets—that is, simultaneous increases in one net asset class and decreases in another—shall be made if any of the following events occur:

- a. The NFP fulfills the purposes for which the net assets were restricted.
- b. Donor-imposed restrictions expire with the passage of time or with the death of a split-interest agreement beneficiary (if the net assets are not otherwise restricted).
- c. A donor withdraws, or court action removes, previously imposed restrictions.
- d. A donor imposes restrictions on otherwise unrestricted net assets. For example, a donor may make a restricted contribution that is

conditioned on the NFP restricting a stated amount of its unrestricted net assets. Such restrictions that are not reversible without donors' consent result in a reclassification of unrestricted net assets to restricted net assets.

Paragraph 74 of FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, which was part of appendix B, "Basis for Conclusions," of FASB Statement No. 117 and not included in FASB ASC, discusses, among other matters, the importance of reporting information beyond totals for the organization as a whole, such as information about which net assets are subject to donor restrictions, and provides as follows:

In assessing the financial position or performance of a not-for-profit organization, however, the Board believes it is important to avoid focusing attention almost exclusively on net assets, change in net assets, total assets, or other highly simplified and aggregated amounts. For example, in Concepts Statement No. 6, *Elements of Financial Statements*, paragraph 106, the Board says, "Since donor-imposed restrictions affect the types and levels of service a not-for-profit organization can provide, whether an organization has maintained certain classes of net assets may be more significant than whether it has maintained net assets in the aggregate." Similarly, it is important to avoid focusing attention almost exclusively on "the bottom line" or other highly simplified and condensed information about business enterprises. Accordingly, this Statement requires not only summary amounts that focus on a not-for-profit organization as a whole but also information about items and components of those amounts; for example, it generally requires reporting information about the gross amounts of items of revenues and expenses and of cash receipts and cash payments.

[Issue Date: May 2010.]

.24 Contributions of Certain Nonfinancial Assets, Such as Fundraising Material, Informational Material, or Advertising, Including Media Time or Space for Public Service Announcements or Other Purposes

Inquiry—In some circumstances, entities other than an NFP use for the NFP's benefit (or provide at no charge to the NFP) certain nonfinancial assets that encourage the public to contribute to the NFP or help the NFP communicate its message or mission. Examples of such activities include the following:

- An advertising agency, television station, or newspaper provides design services or professional talent services.
- A radio or television station gives an NFP (or uses for the NFP's benefit) commercial air time at no charge.
- An NFP distributes a public service announcement to several radio or television stations and asks the stations to air the announcement. (Some stations air the announcement and report information about the airings to the NFP.)
- A magazine, newspaper, or other print media gives an NFP (or uses for the NFP's benefit) advertising space at no charge.
- An Internet site gives an NFP (or uses for the NFP's benefit) advertising space at no charge.

In circumstances in which fundraising material, informational material, or advertising, including media time or space for public service announcements or other purposes, is used for the NFP's benefit (or provided to the NFP at no charge) and encourages the public to contribute to an NFP or help the NFP

communicate its message or mission, should the NFP report a contribution? If so, how should that contribution be measured and reported?

Reply—In circumstances in which fundraising material, informational material, or advertising, including media time or space for public service announcements or other purposes, is used for the NFP's benefit (or provided to the NFP at no charge) and encourages the public to contribute to an NFP or help the NFP communicate its message or mission, NFPs should consider whether they have received a contribution. If they have received a contribution, it should be measured at fair value, pursuant to FASB ASC 958-605-30-2, and the related expense, at the time the expense is recognized, should be reported by function, based on the nature of the contributed item.

As noted in paragraph 5.02 of the AICPA Audit and Accounting Guide *Not-for-Profit Entities*, the FASB ASC glossary defines a *contribution*, in part, as “an unconditional transfer of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner.” As noted in paragraph 5.01 of the Audit and Accounting Guide *Not-for-Profit Entities*, other assets include securities, land, buildings, use of facilities or utilities, material and supplies, intangible assets, and unconditional promises to give in the future.

Paragraph 25 of FASB Concepts Statement No. 6, *Elements of Financial Statements—a replacement of FASB Concepts Statement No. 3 (incorporating an amendment of FASB Concepts Statement No. 2)*, defines *assets* as “probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.” Paragraph 26 of FASB Concepts Statement No. 6, in discussing the characteristics of assets, provides, in part, as follows:

An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred. ... [A]lthough the ability of an entity to obtain benefit from an asset and to control others' access to it generally rests on a foundation of legal rights, legal enforceability of a claim to the benefit is not a prerequisite for a benefit to qualify as an asset if the entity has the ability to obtain and control the benefit in other ways.

Paragraph 28 of FASB Concepts Statement No. 6 elaborates further on the economic benefits of assets, noting that for NFPs, such benefits may be realized in the form of service potential rather than cash inflows, as follows:

The common characteristic possessed by all assets (economic resources) is “service potential” or “future economic benefit,” the scarce capacity to provide services or benefits to the entities that use them. ... In a not-for-profit organization, that service potential or future economic benefit is used to provide desired or needed goods or services to beneficiaries or other constituents, which may or may not directly result in net cash inflows to the organization.

Paragraph 31 of FASB Concepts Statement No. 6, in discussing the momentary nature of certain assets, provides as follows:

Services provided by other entities, including personal services, cannot be stored and are received and used simultaneously. They can be assets of an entity only momentarily—as the entity receives and uses them—although their use may create or add value to other assets of the entity. Rights to

receive services of other entities for specified or determinable future periods can be assets of particular entities.

Accordingly, in circumstances in which fundraising material, informational material, or advertising, including media time or space for public service announcements or other purposes, is used for the NFP's benefit (or provided to the NFP at no charge) and encourages the public to contribute to an NFP or help the NFP communicate its message or mission, the NFP may have received an unconditional transfer of other assets in a voluntary nonreciprocal transfer from another entity acting other than as an owner.

Paragraphs 5.56–.57 of the Audit and Accounting Guide *Not-for-Profit Entities*, in discussing reporting contributions received, provide as follows:

FASB ASC 958-605-25-2 states that except as provided (for contributed services and collections), contributions received shall be recognized as revenues or gains in the period received and as assets, decreases of liabilities, or expenses depending on the form of the benefits received. [FN omitted]

Depending on the kind of benefit received, in addition to recognizing contribution revenue, the NFP should also recognize (a) an increase in assets (for example, cash, securities, contributions receivable, collections [if capitalized, see chapter 7, “Other Assets,” of this guide], and property and equipment); (b) a decrease in liabilities (for example, accounts payable or notes payable); or (c) an expense (for example, donated legal services).

FASB ASC 958-720-45-2, in discussing reporting expenses, provides as follows:

To help donors, creditors, and others in assessing an NFP's service efforts, including the costs of its services and how it uses resources, a statement of activities or notes to financial statements shall provide information about expenses reported by their functional classification, such as major classes of program services and supporting activities, for example:

- a. Program services
- b. Supporting activities
- c. Management and general activities
- d. Fundraising activities
- e. Membership development activities

Accordingly, expenses related to such fundraising material, informational material, or advertising, including media time or space for public service announcements or other purposes, used for the NFP's benefit (or provided to the NFP at no charge) that encourages the public to contribute to an NFP or help the NFP communicate its message or mission should be reported by function at the time the expense is recognized, based on the nature of the contributed item.

[Issue Date: May 2010.]

.25 Multiyear Unconditional Promises to Give—Measurement Objective and the Effect of Changes in Interest Rates

Inquiry—FASB ASC 958-605-25-8 provides that promises to give should be recognized when received.

What is the measurement objective for multiyear unconditional promises to give, and what is the effect of changes in interest rates on that objective?

Reply—The measurement objective for multiyear unconditional promises to give (both the revenue and contribution receivable) is fair value at initial recognition, consistent with FASB ASC 958-605-30-2. The measurement objective for contributions receivable at subsequent measurement depends on whether the NFP has elected the fair value option, pursuant to FASB ASC 825-10. If the NFP has elected the fair value option, pursuant to FASB ASC 825-10, the measurement objective for contributions receivable at subsequent measurement is fair value. If the NFP has not elected the fair value option, pursuant to FASB ASC 825-10, the measurement objective for contributions receivable at subsequent measurement is as described in FASB ASC 958-310-35-4.

The model in FASB ASC 825-10-50-3 is not a fair value model.²¹

As discussed in paragraph 5.20 of the Audit and Accounting Guide *Not-for-Profit Entities*, “[p]resent value techniques are one valuation technique for measuring the fair value of the contribution ... or receivable; other valuation techniques also are available, as described in FASB ASC 820, *Fair Value Measurements and Disclosures*.”

Paragraph 5.112 of the Audit and Accounting Guide *Not-for-Profit Entities*, in discussing the discount rate to be used if present value techniques are used to measure fair value, provides, in part, as follows:

FASB ASC 958-605-30-5 discusses the determination of the discount rate if present value techniques are used to measure fair value. The present value of unconditional promises to give should be measured using a discount rate that is consistent with the general principles for present value measurement discussed in paragraphs 5–9 of FASB ASC 820-10-55-5. In conformity with FASB ASC 835-30-25-11, the discount rate should be determined at the time the unconditional promise to give is initially recognized and should not be revised subsequently unless the NFP has elected to measure the promise to give at fair value in conformity with the “Fair Value Option” subsections of FASB ASC 825-10.

Accordingly, in circumstances in which the NFP

- has not elected the fair value option, pursuant to FASB ASC 825-10, and market interest rates change in periods subsequent to initial recognition, the discount rate used in a present value technique should not be revised to reflect such changes in market rates.
- has elected the fair value option, pursuant to FASB ASC 825-10, and market interest rates change in periods subsequent to initial recognition, the discount rate used in a present value technique should be revised to reflect such changes in market rates.

[Issue Date: May 2010.]

[The next page is 5521.]

²¹ FASB ASC 825-10-50 requires various disclosures, including disclosures of fair value and carrying amounts for all financial instruments (which include contributions receivable) for which it is practicable to estimate that value and the method(s) and significant assumptions used to estimate the fair value of financial instruments. FASB ASC 825-10-55-3 states that disclosures required by the “General” subsection of FASB ASC 825-10-50 are optional if an entity meets all of the following 3 criteria: (a) the entity is a nonpublic entity; (b) the entity’s total assets are less than \$100 million on the date of the financial statements; and (c) the entity has no instrument that, in whole or in part, is accounted for as a derivative instrument.

Section 6300

Insurance Companies

.01 Recognition of Commission Income by Insurance Agency

Inquiry—Insurance agents and brokers receive commissions on the insurance policies that they place for their clients with insurance companies. Commissions consist of a percentage of the premiums that the clients pay for the policies. On policies that are cancelled before the end of their term, usually one year, the insurance company charges back the portion of the commissions related to the unearned premiums to the originating agent or broker. In addition, some brokers may receive contingent commissions from underwriters based on the profitability of policies placed with an underwriter. How should an insurance agent or broker account for revenue from such commissions?

Reply—Commissions should be recognized on the date on which (a) the client is afforded protection under the policy (effective date), (b) the premium due under the policy can be reasonably estimated, and (c) the premium is billable to the client. A provision should be made for expected adjustments relating to policy cancellations when they can be reasonably estimated in accordance with Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 450, *Contingencies*. Contingent commissions should generally be recognized when the insurance agent or broker is notified by the underwriter of the amount to be received.

[Amended; Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.02 Method of Recognizing Revenue From Commissions on Credit Life Insurance

Inquiry—Under arrangements with a lending institution, an insurance agency provides credit life insurance to mortgagors. The borrower pays the premium for the entire term of the insurance (as much as eight years) when the loan is made, and the insurance agency remits to the insurance company this entire sum less a commission.

Should this commission income be recognized when it is received, or should it be recognized over the term of the policy?

Reply—Generally, credit life insurance appears to have more of the characteristics of casualty insurance than it does of life insurance. In particular, from the agent's viewpoint, payment for the policy usually occurs in a lump sum from which agent commissions are deducted. Generally, the efforts of the agency in connection with any individual policy terminate when collection is made or, at least, when the proceeds from the collections are remitted to the insurance company. It would therefore seem that the recognition of income should occur when proceeds of the policy are received.

However, as there is a potential liability for returned premiums, it would appear that a reasonable allowance should be provided at this time for estimated commissions on the portion of the policies that may be cancelled in future years. Most finance companies should have adequate statistics upon which to base such estimates. If the finance company is new, there may be statistics available from similar enterprises.

.03 Recognition of Income on Unclaimed Refunds Due Policyholders on Policy Cancellations

Inquiry—An insurance agency has a material amount of accounts payable legally due to policyholders who have cancelled their insurance prior to the end of the policy term. The company does not notify these policyholders that these amounts are due them. When, if ever, should these credits be taken into income?

Reply—These accounts payable should continue to be reported as liabilities until such time as the individuals involved legally lose their claim to these amounts. Legal counsel should be consulted for an opinion as to whether these amounts would have to be paid over to the state under an escheat law.

Consideration should also be given to the appropriateness of notifying these policyholders that this money is due them.

.04 Reserve for Future Claims of Title Insurance Company

Inquiry—A title insurance company must place part of its premiums in a reserve for future claims. When should this reserve be recognized as income?

Reply—The jurisdiction under which a title insurance company operates usually requires that a stipulated percentage of premiums collected must be deferred in an unearned premium account. Generally, the unearned premium is taken into income over a ten-year period since most claims against title policies tend to occur during this ten-year period. However, actual claims are not charged to the unearned premium account. Actual claims are charged against income (title claims account) with the credit to “Reserve for Claims.” The reserve for claims represents reported claims that have surfaced. The unearned premium account is intended to cover unsurfaced claims.

[.05] Reserved

[.06] Reserved

[.07] Reserved

.08 Definition of an Insurance Benefit Feature

Inquiry—FASB ASC 944-605-25-8 states “If the amounts assessed against the contract holder each period for the insurance benefit feature of an insurance contract are assessed in a manner that is expected to result in profits in earlier years and losses in subsequent years from the insurance benefit function, a liability for unearned revenue shall be recognized in addition to the account balance.” What constitutes the *insurance benefit function* in performing the test described previously?

Reply—The test should be applied separately to the base mortality or morbidity feature and, in addition, separately to each other individual mortality or morbidity feature. Other individual mortality or morbidity features that would need to be tested separately are those features that create incremental mortality or morbidity risk to the base contract (for example, no lapse guarantees or long term care riders in a universal life insurance contract). Indicators that a mortality or morbidity feature should be evaluated separately may include

- explicit incremental charges,
- offered separately in the market place,
- described in the contract as a separate benefit, or
- the contract holder has a choice to accept or reject the additional benefit without rejecting the base contract.

Other insurance benefit features that provide for fixed and guaranteed benefits and premiums, and offered as a rider or an addition to a universal life contract, in practice typically would have been and should continue to be, separately accounted for under FASB ASC 944. Those features that have not been accrued for under FASB ASC 944 should be evaluated under the guidance of FASB ASC 944-20-10-2, paragraphs 20–25 of FASB ASC 944-40-30, and paragraphs 1–2 of FASB ASC 944-605-30.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.09 Definition of an Assessment

Inquiry—In performing the test in FASB ASC 944-605-25-8 (that is, have amounts assessed against the contract holder in a manner that is expected to result in profits in earlier years and losses in subsequent years from the insurance benefit function), what assessments should be used in the comparison of the amount and timing of expected assessments and the related benefits for determining whether amounts are assessed in a manner that is expected to result in profits in earlier years and losses in subsequent years from the insurance benefit function?

Reply—If an insurance benefit function has an explicit fee, there is a presumption that the terms and conditions of a contract entered into between two parties dealing at arms length are representative of their agreement. Therefore, there is a rebuttable presumption that the explicit fee should be used for the test in FASB ASC 944-605-25-8. However, there may be circumstances where the presumption may be overcome if evidence indicates that the substance of the agreement is not captured in the explicit terms of the contract. It is unlikely the presumption can be rebutted in the situation in which the assessment is explicitly incremental upon election of a separate insurance benefit feature and for which the policyholder has the choice to not pay if the election is not made.

In circumstances in which an insurance benefit function has no corresponding explicit fee or if the explicit fee does not capture the substance of the agreement, another method of determining assessments should be used for the test in FASB ASC 944-605-25-8. For example, in some universal life policies, the product's base mortality function may have been designed and priced on an integrated basis with the other functions, such as, administration and asset management. In such products, while the explicit cost of insurance charge is not expected to be sufficient to cover the death benefit risk in all periods, the product may be designed such that other assessments, including administrative fees, asset management fees, and investment margins, are expected to result in profits in subsequent years sufficient to offset the losses from the explicit cost of insurance charges designed shortfalls. In this example, it may be appropriate to include such additional implicit assessments in the test in FASB ASC 944-605-25-8 for the base mortality function. The analysis of implicit assessments would need to appropriately consider the pricing and cost of all components of the product. Indicators that implicit assessments are appropriately allocated to product components are

- allocation is not inconsistent with documentation, if any, of pricing at contract inception,
- assessments are allocated considering the recovery of all costs of each product component,

- allocation does not contradict external information on the market value of an individual product component on a stand-alone basis, and
- allocation method is applied consistently.

There is a presumption that the minimum guaranteed death benefit of a variable annuity and the no-lapse guarantee mortality feature of a universal life or a variable universal life contract will result in profits in earlier years and losses in subsequent years. This pattern of profits followed by losses results from the design and capital markets risks of these benefit features.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.10 Level of Aggregation of Additional Liabilities Determined Under FASB ASC 944

Inquiry—At what level of aggregation should additional liabilities, determined in accordance with FASB ASC 944-40-30-20, be calculated?

Reply—It is presumed that the level of aggregation generally should be consistent with the level at which the entity's DAC amortization ratios and associated DAC balances are calculated. This is the level at which products with common features have been aggregated. It is not appropriate to combine DAC-level groups for aggregation purposes in FASB ASC 944-40-30-20. Aggregation at a more detailed level than the level at which the entity's DAC amortization ratios and associated DAC balances are calculated may be warranted based on an individual entity's facts and circumstances including, but not limited to, the risk characteristics of the corresponding insurance benefit features, such as, variable annuities with a ratchet minimum guaranteed death benefit (MGDB) and variable annuities with a return of premium MGDB, or universal life products with and without secondary guarantees.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.11 Losses Followed by Losses

Inquiry—Should the guidance in FASB ASC 944-605-25-8 be applied if amounts assessed against the contract holder for an insurance benefit feature are expected to result in losses in earlier and subsequent years?

Reply—Yes, the concept underlying FASB ASC 944-605-25-8 is that the insurance entity may be required to establish a liability if it provides an insurance benefit in future periods for which it charges amounts in such periods that are less than the expected value of the insurance benefits to be provided. Consequently, the insurance enterprise should recognize a liability. This concept is applicable in situations in which charges attributable to an insurance benefit feature are less than the expected cost of the insurance benefit in all periods.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.12 Reinsurance

Inquiry—How should a ceding entity account for reinsurance contracts that meet the risk transfer criteria of FASB ASC 944 and that reinsure the insurance benefit features accounted for under FASB ASC 944-20-10-2, paragraphs 20–25 of FASB ASC 944-40-30, and paragraphs 1–2 of FASB ASC 944-605-30?

Reply—The accounting for reinsurance should be separate from the accounting for the direct contracts of the ceding entity in accordance with paragraphs 3–4 of FASB ASC 944-20-40, FASB ASC 944-310-25-2, FASB ASC 944-310-45-7, FASB ASC 944-340-25-1, FASB ASC 944-605-45-1, and FASB ASC 944-605-50-1. Reinsurance recoverables arising from the reinsurance contract should be reported as assets. As stated in FASB ASC 944-40-25-34, the recoverable should be calculated using methods and assumptions consistent with those used to establish the direct contract holder’s liability. Therefore, a benefit ratio using the same assumptions and scenarios used to establish the direct contract liability, as required in FASB ASC 944-40-30-20 should be used to establish a reinsurance recoverable with excess benefit payments ceded under the terms of the reinsurance contract as the numerator and direct assessments as the denominator. As required by FASB ASC 944-605-35-14, the cost of reinsurance shall be amortized over the remaining life of the underlying reinsured contracts if the reinsurance contract is long-duration, or over the contract period of the reinsurance if the reinsurance contract is short-duration. The cost of reinsurance may be recognized based on total direct assessments or on another reasonable manner such as estimated gross profits.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.13 Accounting for Contracts That Provide Annuitization Benefits

Inquiry—Are the provisions of paragraphs 26–27 and 40–41 of FASB ASC 944-40-25, paragraphs 26–29 of FASB ASC 944-40-30, paragraphs 10 and 12–16 of FASB ASC 944-40-35, and FASB ASC 944-40-45-2, dealing with accounting for contracts that provide annuitization benefits, limited only to universal life-type, limited-payment, and investment contracts?

Reply—No. The provisions of FASB ASC 944 relating to accounting for contracts that provide annuitization benefits applies to all insurance and investment contracts that have annuitization benefits. Therefore, any product that includes an annuitization benefit should be evaluated. This includes, but is not limited to, products where the base contracts are accounted for under FASB ASC 944 and where the annuitization benefit has not already been included in establishing the liability. To the extent annuitization benefits features have not already been included in benefit or premium deficiency liabilities, the provisions of paragraphs 26–27 and 40–41 of FASB ASC 944-40-25, paragraphs 26–29 of FASB ASC 944-40-30, paragraphs 10 and 12–16 of FASB ASC 944-40-35, and FASB ASC 944-40-45-2 should be applied.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.14 Note to Sections 6300.15–.24—Accounting by Noninsurance Enterprises for Property and Casualty Insurance Arrangements That Limit Insurance Risk

Insurance enables a company (the insured) to transfer insurance risk to an insurer for a specified premium. Insurance may be purchased for a number of economic reasons generally with the underlying goal of transferring insurance risk, including property damage, injury to others, and business interruption.

The following series of questions and answers (sections 6300.15–.24) focus on certain aspects of finite insurance products that are utilized by noninsurance enterprises. Due to the diverse nature of contracts in the marketplace, the guidance in these questions and answers is designed to assist practitioners in identifying the relevant literature to consider in addressing their specific facts and circumstances. The sections contain many excerpts of applicable guidance,

but readers should be familiar with all the guidance contained in that literature not only the specific paragraphs listed.

GAAP guidance for an insurance enterprise's purchase of reinsurance is more extensive than guidance on accounting by noninsurance enterprises for insurance contracts. The accounting guidance for reinsurance addresses transactions between an insurer (the contract holder) and a reinsurer (the issuer of the contract). Sections 6300.15–.24 address property and casualty insurance contracts between a policyholder and an insurance enterprise, which is similar to the relationship between an insurer and a reinsurer.

.15 Finite Insurance

Inquiry—What are “finite” insurance transactions?

Reply—Finite insurance contracts are contracts that transfer a clearly defined and restricted amount of insurance risk from the policyholder to the insurance company, and the policyholder retains a substantial portion of the related risks under most scenarios. Nevertheless, under certain finite contracts there may be a reasonable possibility that the insurance company will incur a loss on the contract.

.16 Insurance Risk Limiting Features

Inquiry—What types of insurance risk limiting features do finite insurance contracts normally contain?

Reply—Contractual features that serve to limit insurance risk transfer are found in both traditional and finite insurance contracts; however, the degree to which these features limit risk is relatively higher in finite insurance. All contractual provisions that limit risk transfer need to be considered when reviewing insurance contracts. Common features that may limit the transfer of insurance risk include:

- *Sliding scale fees and profit sharing formulae.* These features adjust cash flows between the policyholder and insurance company based on loss experience (for example, increasing payments from the insured enterprise as losses increase and decreasing payments as losses decrease, subject to maximum and minimum limits).
- *Experience refunds.* These arrangements allow the policyholder to share in the favorable experience of the underlying contracts by reference to an “experience account” that typically tracks premiums paid, less fees, less losses incurred, plus interest. Experience provisions also can require the policyholder to share in unfavorable experience by requiring additional payments to the insurer in the event that the experience account is negative.
- *Caps.* Caps are used to limit the insurer's aggregate exposure by imposing a dollar limit, or a limit expressed as a percentage of premiums paid, on the amount of claims to be paid by the insurer. For example, the insurer will not be responsible for losses beyond 150 percent of the premiums paid. While commercial insurance policies usually have limits on the amount of coverage provided, there may be significant risk mitigation for the insurer if the premium paid is a substantial percentage of the maximum coverage provided.
- *Loss Corridors.* This feature, which may exist in various forms, serves to eliminate or limit the risk of loss for a specified percentage or dollar amount of claims within the contract coverage. For example, in a contract providing coverage for a policyholder's first \$3,000,000 of

losses, the insurer will pay the first million and last million of losses but will exclude the corridor from \$1,000,000 to \$2,000,000.

- *Dual-triggers.* This feature requires the occurrence of both an insurable event and changes in a separate pre-identified variable to trigger payment of a benefit/claim. An example is a policy entered into by a trucking company that insures costs associated with rerouting trucks over a certain time period if snowfall exceeds a specified level during that time period.
- *Retrospectively-Rated Premiums.* Such premiums are determined after the inception of the policy based on the loss experience under the policy.
- *Reinstatement Premiums.* To the extent the coverage provided by a contract is absorbed by losses incurred, the contract provides for the policyholder to reinstate coverage for the balance of the contract period for a stated additional premium. To the extent reinstatement is required rather than optional, the additional premium may mitigate risk to the insurer.
- *Termination Provisions.* These provisions can be structured to reduce the risk of the insurer, for example, by allowing for termination by the insurer at a discounted amount under certain circumstances.
- *Payment Schedules.* Features that delay timely reimbursement of losses by the insurer prevent the transfer of insurance risk.

There may be other features and provisions, in addition to the list of common insurance risk transfer limiting features in the preceding, that exist in a contract. Determining the appropriate accounting requires a full understanding of all of the features and provisions of the contract.

.17 Transfer of Insurance Risk

Inquiry—Why is transfer of insurance risk important under GAAP?

Reply—If a contract does not provide for the indemnification of the insured by the insurer, it is accounted for as a deposit (financing) rather than as insurance as noted in FASB ASC 720-20-25-1.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.18 Accounting Guidance for Transfer of Insurance Risk

Inquiry—What GAAP accounting literature provides guidance related to transfer of insurance risk?

Reply—The assessment of transfer of insurance risk requires significant judgment and a complete understanding of the insurance contract and other related contracts between the parties. The greater the number, or degree, or both, of insurance risk limiting features that exist in a contract, the more difficult it becomes to assess whether or not the insurance risk transferred is sufficient to permit the contract to be accounted for as insurance rather than as a deposit.

FASB ASC 720-20-25-1 provides the following guidance on insurance contracts that do not provide for indemnification of the insured by the insurer against loss or liability:

To the extent that an insurance contract or reinsurance contract does not, despite its form, provide for indemnification of the insured or the ceding entity by the insurer or reinsurer against loss or liability, the premium paid less the amount of the premium to be retained by the insurer or reinsurer

shall be accounted for as a deposit by the insured or the ceding entity. Those contracts may be structured in various ways, but if, regardless of form, their substance is that all or part of the premium paid by the insured or the ceding entity is a deposit, it shall be accounted for as such.

FASB ASC 944 establishes the conditions required for a contract between an insurer and a reinsurer to be accounted for as reinsurance and prescribes accounting and reporting standards for those contracts. FASB ASC 944-20-15-41 notes, in part, the following:

Unless the condition in paragraph 944-20-15-53 is met, indemnification of the ceding entity against loss or liability relating to insurance risk in reinsurance of short-duration contracts exists under paragraph 944-20-15-37(a) only if both of the following conditions are met:

- a. Significant insurance risk. The reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance contracts. Implicit in this condition is the requirement that both the amount and timing of the reinsurer's payments depend on and directly vary with the amount and timing of claims settled under the reinsured contracts.
- b. Significant loss. It is reasonably possible that the reinsurer may realize a significant loss from the transaction.

FASB ASC 944 looks to the present value of all cash flows between the parties, however characterized, under reasonably possible outcomes in determining whether it is reasonably possible that the reinsurer may realize a significant loss from the contract.

FASB ASC 720-20-25-2 suggests that noninsurance entities look to the risk transfer guidance in FASB ASC 944, and states, in part, the following:

Entities may find the conditions in Section 944-20-15 useful in assessing whether an insurance contract transfers risk.

FASB ASC 944-20-25-1 states that a multiple-year retrospectively rated insurance contract must indemnify the insured as required by FASB ASC 944-20-15-36 to be accounted for as insurance. FASB ASC 944-20 also indicates that there may be certain situations in which the guarantee accounting in accordance with FASB ASC 460, *Guarantees*, is applicable.

FASB ASC 815, *Derivatives and Hedging*, addresses scenarios where there are dual-triggers and includes a number of relevant examples.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.19 Differences Between Retroactive and Prospective Insurance

Inquiry—What are the differences between retroactive and prospective insurance?

Reply—FASB ASC 944-605-05-7 states that for property and casualty insurance: The distinction between prospective and retroactive reinsurance contracts is based on whether the contract reinsures future or past insured events covered by the underlying contracts.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.20 Accounting for Prospective Insurance

Inquiry—How does a noninsurance enterprise account for prospective insurance contracts that qualify for insurance accounting?

Reply—A noninsurance enterprise amortizes the premiums over the contract period in proportion to the amount of insurance protection provided. If an insured loss occurs, and if it is probable that the policy will provide reimbursement for the loss and the amount of the loss can be reasonably estimated, the noninsurance enterprise records a receivable from the insurance enterprise and a recovery of the incurred loss in the income statement. If it is not probable¹ that the policy will provide reimbursement, then the receivable and recovery are not recorded.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.21 Accounting for Retroactive Insurance

Inquiry—How does a noninsurance enterprise account for retroactive insurance contracts that qualify for insurance accounting?

Reply—Paragraphs 3–4 of FASB ASC 720-20-25 state the following:

Notwithstanding that Topic 944 applies only to insurance entities, purchased retroactive insurance contracts that indemnify the insured shall be accounted for in a manner similar to the manner in which retroactive reinsurance contracts are accounted for under Subtopic 944-605. The guidance in that Subtopic shall be applied, as appropriate, based on the facts and circumstances of the particular transaction. That is, amounts paid for retroactive insurance shall be expensed immediately. Simultaneously, a receivable shall be established for the expected recoveries related to the underlying insured event.

If the receivable established exceeds the amounts paid for the insurance, the resulting gain is deferred. Immediate gain recognition and liability derecognition are not appropriate because the liability has not been extinguished (the entity is not entirely relieved of its obligation). Additionally, the liability incurred as a result of a past insurable event and amounts receivable under the insurance contract do not meet the criteria for offsetting under paragraph 210-20-45-1.

FASB ASC 720-20-35-2 further states the following:

If the amounts and timing of the insurance recoveries can be reasonably estimated, the deferred gain shall be amortized using the interest method over the estimated period over which the entity expects to recover substantially all amounts due under the terms of the insurance contract. If the amounts and timing of the insurance recoveries cannot be reasonably estimated, then the proportion of actual recoveries to total estimated recoveries shall be used to determine the amount of the amortization.

Paragraphs 22–23 of FASB ASC 944-605-25 state the following:

Amounts paid for retroactive reinsurance of short-duration contracts that meets the conditions for reinsurance accounting shall be reported as reinsurance receivables to the extent those amounts do not exceed the recorded liabilities relating to the underlying reinsured contracts. If the recorded liabilities exceed the amounts paid, reinsurance receivables shall be increased to reflect the difference and the resulting gain deferred.

If the amounts paid for retroactive reinsurance for short-duration contracts exceed the recorded liabilities relating to the underlying reinsured short-duration contracts, the ceding entity shall increase the related liabilities or

¹ According to the Financial Accounting Standards Board (FASB) *Accounting Standards Codification (ASC)* glossary, *probable* means that the future event or events are likely to occur.

reduce the reinsurance receivable or both at the time the reinsurance contract is entered into, so that the excess is charged to earnings.

FASB ASC 944-605-35-9 further states the following:

Any gain deferred under paragraph 944-605-25-22 shall be amortized over the estimated remaining settlement period. If the amounts and timing of the reinsurance recoveries can be reasonably estimated, the deferred gain shall be amortized using the effective interest rate inherent in the amount paid to the reinsurer and the estimated timing and amounts of recoveries from the reinsurer (the interest method). Otherwise, the proportion of actual recoveries (the recovery method) shall determine the amount of amortization.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.22 Accounting for Multiple-Year Retrospectively Rated Insurance

Inquiry—How does a noninsurance enterprise account for a multiple-year retrospectively rated insurance contract?

Reply—As noted in FASB ASC 720-20-05-10, multiple-year retrospectively rated contracts

include a “retrospective rating” provision that provides for at least one of the following based on contract experience:

- a. Changes in the amount or timing of future contractual cash flows, including premium adjustments, settlement adjustments, or refunds to the noninsurance entity
- b. Changes in the contract’s future coverage

FASB ASC 720-20-05-9 also states, in part:

A critical feature of these contracts is that part or all of the retrospective rating provision is obligatory such that the retrospective rating provision creates for each party to the contract future rights and obligations as a result of past events.

FASB ASC 944-20-25-2 also discusses the accounting for retrospective adjustments and states:

For a multiple-year retrospectively rated insurance contract accounted for as insurance, the insurer shall both:

- a. Recognize an asset to the extent that the insured has an obligation to pay cash (or other consideration) to the insurer that would not have been required absent experience under the contract
- b. Recognize a liability to the extent that any cash (or other consideration) would be payable by the insurer to the insured based on experience to date under the contract.

Paragraphs 3–4 of FASB ASC 944-20-35 further state:

The amount recognized under paragraph 944-20-25-4 in the current period shall be computed, using a with-and-without method, as the difference between the ceding entity’s total contract costs before and after the experience under the contract as of the reporting date, including costs such as premium adjustments, settlement adjustments, and impairments of coverage.

The amount of premium expense related to impairments of coverage shall be measured in relation to the original contract terms. Future experience

under the contract (that is, future losses and future premiums that would be paid regardless of past experience) shall not be considered in measuring the amount to be recognized.

FASB ASC 944-20-25-4 also further states:

For contracts that meet all of the conditions described in paragraph 944-20-15-55:

- a. The ceding entity shall recognize a liability and the assuming entity shall recognize an asset to the extent that the ceding entity has an obligation to pay cash (or other consideration) to the reinsurer that would not have been required absent experience under the contract (for example, payments that would not have been required if losses had not been experienced).
- b. The ceding entity shall recognize an asset and the assuming entity shall recognize a liability to the extent that any cash (or other consideration) would be payable from the assuming entity to the ceding entity based on experience to date under the contract.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.23 Deposit Accounting

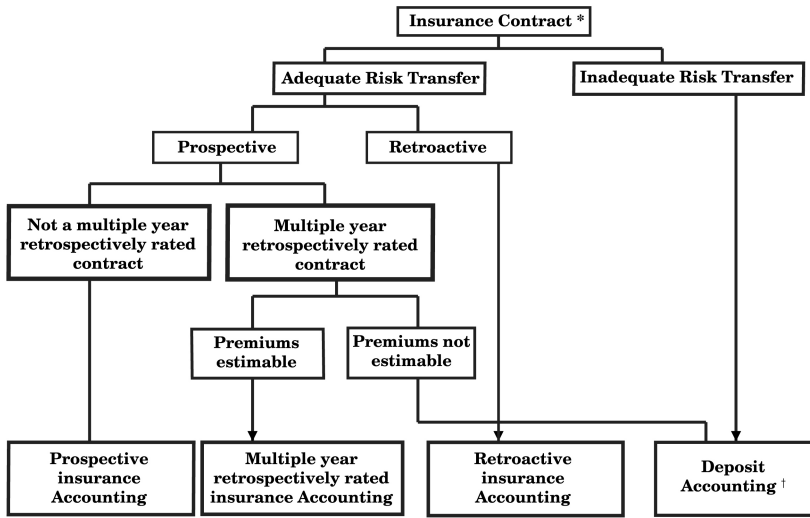
Inquiry—What is deposit accounting?

Reply—Deposit accounting essentially treats the contract as a financing transaction similar to a loan taking into account the time value of money. FASB ASC 340 provides guidance on how to account for insurance and reinsurance contracts that do not transfer insurance risk.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.24 Identifying Accounting Model for Insurance Transactions

The accompanying chart depicts the basic decision process in identifying the appropriate accounting model for insurance transactions.



*The insurance model discussed in this series of technical practice aids is based on property and casualty and other short-duration contracts, as defined in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 944, *Financial Services—Insurance*.

† FASB ASC-944-20 should also be considered in determining the accounting for multiple-year retrospectively rated contracts that do not transfer risk.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.25 Integrated/Nonintegrated Contract Features in Applying FASB ASC 944-30

Inquiry—If there are contract features that do not meet the definition of nonintegrated contract features contained in the FASB ASC glossary, how should the contract features be evaluated under FASB ASC 944-30?

Reply—The flowchart in FASB ASC 944-30-55-11, titled “Summary of Internal Replacement Transactions Accounting Model,” asks the question, “Does the contract modification involve the addition of or changes to a nonintegrated contract feature?” If the answer is *Yes*, the nonintegrated contract feature is evaluated separately from the base contract. All other modifications need to be evaluated to determine if the contract modification results in a substantially changed replacement contract in accordance with the criteria in FASB ASC 944-30-35-37.

When applying the guidance in FASB ASC 944-30 to determine whether a feature is integrated or nonintegrated, one indicator of a nonintegrated contract feature is that it is distinguishable as a separate component from the base contract.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.26 Evaluation of Significance of Modification in Applying FASB ASC 944-30

Inquiry—When analyzing a contract feature under FASB ASC 944-30-35-37(a), how should the significance of the change in the degree of mortality risk, morbidity risk, or other insurance risk be determined?

Reply—In assessing the significance of a change in the degree of mortality, morbidity, or other insurance risk, the insurance enterprise should consider the specific facts and circumstances of the modification as well as which approach or approaches it considers most appropriate to analyze the substance of the change. It is the substance of the contract between the insurance enterprise and the contract holder that is to be evaluated, and not just the economics to the insurance enterprise that is critical to determining whether an internal replacement results in a substantially changed contract.

FASB ASC 944-30 does not require any one specific approach for analyzing the significance of a change in insurance risk; rather, it provides examples of several approaches that may be used in assessing changes in the degree of insurance risk. Factors to consider in determining whether there are significant changes in insurance risks may include changes in actuarially estimated costs for that benefit feature (for example, changes in the death benefit provided) or, alternatively, changes in the FASB ASC 944 benefit ratio related to that benefit feature (for example, giving consideration to the change in the relationship between the actuarially estimated future costs of the benefit feature and estimated total future fees to be charged for the contract). Another example of assessing the significance of a change for a universal life contract is by comparing the change in the relationship between the expected cost of the benefit and the charges for the benefit. Another potential comparison would be the change in the net amount at risk before and after the modification. Reunderwriting an entire contract generally would indicate a significant change in the kind or degree of insurance risk.

Different approaches utilized to assess the significance of a change in the degree of mortality, morbidity, or other insurance risk could result in different conclusions. Therefore, it may be necessary to consider multiple approaches to evaluate the significance of a change. For example, a change from a 20-pay life insurance contract to a 10-pay life insurance contract, where the two premiums are determined to be actuarially equivalent amounts, is an internal replacement that may or may not result in the replacement contract being determined to be substantially changed from the replaced contract. Using actuarially estimated cost before and after the modification would not result in a significant change (for example, the death benefit remains the same, only the premium payment period is changing). Comparing the relationship of the present value of estimated cost and the present value of the actuarially equivalent premiums also would not result in a significant change. However, if one used the net amount at risk as the basis for comparison, the change could be considered significant, given that the net amount at risk would differ for contracts with different premium collection periods.

While all these approaches, and perhaps others, would be appropriate in analyzing the significance of the change in this specific example, not all of these approaches would be appropriate in all circumstances. Any approach utilized should consider the substance of the change between the insurance enterprise and the contract holder. For instance, a minimum guaranteed death benefit (MGDB) is essentially a combination of mortality and investment risk and, therefore, it generally would not be appropriate to analyze the change in a MGDB based on a comparison of net expected cost (expected costs net of expected charges for the MGDB benefit) or the change in the relationship

between the expected cost and charges for the MGDB benefit due to the interaction of the mortality and investment risk.

The approach or approaches determined to be appropriate to evaluate the substance of a change should be applied consistently in analyzing similar types of modifications for similar contracts.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.27 Changes in Investment Management Fees and Other Administrative Charges in Applying FASB ASC 944-30

Inquiry—How should changes in investment management fees and other administrative charges be evaluated under the guidance in FASB ASC 944-30?

Reply—Changes in accordance with terms and within ranges specified in the contract, without any other change in benefits or coverages, are not modifications to the contract.

Changes in investment management fees and charges that are not in accordance with terms specified in the contract should be evaluated under the guidance in FASB ASC 944-30-35-37(b) based on the substance of the fees and consider whether the change in fees is significant in the context of the overall investment return rights. Changes in the structure of investment management fees and charges (for example, between flat fee, sliding scale, or percentage of assets), whether made by the insurance entity or investment advisor, may or may not result in a significant change to the nature of investment return rights.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.28 Definition of Reunderwriting for Purposes of Applying FASB ASC 944-30

Inquiry—Is the performance of limited examination procedures in conjunction with the election of a benefit, feature, right, or coverage by the contract holder considered underwriting or reunderwriting as contemplated by FASB ASC 944-30-35-26(b)?

Reply—It depends. The performance of examination procedures with respect to specific risks or components of a contract would not represent underwriting or reunderwriting as long as the procedures are limited in nature and do not involve judgment or discretion with respect to acceptance or price. For example, examination procedures undertaken to confirm data used to calculate benefit amounts, such as the income verification procedures undertaken as part of a benefit step-up in a disability policy, or to gather information to verify representations made by the contract holder with respect to the election being made, such as limited procedures to validate an insured's claim of currently being a nonsmoker, would not be considered underwriting or reunderwriting.

The lack of underwriting is not, by itself, determinative that an election is not a modification or that a change is not substantial. The election should be evaluated against the other conditions of FASB ASC 944-30.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.29 Contract Reinstatements in Applying FASB ASC 944-30

Inquiry—How should insurance enterprises apply the guidance in FASB ASC 944-30 to contract reinstatements?

Reply—If an insurance enterprise determines it has no further obligation to pay claims due to the lapse of a contract, the related contract would be

considered extinguished. If the insurance contract is later reinstated, it would be accounted for as a newly issued contract in the period in which the reinstatement occurs. Unamortized deferred acquisition costs, unearned revenue liabilities, and deferred sales inducement assets related to the terminated contract should not be reestablished in connection with the newly issued contract.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.30 Commissions Paid on an Increase in Insurance Coverage or Incremental Deposits in Applying FASB ASC 944-30

Inquiry—Should additional commissions incurred on either an increase in insurance coverage or incremental deposits not provided for in the replaced contract, related to a contract modification determined to result in a substantially unchanged replacement contract under FASB ASC 944-30, be accounted for as maintenance costs?

Reply—No. If commissions are paid on either an increase in insurance coverage or incremental deposit, not previously provided for in the contract, related to a contract modification determined to result in a substantially unchanged replacement contract, the commissions should be accounted for as acquisition costs in accordance with the provisions of FASB ASC 944, as appropriate.

For example, an increase in face amount of a universal life-type contract results in a replacement contract that is determined to be substantially unchanged. The modification is an integrated feature because the universal life-type contract has only a single account value and the death benefit is the excess of face amount over account value. In this situation, the commission incurred on what is essentially the sale of new insurance coverage should not be considered maintenance expense, but rather should be accounted for as acquisition costs in accordance with the provisions of FASB ASC 944. The substance of the modification in this example is the sale of additional insurance.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.31 Participating Dividends and the Interaction of Guidance in FASB ASC 944

Inquiry—How are paid up additions funded by dividends on participating policies evaluated under FASB ASC 944-30, and what is the impact on estimated gross margins?

Reply—Paid up additions funded by dividends on participating policies that meet the conditions of FASB ASC 944-30-35-26 would not be considered internal replacements subject to the guidance in FASB ASC 944-30. Paid up additions that do not meet the conditions of FASB ASC 944-30-35-26 would be considered nonintegrated contract features under FASB ASC 944-30.

For paid up additions that do not meet the conditions of FASB ASC 944-30-35-26, FASB ASC 944 addresses the accounting and the impact of various dividend options, including paid up additions, on estimated gross margins. Under FASB ASC 944-30-35-15, the estimated gross margins should include an insurance company's best estimate of the dividend options that policyholders will elect, which would include the option to use dividends to fund paid up additions. FASB ASC 944-30 does not amend or affect that guidance in FASB ASC 944.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.32 Premium Changes to Long Duration Contracts in Applying FASB ASC 944-30

Inquiry—Are changes in premiums to long-duration insurance contracts for which the insurer has the right to make changes in premium rates considered modifications as contemplated in FASB ASC 944-30?

Reply—It depends.

FASB ASC 944-20-55-5 states:

. . . individual and group insurance contracts that are . . . guaranteed renewable (renewable at the option of the insured), or collectively renewable (individual contracts within a group are not cancelable), ordinarily are long-duration contracts.

The AICPA Audit and Accounting Guide *Life and Health Insurance Entities* defines a guaranteed renewable contract as:

An insurance contract whereby the insured has the right to continue in force by the timely payment of premiums for a period that coincides approximately with the average working lifetime (for federal income tax purposes at least until age sixty), with the right reserved by the insurer to make changes in premium rates by classes.

The right to adjust premium rates for group long-duration insurance contracts generally would not meet the characteristics of a modification under FASB ASC 944-30 as long as all of the following conditions are met:

- The right to adjust premium rates is provided for under the terms of the insurance contract,
- The change to premium rates for a contract holder is the same change in premium rates that is applicable to the entire class of contract holders,
- Changes to premium rates do not involve consideration by the insurer of specific experience of the contract holder, and
- No other changes in benefits or coverages occur.

Further, the determination of rates based on a formula specified within the contract that does not involve insurer discretion would not be considered a modification as contemplated under FASB ASC 944-30.

Changes to a contract that involve the adjustment of rates or benefits based on a judgmental review of actual experience of the contract holder or the renegotiation of rates or benefits with that contract holder, even if no reunderwriting has occurred, generally would be considered a modification that is subject to the guidance in FASB ASC 944-30.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.33 Evaluation of Changes Under FASB ASC 944-30-35-37(a)

Inquiry—How should changes in the period of coverage or insured risk under FASB ASC 944-30-35-37(a) be evaluated?

Reply—A change in the period of coverage should be evaluated based on a comparison of the remaining period of coverage of the replaced contract to the remaining period of coverage of the replacement contract when assessing the significance of that change. Similarly, when determining whether there are

significant changes in insurance risk under FASB ASC 944-30-35-37(a) the evaluation should be based on a comparison of the remaining insurance coverage of the replaced contract to the remaining insurance coverage of the replacement contract.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.34 Nature of Investment Return Rights in FASB ASC 944-30-35-37(b)

Inquiry—What constitutes the *nature of the investment return rights* in FASB ASC 944-30-35-37(b)?

Reply—The phrase *nature of the investment return rights* encompasses the manner in which the contract's investment return is determined. For pass-through contracts, the addition of a floor or the capping of the returns, such that actual returns (net of fees and charges) are not passed through to the policyholder, fundamentally changes the nature of the investment return rights.

If the contract is referenced to a pool of assets or otherwise indexed (for example, S&P 500 or LIBOR), the underlying referenced pool of assets or index is an inherent component of the nature of investment return rights, and changes in these provisions would result in a change to the nature of investment return rights between the insurance enterprise and the contract holder under FASB ASC 944-30-35-37(b). This differs from a contract holder reallocation of funds among multiple investment alternatives provided for in the contract in which the investment performance of the investments passes through to the contract holder.

Contract holder liquidity rights related to investment guarantees (for example, variable annuity guaranteed minimum accumulation benefits, guaranteed minimum income benefits, and guaranteed minimum withdrawal benefits) are inherent components of the nature of investment return rights, and the addition of a different investment guarantee with substantively different timing of cash flow accessibility to the contract holder would result in a change to the nature of investment return rights between the insurance enterprise and the contract holder under FASB ASC 944-30-35-37(b).

Changes to a component (or components) of an investment return formula (for example, the strike price of the guarantee for a variable annuity with a guaranteed minimum accumulation benefit or other modification to an existing investment guarantee) should be evaluated in a manner similar to changes in minimum guarantees for contracts subject to periodic discretionary declaration.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.35] Reserved

.36 Prospective Unlocking

Inquiry—Certain insurance contracts classified as long-duration insurance contracts under FASB ASC 944, may include provisions that allow for premium rate increases by class of customer, subject to regulatory approval. Policies with these provisions may include long-term care, Medicare supplements, and certain other guaranteed renewable contracts.

Is an insurance company permitted to “unlock” its original FASB ASC 944 assumptions after contract inception for collected, approved, or expected premium rate increases for the contracts previously described in situations other than in premium deficiency?

Reply—No, FASB ASC 944 policyholder benefit liability assumptions cannot be unlocked for collected, approved, or expected premium rate increases for the contracts described in situations other than in the premium deficiency situations described in paragraphs 7–9 of FASB ASC 944-60-25.

FASB ASC 944 requires that best estimate assumptions (with a provision for adverse deviation) be determined at contract inception and used to calculate the long duration policy benefit liability. Paragraphs 5–6 of FASB ASC 944-40-35 state the following:

Original assumptions shall continue to be used in subsequent accounting periods to determine changes in the liability for future policy benefits (often referred to as the lock-in concept) unless a premium deficiency exists subject to paragraphs 944-60-25-7 through 25-9.

Changes in the liability for future policy benefits that result from its periodic estimation for financial reporting purposes shall be recognized in income in the period in which the changes occur.

FASB ASC 944-60-25-7 describes the premium deficiency situations that can exist. As FASB ASC 944-60-30-1 describes, the first situation occurs when the present value of future payments for benefits and related expenses less the present value of future gross premiums (both determined using revised assumptions based on actual and expected experience) exceed the existing liability for future policy benefits reduced by unamortized acquisition costs. As FASB ASC 944-60-25-9 describes, a premium deficiency can also exist when the liability on a particular line of business is not deficient in the aggregate, but circumstances are such that profits would be recognized in early years and losses in later years.

[Issue Date: December 2008; Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.37 Application of Accounting Standards Update No. 2010-26, *Financial Services—Insurance (Topic 944): Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts (a consensus of the FASB Emerging Issues Task Force)*

Inquiry—How should Accounting Standards Update (ASU) No. 2010-26, *Financial Services—Insurance (Topic 944): Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts (a consensus of the FASB Emerging Issues Task Force)*, be applied?

Reply—The application of ASU No. 2010-26 will be based on an election of the entity and could be applied in either of the following ways:

- a. Prospectively
- b. Retrospectively, as described in FASB ASC 250-10

If an entity decides to retrospectively apply, paragraph BC16 of ASU No. 2010-26 discusses that the task force did not believe that an entity is necessarily expected to reperform its detailed capitalization, amortization, and premium deficiency calculations for every prior year that is restated. Specifically, paragraph BC16 states that the

Task Force members stated that an entity may need to make reasonable estimates of the effect on prior years on the basis of its specific circumstances in order to adopt the amendments retrospectively. In electing retrospective application, the Task Force did not believe that an entity is necessarily expected to reperform its detailed capitalization, amortization, and premium deficiency calculations for every prior year if it has ways to

reasonably estimate those amounts in accordance with Subtopic 250-10, *Accounting Changes and Error Corrections—Overall*.

[Issue Date: July 2011.]

.38 Retrospective Application of ASU No. 2010-26

Inquiry—If different levels of historical information are available for various products, how should this information be included when retrospectively applying ASU No. 2010-26? Can ASU No. 2010-26 be applied retrospectively to different points in time for various products?

Reply—If the entity has determined that it is impracticable to determine the cumulative effect of applying a change in accounting principle to all prior periods (as discussed in paragraphs 5–7 of FASB ASC 250-10-45) for all contracts subject to ASU No. 2010-26 and is applying the new accounting principle as if the change was made prospectively as of the earliest date practicable (in accordance with FASB ASC 250-10), the effect of applying a change in accounting principle for deferral of acquisition costs should be applied at a single point in time to contracts that were entered into from the point of retrospective application and forward.

Determining the earliest practicable date of retrospective application of ASU No. 2010-26 is a matter of judgment. Accordingly, the entity will need to make a determination, based on individual facts and circumstances, about what single point in time to use as a starting point for retrospective application for all products. The guidance on reporting a change in accounting principle made in an interim period in FASB ASC 250-10-45-14 should also be considered.

The entity will adopt the deferral guidance in ASU No. 2010-26 for contracts entered into from the date of retrospective application and forward. Therefore, the acquisition costs that were previously deferred relating to periods prior to the date of retrospective application will be based upon the previous applicable guidance under FASB ASC 944-30 for deferral of acquisition costs. It is recommended that the entity disclose the types of costs deferred under ASU No. 2010-26 and whether differences exist in the costs deferred under the previous guidance of FASB ASC 944-30 and ASU No. 2010-26.

For example, an insurance entity only sells product A and product B, and they are both material to the entity for all prior periods. For product A, the entity has sufficient information going back three years; however, for product B, the entity has sufficient information going back seven years. In this example, the entity would be limited to three years of retrospective application (that is, the earliest date practicable) of ASU No. 2010-26, and all years prior to the three years that would be retrospectively adjusted would continue to follow the previous accounting policy used to defer acquisition costs.

The guidance in ASU No. 2010-26 does not change the required amortization methods for acquisition costs that are deferrable; therefore, all deferrable cost will be amortized in the same manner, notwithstanding that the types of cost deferred for certain periods may be different. However, ASU No. 2010-26 requires that advertising costs that meet the capitalization criteria for direct-response advertising in FASB ASC 340-20 should be included in deferred acquisition costs and amortized in the same manner as all other deferred acquisition costs.

[Issue Date: July 2011.]

.39 Cumulative Effect of Change in Accounting Principle — ASU No. 2010-26

Inquiry—If an entity is retrospectively applying the guidance in ASU No. 2010-26, what effects of a change in accounting principle should be included in the cumulative effect?

Reply—As stated in FASB ASC 250-10-45-8:

Retrospective application shall include only the direct effects of a change in accounting principle, including any related income tax effects. Indirect effects that would have been recognized if the newly adopted accounting principle had been followed in prior periods shall not be included in the retrospective application. If indirect effects are actually incurred and recognized, they shall be reported in the period in which the accounting change is made.

In addition to the impact on deferrals and amortization of acquisition costs, including any impact to income taxes, the following are some items to consider when evaluating the direct effects of retrospective application of ASU No. 2010-26:

- *Premium deficiency (loss recognition).* If a premium deficiency was recognized in prior financial statements, an entity should determine whether the amount of the premium deficiency loss that was recognized would change if deferred acquisition costs had been measured based on the guidance in ASU No. 2010-26. In those situations when the application of this accounting change results in additional acquisition costs being deferred in prior periods, entities should evaluate whether a premium deficiency is needed based on the revised DAC amount.
- *Shadow accounts.* Adjustments made to DAC as a result of ASU No. 2010-26 may also require adjustments to shadow DAC² or shadow premium deficiency amounts.
- *Limited payment contracts.* For limited pay contracts, the calculation of deferred profit liability includes capitalizable acquisition costs.³ Therefore, changes in the amount of DAC due to the adoption of ASU No. 2010-26 will result in changes to the deferred profit liability.
- *Equity method investee that is an insurance entity.* The amount recognized relating to an equity method investment in an insurance entity may be affected by an investee's retrospective adoption of ASU No. 2010-26.
- *Noncontrolling interest of an insurance subsidiary.* The noncontrolling interest balance should be adjusted to reflect the adoption of ASU No. 2010-26 to the extent that the noncontrolling interest relates to an entity with DAC.

² As discussed in FASB ASC 320-10-S99-2:

[A]sset amounts that are amortized using the gross-profits method, such as deferred acquisition costs accounted for under FASB ASC 944-30-35-4 and certain intangible assets arising from insurance contracts acquired in business combinations, should be adjusted to reflect the effects that would have been recognized had the unrealized holding gains and losses actually been realized.

Also, loss recognition assessments due to the impact of unrealized gains or losses may need to be adjusted to reflect the revised deferred cost. These adjustments, due to the unrealized investment gains and losses, are commonly referred to in practice as *shadow deferred acquisition cost* or *shadow premium deficiency adjustments*.

³ As discussed in paragraph 9 of FASB ASC 944-30-25, capitalizable acquisition costs should be included in the calculation of net premiums and for purposes of determining the deferred profit for limited payment contracts.

- *Divested operations.* Adjustments made to DAC of a divested entity may affect a gain or loss previously recorded on the sale of an insurance entity, as well as the amounts reported in the financial statements prior to sale (for example, assets and liabilities held for sale, income (loss) from discontinued operations).
- *Reinsurance.* Adjustments made to DAC due to the adoption of ASU No. 2010-26 may also require adjustments to amounts related to reinsurance transactions involving long duration reinsurance contracts.⁴
- *Foreign exchange.* Entities that conduct business in multiple currencies should consider the impact of ASU No. 2010-26 on foreign exchange translation adjustments, as well as foreign exchange transactions (for example, the remeasurement of DAC from nonfunctional currency to functional currency).⁵

[Issue Date: October 2012.]

.40 Deferrable Commissions and Bonuses Under ASU No. 2010-26

Inquiry—Under the guidance of ASU No. 2010-26, are all commissions and bonuses deferrable?

Reply—Commissions and bonuses are not deferrable solely due to an insurance entity having a sales transaction. To be deferrable as an incremental direct acquisition cost, the costs must result directly from, and be essential to, the sales transaction(s) and would not have been incurred by the insurance entity had the sales transaction(s) not occurred.

Entities will need to use judgment to determine whether acquisition costs related to commissions and bonuses for employees or nonemployees meet the criterion to be deferrable under ASU No. 2010-26 of resulting directly from, and being essential to, the sale transaction.

FASB ASC 944-30-55-1F and 944-30-55-1G provide examples of some of the types of activities for which related costs are deferrable and those that are not. Chapter 10, “Commissions, General Expenses, and Deferred Acquisition Costs,” of the AICPA Audit and Accounting Guide *Life and Health Insurance Entities* contains discussion of the guidance in ASU No. 2010-26.

[Issue Date: October 2012.]

[The next page is 5641.]

⁴ FASB ASC 944-30-35-64 provides that “proceeds from reinsurance transactions that represent recovery of acquisition costs shall reduce applicable unamortized acquisition costs in such a manner that net acquisition costs are capitalized and charged to expense in proportion to net revenue recognized.” The remainder is deferred and amortized as part of the estimated cost of reinsurance under FASB ASC 944-605-30-4. Changes to deferrable amounts will, therefore, affect the estimated cost of reinsurance.

⁵ FASB ASC 830-10-45-18 describes nonmonetary items as being “[o]ther intangible assets, deferred charges and credits, except policy acquisition costs for life insurance companies,” thus, requiring that in remeasurements to functional currency, capitalized acquisition costs of life insurance companies should be accounted for as if they were monetary. FASB ASC 255-10-55-1 notes that deferred property and casualty insurance policy acquisition costs related to unearned premiums should be accounted for as nonmonetary items.

Section 6400

Health Care Entities

[.01] Reserved

[.02] Reserved

[.03] Reserved

.04 Hospital as Collecting Agent for Physicians [Amended]

Inquiry—Under an agreement with several physicians, a hospital acts as collecting agent for the physicians' fees, and the physicians, in return, provide professional services at the hospital. These physicians are not employees; payroll taxes are not paid for them, and the hospital cannot exercise any of the prerogatives of an employer. To enable it to collect the physicians' Medicare fees, the hospital holds valid assignments. Should the amounts collected as physicians' fees be included in the income and expenses of the provider hospital?

Reply—No. As discussed in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 954-305-45-4, health care entities may receive and hold assets owned by others under agency relationships; for example, they may perform billing and collection services for physicians. In accepting responsibility for those assets, an entity incurs a liability to the principal under the agency relationship to return the assets in the future. In the preceding example, the hospital is functioning as a conduit with respect to the physicians' fees. As a result, the fees should be reported as a liability to the physicians and not recognized in the statement of revenues and expenses. Agency funds are reported as unrestricted assets.

[Amended, September 1997; Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.05] Reserved

[.06] Reserved

[.07] Reserved

[.08] Reserved

[.09] Reserved

[.10] Reserved

[.11] Reserved

.12 General Obligation Bonds Issued for Current Use by City Owned Hospital [Amended]

Inquiry—A hospital is a city municipal enterprise. The city council issued general obligation bonds to provide funds for the hospital's operations, without restriction. The hospital's assets will not be used to pay principal or interest on the bonds. Should the general obligation bond liability be reported in the hospital's financial statements?

Reply—No. FASB ASC 954-470-25-1 states that if a health care entity has no obligation to make payments of principal and interest on the debt, the entity should not reflect the liability on its balance sheet. The proceeds from the bond

issue are contributions from the city. Therefore, the hospital should not report the bonds as a liability in its financial statements.

[Amended, September 1997; Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.13] Reserved

[.14] Reserved

[.15] Reserved

[.16] Reserved

.17 Elimination of Profit on Intercompany Sales

Inquiry—FASB ASC 810-10-45-1 addresses the elimination of intercompany profit or loss on assets remaining within a combined or consolidated group. FASB ASC 980-810-45-1 indicates the following with regard to intercompany profit:

Profit on sales to regulated affiliates shall not be eliminated in general-purpose financial statements if both of the following criteria are met:

- a. The sales price is reasonable.
- b. It is probable that, through the rate-making process, future revenue approximately equal to the sales price will result from the regulated affiliate's use of the products.

Because health care providers are, in certain cases, reimbursed for operating costs, it is possible that, assuming they meet certain related party tests under third-party regulations, an entity could receive reimbursement on intercompany sales that include a profit. Thus, one could argue that under that circumstance, it would not be appropriate to eliminate profit on intercompany sales using the criteria set forth in FASB ASC 980, *Regulated Operations*.

Reply—In some instances health care entities may encounter situations where they fall under FASB ASC 980-10-15-2. Generally, however, as explained in FASB ASC 980-10-15-7, the normal Medicare and Medicaid arrangements are excluded from the scope of FASB ASC 980 on the basis that the “regulator” is also a party to the contract. Accordingly, gains or losses on sale of assets within the group should be eliminated in combined or consolidated financial statements. However, these gains or losses would be recognized and disclosed as appropriate in the separate financial statements of the members of the group.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.18] Reserved

.19 Offsetting of Limited Use Assets

Inquiry—Can limited-use assets of one entity be offset against the related liability of another entity in combined or consolidated financial statements?

Reply—Unless a *right of setoff* exists as defined in the FASB ASC glossary, assets, in general, should not be offset against related liabilities in any financial statement presentation.

[Amended; Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.20 Format of Combined or Consolidated Financial Statements

Inquiry—When presenting combined or consolidated financial statements of various health care entities, is there a prescribed or recommended presentation format?

Reply—No. The sample financial statements contained in FASB ASC 954, *Health Care Entities*, do not prescribe the format of statements. In addition, no single format for combined or consolidated financial statements has been considered appropriate in all circumstances.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.21] Reserved

[.22] Reserved

[.23] Reserved

[.24] Reserved

.25 Accounting for Transfer of Assets From Not-for-Profit to For-Profit Entities

Inquiry—How should subsequent transfers of assets, evidenced as additional investment, from not-for-profit entities to for-profit entities be accounted for by the transferee and transferor?

Reply—Additional investments in for-profit entities (subsequent to the original transfer of assets) should be reflected by the transferee as an increase in capital stock or paid-in capital, or both. The transferor would record a corresponding increase in its investment account in the for-profit entity, if a financial interest was received (for example, additional capital stock).

.26 Transfer of Assets From Subsidiary For-Profit Entity to Not-for-Profit Stockholder Parent

Inquiry—How should transfers of assets from a “subsidiary” for-profit entity (F) to a not-for-profit entity (N) that is a minority stockholder of F be recorded?

Reply—This transaction would generally be recorded as a dividend, which would be reported as a reduction in F’s retained earnings. Any dividend in excess of retained earnings is a “liquidating” dividend; as such, it would be reported as a reduction in F’s paid-in capital account. If N accounts for its investment in F using the equity method, then the not-for-profit entity would report all dividends received as a reduction of its investment account, in accordance with FASB ASC 323, *Investments—Equity Method and Joint Ventures*. If N’s investment in F is accounted for using the cost method, because the conditions for applying the equity method are not met, the dividends would be reported as income.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.27] Reserved

[.28] Reserved

.29 Timing of Recording Transfers Between Related Entities

Inquiry—When should a transfer of assets between related entities be recorded—only when the transfer is actually made, or at some earlier point?

Reply—In most situations, transfers should be recorded at the time they are formally obligated to occur (formal board resolutions, legal notes, passage of title to real estate, and so on). This would be the case when each of the entities have independent governance, and the timing of the transfer is controlled by the governing board of the transferor. Yet, in situations where there is clear, common control of the related entities, it would be appropriate to record transfers at the time when both (a) the transfer amount is known and (b) the receiving entity is given control over the timing of the transfer.

.30 Accounting for Transactions Involving Medicaid Voluntary Contribution or Taxation Programs [Amended]

Inquiry—The Medicaid program is set up on a state-by-state basis to provide medical assistance to the indigent. Although state-administered, the program is actually a joint federal and state program for which the federal government picks up a portion of the cost. Under this arrangement, the federal government “matches” a percentage of the total amount paid by the state to health care providers. This matching is referred to as federal financial participation.

States have attempted to increase the amount of federal matching funds for which they are eligible by increasing the amount of medical assistance they provide. In order to pay for the increased medical assistance, some states have imposed a tax on health care entities, sought donations or other voluntary payments from them, or both. As a result, the states have been able to generate additional federal matching funds without expending additional state funds. How should a health care entity account for these taxes or donations made to the state?

Reply—Congress has passed legislation prohibiting the use of health care entity taxes or donations except in limited situations.

The accounting for these types of programs is dependent on the individual facts and circumstances. For example, if there is a guarantee that specific monies given to the state by the health care entity will be ‘returned’ to the entity from the state, those amounts should be recorded as receivables. In addition, if the health care entity has met all requirements to be legally entitled to additional funds from the state, the revenue/gain should be recognized.

However, if the monies go into a pool with other contributions which are then disbursed based on factors over which the health care entity has little or no control, the payments should be recognized as an expense. Any subsequent reimbursements would be recognized as revenue/gain when the provider is entitled to them and payment is assured.

Care should be taken to avoid delayed recognition of expenses or to improperly recognize contingent gains. Because of complexities involved, it may be necessary to consult with legal counsel.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.31] Reserved

[.32] Reserved

.33 Accounting for a Joint Operating Agreement

Inquiry—Two not-for-profit health care systems enter into a Joint Operating Agreement whereby both (the Venturers) agree to jointly operate and control certain of their hospitals while sharing in the operating results and residual interest upon dissolution based upon an agreed-upon ratio. Neither of

the Venturers receives cash or other monetary assets as part of entering into the Agreement. How should the Venturers account for the Agreement?

Reply—Joint Operating Agreements are similar to joint ventures and typically are characterized by factors such as:

- Common purpose (for example, to share risks and rewards; to develop a new market, health service or program; to pool resources)
- Joint funding: all parties contribute resources toward its accomplishment
- Defined relationship: typically governed by an agreement
- Joint control: control is not derived from holding a majority of the voting interest

Even though the Agreement does not provide for a separate legal entity (such as a corporation or partnership), the same principles apply. For example, because there is joint control (that is, neither party controls the venture), consolidation would not be appropriate. Instead, such agreements should be accounted for similar to a corporate joint venture using the equity method of accounting (see FASB ASC 323). Because the transaction did not reflect the culmination of the earnings process, the Venturers' basis in the investment would be recorded at net book value.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.34 Accounting for Computer Systems Costs Incurred in Connection With the Health Insurance Portability and Accountability Act of 1996 (HIPAA)

Inquiry—The Health Insurance Portability and Accountability Act of 1996 (HIPAA) was enacted by the federal government with the intent to assure health insurance portability, improve the efficiency and effectiveness of the health care system, reduce health care fraud and abuse, help ensure security and privacy of health information, and enforce standards for transacting health information. HIPAA addresses issues of security and confidentiality in the transfer of electronic patient information and facilitates the reduction of administrative costs by standardizing health care electronic transactions.

How should health care entities account for computer systems costs incurred in connection with HIPAA?

Reply—Costs associated with upgrading and improving computer systems to comply with HIPAA should follow the guidance set forth in FASB ASC 350-40. The accounting for specific compliance costs depends on whether the costs relate to “upgrades and enhancements” or maintenance. The following summarizes the financial reporting requirements for each type of cost:

- *Upgrades* are defined in the FASB ASC glossary as, “an improvement to an existing product that is intended to extend the life or improve significantly the marketability of the original product through added functionality, enhanced performance, or both. The terms upgrade and enhancement are used interchangeably to describe improvements to software products; however, in different segments of the software industry, those terms may connote different levels of packaging or improvements. This definition does not include platform-transfer rights.” For example, if the changes increase the security of the data from tampering or alteration or reduce the ability of unauthorized persons to gain access to the data, those changes would be tasks that

the software previously could not perform and the associated qualifying costs of application development stage activities should be capitalized. Conversely, if the changes merely reconfigure existing data to conform to the HIPAA standard or regulatory requirements, such changes would not result in the capability to perform of additional tasks and the associated costs therewith should be expensed as incurred. Because many of the costs associated with HIPAA relate to compliance with the Act and do not result in “additional functionality,” those costs should be expensed as incurred.

- *Maintenance costs* should be expensed as incurred. Training costs and data conversion costs, except for costs to develop or obtain software that allows for access or conversion of old data by new systems, should also be expensed as incurred.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.35 Note to Sections 6400.36–.42—Implementation of FASB ASC 958—Classification of a Beneficiary’s Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (in the Beneficiary’s Financial Statements)

Some not-for-profit entities have separate fund-raising foundations (commonly referred to as “institutionally related foundations”) that solicit contributions on their behalf. FASB ASC 958, *Not-for-Profit Entities*, provides guidance on (among other things) the accounting that should be followed by such institutionally related foundations and their related beneficiary entity(ies) with respect to contributions received by the foundation.

Some institutionally related foundations and their beneficiary entities meet the characteristics of financially interrelated entities provided in FASB ASC 958-20-15-2. If entities are financially interrelated, FASB ASC 958 provides that the balance sheet of the beneficiary entity(ies) should reflect that entity’s interest in the net assets of the foundation, and that interest should be periodically adjusted to reflect the beneficiary’s share of the changes in the net assets of the foundation. This accounting is similar to the equity method of accounting, which is described in FASB ASC 323.

FASB ASC 323-10-35-5 requires that the periodic adjustment of the investment be included in the determination of the investor’s net income. The purpose of sections 6140.14–.18 (applicable to not-for-profit entities [NPEs] other than health care [HC] entities) and sections 6400.36–.42 (applicable to not-for-profit health care entities) is to clarify that in circumstances in which the recipient and the beneficiary are financially interrelated:

- Beneficiary entities should segregate the adjustment into changes in restricted and unrestricted net assets. (NPE TPA [sections 6140.14–.16]; HC TPA [sections 6400.36–.37 and .39])
- In circumstances in which the beneficiary can influence the financial decisions of the recipient entity to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient to the beneficiary, the existence of the recipient entity should be transparent in determining the net asset classifications in the beneficiary’s financial statements. In other words, the recipient cannot impose time or purpose restrictions beyond those imposed by the donor. (NPE TPA [section 6140.14 and .16]; HC TPA [sections 6400.36 and .39])

- In circumstances in which the beneficiary cannot influence the financial decisions of the recipient entity to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient to the beneficiary, the existence of the recipient entity creates an implied time restriction on the beneficiary's net assets attributable to the beneficiary's interest in the net assets of the recipient (in addition to any other restrictions that may exist). Accordingly, in recognizing its interest in the net assets of the recipient entity and the changes in that interest, the beneficiary should classify the resulting net assets and changes in those net assets as temporarily restricted (unless donors placed permanent restrictions on their contributions). (NPE TPA [section 6140.15]; HC TPA [section 6400.37])
- In circumstances in which the beneficiary can influence the financial decisions of the recipient entity to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient to the beneficiary and some net assets held by the recipient for the benefit of the beneficiary are subject to purpose restrictions [for example, net assets of the recipient restricted to the beneficiary's purchase of property, plant, and equipment (PPE)], expenditures by the beneficiary that meet those purpose restrictions result in the beneficiary (and recipient) reporting reclassifications from temporarily restricted to unrestricted net assets (assuming that the beneficiary has no other net assets subject to similar purpose restrictions), unless those net assets are subject to time restrictions that have not expired, including time restrictions that are implied on contributed long-lived assets as a result of the beneficiary's accounting policy pursuant to FASB ASC 958-605-45-6. (If those net assets are subject to time restrictions that have not expired and the beneficiary has other net assets with similar purpose restrictions, the restrictions on those other net assets would expire in accordance with FASB ASC 958. These TPAs do not, however, establish a hierarchy pertaining to which restrictions are released first—restrictions on net assets held by the recipient or purpose restrictions on net assets held by the beneficiary.) (NPE TPA [section 6140.17]; HC TPA [section 6400.40])
- In circumstances in which the beneficiary cannot influence the financial decisions of the recipient entity to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient to the beneficiary and some net assets held by the recipient for the benefit of the beneficiary are subject to purpose restrictions, though not subject to time restrictions other than the implied time restrictions that exist because the beneficiary cannot determine the timing and amount of distributions from the recipient to the beneficiary, expenditures by the beneficiary that are consistent with those purpose restrictions should not result in the beneficiary reporting a reclassification from temporarily restricted to unrestricted net assets, subject to the exceptions in the following sentence. Expenditures by the beneficiary that are consistent with those purpose restrictions should result in the beneficiary reporting a reclassification from temporarily restricted to unrestricted net assets if (a) the recipient has no discretion in deciding whether the purpose restriction is met¹ or (b) the

¹ In some circumstances, the purpose restrictions may be so broad that the recipient entity has discretion in deciding whether expenditures by the beneficiary that are consistent with those purpose restrictions actually meet those purpose restrictions. For example, the recipient's net assets may have arisen from a contribution that was restricted for the beneficiary's

recipient distributes or obligates itself to distribute to the beneficiary amounts attributable to net assets restricted for the particular purpose, or otherwise indicates that the recipient intends for those net assets to be used to support the particular purpose as an activity of the current period. In all other circumstances, (a) purpose restrictions and (b) implied time restrictions on the net assets attributable to the interest in the recipient entity exist and have not yet expired. (However, if the beneficiary has other net assets with similar purpose restrictions, those restrictions would expire in accordance with FASB ASC 958. These TPAs do not establish a hierarchy pertaining to which restrictions are released first—restrictions on net assets held by the recipient or restrictions on net assets held by the beneficiary.) (NPE TPA [section 6140.18]; HC TPA [section 6400.41])

- *For HC NPEs Only.* In circumstances in which the beneficiary can influence the financial decisions of the recipient to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient to the beneficiary, changes in the beneficiary's interest in the net assets of a recipient entity attributable to unrealized gains and losses on investments should be included or excluded from the performance indicator in accordance with FASB ASC 954-10, FASB ASC 954-205-45, FASB ASC 954-320-45, FASB ASC 954-320-55, and FASB ASC 954-605, in the same manner that they would have been had the beneficiary had the transactions itself. Similarly, in applying this guidance, the determination of whether amounts are included or excluded from the performance measure should comprehend that if the beneficiary cannot influence the financial decisions of the recipient entity to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient to the beneficiary, an implied time restriction exists on the beneficiary's net assets attributable to the beneficiary's interest in the net assets of the recipient (in addition to any other restrictions that may exist). Accordingly, in circumstances in which the beneficiary cannot influence the financial decisions of the recipient entity to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient to the beneficiary, the beneficiary should classify the resulting net assets and changes in those net assets as temporarily restricted (unless donors placed permanent restrictions on their contributions) and therefore exclude those changes from the performance indicator. (HC TPA [section 6400.42])
- *For HC NPEs Only.* In circumstances in which the recipient entity and the beneficiary are both controlled by the same entity, entities should consider the specific facts and circumstances to determine whether the beneficiary can influence the financial decisions of the recipient entity to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient to the beneficiary. (HC TPA [section 6400.38])

(footnote continued)

purchase of research equipment, with no particular research equipment specified. Purchasing an XYZ microscope, which is consistent with that purpose restriction, may or may not meet that purpose restriction, depending on the decision of the recipient. In contrast, the net assets may have arisen from a contribution that was restricted for an XYZ microscope. Purchasing an XYZ microscope, which also is consistent with that purpose restriction, would result in the recipient having no discretion in determining whether that purpose restriction is met.

**Technical Practice Aids for Not-for-Profit Entities
Implementation of FASB ASC 958—Classification of a Beneficiary’s
Interest in the
Net Assets of a Financially Interrelated Fund-Raising Foundation
(in the Beneficiary’s Financial Statements)**

HC NPEs			
NPEs that are not HC NPEs			
<p>Can the beneficiary determine the timing and amount of distributions from the recipient to the beneficiary? [Not-for-profit health care entities (HC NPEs) under common control consider HC Technical Practice Aid (TPA) section 6400.38]</p>	<p>How does the existence of the recipient affect the beneficiary’s reporting of its interest?</p>	<p>Are any net assets held by the recipient for the benefit of the beneficiary subject to donor-imposed purpose restrictions and has the beneficiary made expenditures that meet those purpose restrictions (in circumstances in which the beneficiary can determine the timing and amount of distributions from the recipient to the beneficiary) or that are consistent with those purpose restrictions (in circumstances in which the beneficiary cannot determine the timing and amount of distributions from the recipient to the beneficiary)?</p>	<p>Are any changes in the beneficiary’s interest in the net assets of the recipient attributable to unrealized gains and losses on investments?</p>

(continued)

HC NPEs			
NPEs that are not HC NPEs			
Yes	Existence of recipient is transparent in determining net asset classifications. (NPE TPA [sections 6140.14 and .16]; HC TPA [sections 6400.36 and .39])	Reclass the applicable net assets from temporarily restricted (TR) to unrestricted (UR) unless those net assets are subject to time restrictions that have not expired. (NPE TPA [section 6140.17]; HC TPA [section 6400.40])	Changes in the beneficiary's interest in the net assets of a recipient entity attributable to unrealized gains and losses on investments should be included or excluded from the performance indicator in accordance with FASB ASC 954-10, FASB ASC 954-205-45, FASB ASC 954-320-45, FASB ASC 954-320-55, and FASB ASC 954-605, in the same manner that they would have been had the beneficiary had the transactions itself. (HC TPA [section 6400.42])
No	Existence of the recipient creates an implied time restriction on the beneficiary's net assets attributable to the beneficiary's interest in the net assets of the recipient. (NPE TPA [section 6140.15]; HC TPA [section 6400.37])	Reclass the applicable net assets from TR to UR only if the purpose restriction and the implied time restriction are met. Whether the purpose restriction is met depends in part on (1) whether the recipient has discretion in determining whether the purpose restriction is met and (2) the recipient's decision in exercising that discretion, if any. (NPE TPA [section 6140.18]; HC TPA [section 6400.41])	An implied time restriction exists on the beneficiary's net assets attributable to the beneficiary's interest in the net assets of the recipient. The beneficiary should classify the resulting net assets and changes in those net assets as temporarily restricted (unless donors placed permanent restrictions on their contributions) and therefore exclude those changes from the performance indicator. (HC TPA [section 6400.42])

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.36 Application of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (The beneficiary can influence the operating and financial decisions of the foundation to such an extent that the beneficiary can determine the timing and amount of distributions from the foundation.)

Inquiry—ABC Hospital, a not-for-profit health care entity subject to FASB ASC 954,² and ABC Foundation are financially interrelated entities as described in FASB ASC 958-20-15-2. ABC Foundation's bylaws state that it is organized for the purpose of stimulating voluntary financial support from donors for the sole benefit of ABC Hospital. Assume that ABC Hospital can influence the operating and financial decisions of ABC Foundation to such an extent that ABC Hospital can determine the timing and amount of distributions from ABC Foundation to ABC Hospital.

During its most recent fiscal year, ABC Foundation's activities resulted in an increase in net assets (before distributions) of \$3,200, comprised of \$2,000 in unrestricted contributions, \$1,000 in temporarily restricted contributions (purpose restrictions), \$500 in unrestricted dividend and interest income, and \$300 in expenses. In addition, ABC Foundation distributed \$2,500 in cash representing unrestricted net assets to ABC Hospital. How should this activity be reported in ABC Hospital's financial statements?

Reply—Because ABC Foundation (the recipient entity) and ABC Hospital (the beneficiary) are financially interrelated, FASB ASC 958-20-25-2 requires ABC Hospital to recognize its interest in the net assets of ABC Foundation and periodically adjust that interest for its share of the change in net assets of ABC Foundation. This is similar to the equity method of accounting described in FASB ASC 323.

In recognizing its interest in the net assets of ABC Foundation and the changes in that interest, ABC Hospital should classify the resulting net assets as if contributions were received by ABC Hospital directly from the donor, because ABC Hospital can influence the operating and financial decisions of ABC Foundation to such an extent that ABC Hospital can determine the timing and amount of distributions from ABC Foundation to ABC Hospital. In other words, the existence of ABC Foundation should be transparent in determining the net asset classifications in ABC Hospital's financial statements because ABC Foundation cannot impose time or purpose restrictions beyond those imposed by the donor. (Any instructions given by ABC Foundation are designations, rather than restrictions.)

In the circumstances described previously, ABC Hospital would initially increase its asset, "Interest in Net Assets of ABC Foundation" for the change in ABC Foundation's net assets (\$3,200). ABC Hospital's Statement of Operations would include "Change in Unrestricted Interest in ABC Foundation" of \$2,200 (which would be included in the performance indicator in accordance with FASB ASC 954-10, FASB ASC 954-205, FASB ASC 954-310, 954-405, and FASB ASC 954-605) and "Change in Temporarily Restricted Interest in ABC Foundation" of \$1,000 which would be reported in the Statement of Changes in Net Assets.

² This section addresses not-for-profit health care entities subject to Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 954, *Health Care Entities*. Section 6140.14, "Application of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (The beneficiary can influence the operating and financial decisions of the foundation to such an extent that the beneficiary can determine the timing and amount of distributions from the foundation.)," addresses a similar issue for not-for-profit entities subject to FASB ASC 958, *Not-for-Profit Entities*.

The \$2,500 distribution from ABC Foundation to ABC Hospital would not be reported as an increase in net assets on ABC Hospital's Statement of Operations or its Statement of Changes in Net Assets. By analogy to equity method accounting, the \$2,500 would be reported in a manner similar to a distribution from a subsidiary to its parent (for example, a dividend). ABC Hospital should report the distribution by increasing cash and decreasing its interest in the net assets of ABC Foundation.

If the distribution represented restricted net assets, ABC Hospital would not reclassify the net assets from temporarily restricted to unrestricted at the time of the distribution. Instead, ABC Hospital would reclassify the net assets from temporarily restricted to unrestricted when those restrictions were met.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.37 Application of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (The beneficiary cannot influence the operating and financial decisions of the foundation to such an extent that the beneficiary can determine the timing and amount of distributions from the foundation.)

Inquiry—ABC Hospital, a not-for-profit health care entity subject to FASB ASC 954,³ and ABC Foundation are financially interrelated entities described in FASB ASC 958-20-15-2. ABC Foundation's bylaws state that it is organized for the purpose of stimulating voluntary financial support from donors for the sole benefit of ABC Hospital. Assume that ABC Hospital cannot, however, influence the operating and financial decisions of ABC Foundation to such an extent that ABC Hospital can determine the timing and amount of distributions from ABC Foundation to ABC Hospital.

During its most recent fiscal year, ABC Foundation's activities resulted in an increase in net assets (before distributions) of \$3,200, comprised of \$2,000 in unrestricted contributions, \$1,000 in temporarily restricted contributions (purpose restrictions), \$500 in unrestricted dividend and interest income, and \$300 in expenses. In addition, ABC Foundation elected to distribute \$2,500 in cash representing unrestricted net assets to ABC Hospital. How should this activity be reported in ABC Hospital's financial statements?

Reply—Because ABC Foundation (the recipient entity) and ABC Hospital (the beneficiary) are financially interrelated, FASB ASC 958-20-25-2 requires ABC Hospital to recognize its interest in the net assets of ABC Foundation and periodically adjust that interest for its share of the change in net assets of ABC Foundation. This is similar to the equity method of accounting described in FASB ASC 323.

ABC Hospital cannot influence the operating and financial decisions of ABC Foundation to such an extent that ABC Hospital can determine the timing and amount of distributions from ABC Foundation. Therefore, an implied time restriction exists on ABC Hospital's interest in the net assets of ABC Foundation (in addition to any other restrictions that may exist). Accordingly, in recognizing its interest in the net assets of ABC Foundation and the changes in that interest, ABC Hospital should classify the resulting net assets as

³ This section addresses not-for-profit health care entities subject to FASB ASC 954. Section 6140.15, "Application of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (The beneficiary cannot influence the operating and financial decisions of the foundation to such an extent that the beneficiary can determine the timing and amount of distributions from the foundation.)," addresses a similar issue for not-for-profit entities subject to FASB ASC 958.

changes in temporarily restricted net assets (unless donors placed permanent restrictions on their contributions).

In the circumstances previously described, ABC Hospital would initially increase its asset, "Interest in Net Assets of ABC Foundation" for the change in ABC Foundation's net assets (\$3,200). ABC Hospital's Statement of Changes in Net Assets would include "Change in Temporarily Restricted Interest in ABC Foundation" of \$3,200 as an increase in temporarily restricted net assets.

The \$2,500 distribution from ABC Foundation to ABC Hospital would not be reported as an increase in net assets on ABC Hospital's Statement of Operations or its Statement of Changes in Net Assets. By analogy to equity method accounting, the \$2,500 would be treated similar to a distribution from a subsidiary to its parent (for example, a dividend). ABC Hospital should report the distribution by increasing cash and decreasing its interest in the net assets of ABC Foundation.

ABC Hospital would reclassify the net assets from temporarily restricted to unrestricted at the time of the distribution, because the time restriction would expire at the time of the distribution. The reclassification would be reported as "net assets released from restrictions" and included in the performance indicator in the statement of operations. (If those net assets were subject to purpose or time restrictions that remained even after the net assets had been distributed to ABC Hospital, ABC Hospital would not reclassify the net assets from temporarily restricted to unrestricted at the time of the distribution. Instead, ABC Hospital would reclassify the net assets from temporarily restricted to unrestricted when those restrictions were met and the reclassification would be included in or excluded from the performance indicator in accordance with FASB ASC 954-10, FASB ASC 954-205, FASB ASC 954-310, FASB ASC 954-405, and FASB ASC 954-605.)

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.38 Application of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation—Does Common Control Lead to the Conclusion That the Beneficiary Can Determine the Timing and Amount of Distributions from the Recipient?

Inquiry—ABC Holding Company (a not-for-profit entity) has two not-for-profit subsidiaries (ABC Hospital and ABC Foundation) that it controls and consolidates in accordance with the guidance in FASB ASC 954-10, FASB ASC 954-205, FASB ASC 954-605, and FASB ASC 954-810. ABC Hospital and ABC Foundation are brother-sister entities that are financially interrelated entities as described in FASB ASC 958-20-15-2. ABC Hospital issues separate financial statements in connection with a loan agreement. ABC Foundation's bylaws state that it is organized for the purpose of stimulating voluntary financial support from donors for the sole benefit of ABC Hospital.

Because ABC Hospital and ABC Foundation are under common control, does that lead to the conclusion that ABC Hospital can influence the financial decisions of ABC Foundation (either directly or indirectly) to such an extent that ABC Hospital can determine the timing and amount of distributions from ABC Foundation to ABC Hospital?

Reply—In some circumstances ABC Hospital, though a subsidiary of ABC Holding Company, may be able to influence the financial decisions of ABC Foundation (either directly or indirectly) to such an extent that ABC Hospital can determine the timing and amount of distributions from ABC Foundation to ABC Hospital. For example, if ABC Hospital formed ABC Holding Company as

a nominally-capitalized shell with no real operating powers, a rebuttable presumption exists that ABC Hospital can influence the financial decisions of ABC Foundation (either directly or indirectly) to such an extent that ABC Hospital can determine the timing and amount of distributions from ABC Foundation to ABC Hospital. On the other hand if, for example, ABC Hospital formed ABC Holding Company to be an operating entity with substance, other factors would need to be considered in determining whether ABC Hospital can influence the financial decisions of ABC Foundation (either directly or indirectly) to such an extent that ABC Hospital can determine the timing and amount of distributions from ABC Foundation to ABC Hospital. Therefore, it is necessary to consider the facts and circumstances surrounding the relationships between ABC Holding Company and ABC Hospital, and ABC Hospital and ABC Foundation, to determine whether ABC Hospital exerts enough influence over ABC Foundation to determine the timing and amount of distributions from ABC Foundation to ABC Hospital. Indicators to consider may include, but are not limited to, the following:

- What is the extent of overlap among the boards of ABC Hospital, ABC Holding Company, and ABC Foundation (for example, do a majority of the individuals who govern ABC Hospital also govern ABC Foundation; do a majority of the individuals who govern ABC Hospital also govern ABC Holding Company; are the boards of ABC Hospital, ABC Foundation and ABC Holding Company substantially independent of one another)? The greater the overlap among the boards of ABC Hospital and either ABC Holding Company or ABC Foundation, the more likely that ABC Hospital can influence the financial decisions of ABC Foundation (either directly or indirectly) to such an extent that ABC Hospital can determine the timing and amount of distributions from ABC Foundation to ABC Hospital.
- What is the extent of overlap among management teams of ABC Hospital, ABC Holding Company, and ABC Foundation (for example, do the individuals who manage ABC Hospital also manage ABC Foundation; do the individuals who manage ABC Hospital also manage ABC Holding Company; does ABC Holding Company have a separate management team that exercises significant authority over both ABC Hospital and ABC Foundation)? The greater the overlap between ABC Hospital's management and management of either ABC Holding Company or ABC Foundation, the more likely that ABC Hospital can influence the financial decisions of ABC Foundation (either directly or indirectly) to such an extent that ABC Hospital can determine the timing and amount of distributions from ABC Foundation to ABC Hospital.
- What are the origins of the parent/holding company structure? For example, were ABC Holding Company and ABC Foundation created by ABC Hospital through a corporate restructuring, which may indicate that ABC Hospital, as the original entity, can influence the financial decisions of ABC Foundation (either directly or indirectly) to such an extent that ABC Hospital can determine the timing and amount of distributions from ABC Foundation to ABC Hospital. Alternatively, were ABC Hospital and ABC Foundation independent entities that merged and created ABC Holding Company to govern the combined entity, which may indicate that ABC Hospital cannot influence the financial decisions of ABC Foundation (either directly or indirectly) to such an extent that ABC Hospital can determine the timing and amount of distributions from ABC Foundation to ABC Hospital.

- What is the number of entities under common control? The greater the number of entities under ABC Holding Company's control, the less likely it is that any one subsidiary, such as ABC Hospital, can influence the financial decisions of another brother-sister subsidiary, such as ABC Foundation, (either directly or indirectly) to such an extent that ABC Hospital can determine the timing and amount of distributions from ABC Foundation to ABC Hospital

Other relevant facts and circumstances should also be considered.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.39 Application of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (More Than One Beneficiary—Some Contributions Are Designated)

Inquiry—DEF Health Entity is the parent company of three brother-sister not-for-profit entities: Health A, a not-for-profit health care entity subject to FASB ASC 954⁴ Health B, and Foundation. Foundation is organized for the purpose of raising contributions for the benefit of both Health A and Health B. The four entities are legally separate not-for-profit entities that are financially interrelated pursuant to the guidance in FASB ASC 958-20-15-2. Assume that Health A can influence the financial decisions of Foundation to such an extent that Health A can determine the timing and amount of distributions from Foundation to Health A.

A donor contributes \$5,000 cash to Foundation and stipulates that the contribution is for the benefit of Health A. Foundation would record the contribution as temporarily restricted revenue because Foundation must use the contribution for the benefit of Health A. In its separately issued financial statements, Health A would recognize its interest in the net assets attributable to that contribution by debiting "Interest in Net Assets of Foundation" for \$5,000. Would the offsetting credit be reported as temporarily restricted revenue (because the net assets attributable to the contribution are restricted on Foundation's Balance Sheet) or unrestricted revenue (because there are no donor-imposed time restrictions or purpose restrictions on how Health A must use the contribution)?

Reply—Health A should report the offsetting credit as unrestricted revenue. Because Health A can influence the financial decisions of Foundation to such an extent that Health A can determine the timing and amount of distributions from Foundation to Health A, no implied time restriction exists on Health A's net assets attributable to its interest in the net assets of Foundation. Accordingly, in recognizing its interest in the net assets of Foundation and the changes in that interest, Health A should classify the resulting net assets as if contributions were received by Health A directly from the donor. In other words, the existence of Foundation should be transparent in determining the net asset classifications in Health A's separately issued financial statements because Foundation cannot impose time or purpose restrictions beyond those imposed by the donor. (Any instructions given by Foundation are designations, rather than restrictions.)

⁴ This section addresses not-for-profit health care entities subject to FASB ASC 954. Section 6140.16, "Application of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (More Than One Beneficiary—Some Contributions Are Designated)," addresses a similar issue for not-for-profit entities subject to FASB ASC 958.

Because no donor-imposed restrictions exist on how Health A must use the contribution, Health A should report the change in its interest in the net assets attributable to the contribution as an increase in unrestricted net assets that is included in its performance indicator (in accordance with FASB ASC 954-10, FASB ASC 954-205, FASB ASC 954-310, FASB ASC 954-405, and FASB ASC 954-605) in its separately issued Statement of Operations. When Foundation actually distributes the funds, Health A should increase cash and decrease its interest in net assets of Foundation; the distributions would have no effect on Health A's Statement of Operations or its Statement of Changes in Net Assets.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.40 Application of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (The beneficiary makes an expenditure that meets a purpose restriction on net assets held for its benefit by the recipient entity—The beneficiary can influence the operating and financial decisions of the recipient to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient.)

Inquiry—ABC Hospital, a not-for-profit health care entity subject to FASB ASC 954,⁵ and ABC Foundation are financially interrelated entities as described in FASB ASC 958-20-15-2. ABC Foundation's bylaws state that it is organized for the purpose of stimulating voluntary financial support from donors for the sole benefit of ABC Hospital. Assume that ABC Hospital can influence the operating and financial decisions of ABC Foundation to such an extent that ABC Hospital can determine the timing and amount of distributions from ABC Foundation to ABC Hospital.

ABC Foundation's net assets consist of \$3,000,000 resulting from cash contributions restricted for the purchase of PPE by ABC Hospital. ABC Hospital has recorded its interest in those net assets by debiting "Interest in net assets of ABC Foundation" and crediting "Change in interest in ABC Foundation," which is reported as an increase in temporarily restricted net assets. ABC Hospital's accounting policy is to not imply a time restriction that expires over the useful life of the donated long-lived assets pursuant to FASB ASC 958-605-45-6 and it has no other net assets restricted for the purchase of PPE.⁶ ABC Hospital subsequently purchased and placed into service \$3,000,000 of PPE that meets those donor restrictions prior to receiving a distribution from ABC Foundation. Should ABC Hospital reclassify \$3,000,000 from temporarily-restricted net assets as a result of building and placing into service the \$3,000,000 of PPE?

Reply—Because ABC Foundation (the recipient entity) and ABC Hospital (the beneficiary) are financially interrelated, FASB ASC 958-20-25-2 requires ABC Hospital to recognize its interest in the net assets of ABC Foundation and periodically adjust that interest for its share of the change in net assets of ABC

⁵ This section addresses not-for-profit health care entities subject to FASB ASC 954. Section 6140.17, "Application of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (The beneficiary makes an expenditure that meets a purpose restriction on net assets held for its benefit by the recipient entity—The beneficiary can influence the operating and financial decisions of the recipient to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient.)," addresses a similar issue for not-for-profit entities subject to FASB ASC 958.

⁶ The assumption that ABC Hospital has no other net assets restricted for the purchase of PPE is intended to avoid establishing a hierarchy pertaining to which restrictions are released first—restrictions on net assets held by the recipient or restrictions on net assets held by the beneficiary. That issue is not addressed in this TPA.

Foundation. This is similar to the equity method of accounting described in FASB ASC 323.

In recognizing its interest in the net assets of ABC Foundation and the changes in that interest, ABC Hospital should classify the resulting net assets as if contributions were received by ABC Hospital directly from the donor, because ABC Hospital can influence the operating and financial decisions of ABC Foundation to such an extent that ABC Hospital can determine the timing and amount of distributions from ABC Foundation to ABC Hospital. Accordingly, the net assets representing contributions restricted for the purchase of PPE should be reported as temporarily restricted net assets (purpose restricted) in ABC Hospital's financial statements. Upon purchasing and placing into service the PPE, ABC Hospital (and ABC Foundation) should reclassify \$3,000,000 from temporarily restricted to unrestricted net assets,⁷ reported separately from the performance indicator in the statement of operations in accordance with the guidance in FASB ASC 954-10, FASB ASC 954-205, FASB ASC 954-310, FASB ASC 954-405, and FASB ASC 954-605. In other words, the existence of ABC Foundation should be transparent in determining the net asset classifications in ABC Hospital's financial statements because ABC Foundation cannot impose time or purpose restrictions beyond those imposed by the donor. (Any instructions given by ABC Foundation are designations, rather than restrictions.)

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.41 Application of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (The beneficiary makes an expenditure that is consistent with a purpose restriction on net assets held for its benefit by the recipient entity—The beneficiary cannot influence the operating and financial decisions of the recipient to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient.)

Inquiry—ABC Hospital, a not-for-profit health care entity subject to FASB ASC 954,⁸ and ABC Foundation are financially interrelated entities as described in FASB ASC 958-20-15-2. ABC Foundation's bylaws state that it is organized for the purpose of stimulating voluntary financial support from donors for the sole benefit of ABC Hospital. Assume that ABC Hospital cannot, however, influence the operating and financial decisions of ABC Foundation to such an extent that ABC Hospital can determine the timing and amount of distributions from ABC Foundation to ABC Hospital.

⁷ In this fact pattern, ABC Research Institute's interest in the net assets of ABC Foundation is subject to only purpose restrictions because the net assets arose from cash contributions with no time restrictions. If instead the net assets arose from promises to give rather than from cash contributions, the net assets might be subject to time restrictions in addition to the purpose restrictions. In determining whether net assets that arose from promises to give are subject to time restrictions, NPEs should consider the guidance in section 6140.04, *Lapsing of Restrictions on Receivables if Purpose Restrictions Pertaining to Long-Lived Assets are Met Before the Receivables are Due*, which discusses whether restrictions on net assets arising from promises to give that are restricted by donors for investments in long-lived assets are met when the assets are placed in service or when the receivables are due.

⁸ This section addresses not-for-profit health care entities subject to FASB ASC 954. Section 6140.18, "Application of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (The beneficiary makes an expenditure that is consistent with a purpose restriction on net assets held for its benefit by the recipient entity—The beneficiary cannot influence the operating and financial decisions of the recipient to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient.)" addresses a similar issue for not-for-profit entities subject to FASB ASC 958.

ABC Foundation's net assets consist of \$3,000,000 resulting from cash contributions restricted for the purchase of PPE ABC Hospital. ABC Hospital has recorded its interest in those net assets by debiting "Interest in net assets of ABC Foundation" and crediting "Change in interest in ABC Foundation," which is reported as an increase in temporarily restricted net assets. ABC Hospital has no other net assets restricted for the purchase of PPE.⁹

ABC Hospital subsequently built and placed into service the New Modern Hospital Wing (at a cost of \$3,000,000) prior to receiving a distribution from ABC Foundation or any indication from ABC Foundation that it intends to support building and placing into service the New Modern Hospital Wing. Should ABC Hospital reclassify \$3,000,000 from temporarily-restricted net assets to unrestricted net assets as a result of building and placing into service the New Modern Hospital Wing?

Reply—From ABC Hospital's perspective, its interest in the net assets of ABC Foundation has two restrictions—a purpose restriction (the purchase of the PPE) and an implied time restriction. (ABC Hospital cannot influence the operating and financial decisions of ABC Foundation to such an extent that ABC Hospital can determine the timing and amount of distributions from ABC Foundation to ABC Hospital, including distributions pertaining to expenditures by ABC Hospital that meet the donor-imposed purpose restrictions. Therefore, an implied time restriction exists on ABC Hospital's interest in the net assets of ABC Foundation.) FASB ASC 958-205-45-9 provides, in part, as follows:

If two or more temporary restrictions are imposed on a contribution, the effect of the expiration of those restrictions is recognized in the period in which the last remaining restriction has expired.

FASB ASC 958-205-45-11 further provides, in part:

Temporarily restricted net assets with time restrictions are not available to support expenses until the time restrictions have expired.

In considering whether the purpose restriction on ABC Hospital's interest in the net assets of ABC Foundation is met, ABC Hospital should determine whether ABC Foundation has discretion in deciding whether an expenditure by ABC Hospital that is consistent with the purpose restriction satisfies that purpose restriction. For example, if the restricted net assets arose from a contribution that was restricted for "building projects of ABC Hospital," with no particular building project specified, purchasing and placing into service the New Modern Hospital Wing is consistent with the purpose restriction but may or may not meet it, because ABC Foundation has some discretion in deciding which building project releases the purpose restriction. In other words, ABC Foundation may, at its discretion, either release restricted net assets in support of building the New Modern Hospital Wing or not, because the purpose restriction imposed by the donor was broad enough to give ABC Foundation discretion in deciding which building projects meet the purpose restriction. If ABC Foundation has such discretion, a purpose restriction and an implied time restriction on ABC Hospital's interest in the net assets of ABC Foundation exist. Therefore, ABC Hospital should not reclassify \$3,000,000 from temporarily-restricted net assets to unrestricted net assets as a result of building and placing into service the New Modern Hospital Wing unless ABC Foundation distributes or obligates itself to distribute to ABC Hospital amounts

⁹ The assumption that ABC Hospital has no other net assets restricted for the purchase of PPE is intended to avoid establishing a hierarchy pertaining to which restrictions are released first—restrictions on net assets held by the recipient or restrictions on net assets held by the beneficiary. That issue is not addressed in this TPA.

attributable to net assets restricted for the purchase of PPE by ABC Hospital, or ABC Foundation otherwise indicates that it intends for those net assets to be used to support the building and placing into service the New Modern Hospital Wing as an activity of the current period (assuming that ABC Hospital had no other net assets that were restricted for the purchase of PPE).^{10 11}

In contrast to the example in the previous paragraph, if the restricted net assets arose from a contribution that was restricted for “building and placing into service the New Modern Hospital Wing,” ABC Foundation has no discretion in deciding whether that purpose restriction is met by building and placing into service the New Modern Hospital Wing. Therefore, if ABC Hospital builds and places into service the New Modern Hospital Wing, the purpose restriction is met (assuming that ABC Hospital had no other net assets that were restricted for building and placing into service the New Modern Hospital Wing). In addition, the implied time restriction is met because ABC Foundation is required to distribute the funds to ABC Hospital in order to meet the donor’s stipulation. Therefore, ABC Hospital (and ABC Foundation) should reclassify \$3,000,000 from temporarily-restricted net assets as a result of building and placing into service the New Modern Hospital Wing.

In summary, ABC Hospital should not reclassify \$3,000,000 from temporarily-restricted net assets to unrestricted net assets as a result of building and placing into service the New Modern Hospital Wing until both the

¹⁰ In this fact pattern, the expenditure is made prior to meeting the purpose restriction and the implied time restriction that exists because ABC Hospital cannot determine the timing and amount of distributions from ABC Foundation to ABC Hospital. FASB ASC 958-205-45-11 provides that in circumstances in which both purpose and time restrictions exist, expenditures meeting the purpose restriction must be made simultaneous with or after the time restriction has expired in order to satisfy both the purpose and time restriction and result in a reclassification of net assets from temporarily restricted to unrestricted. In other words, time restrictions, if any, must be met before expenditures can result in purpose restrictions being met. In this fact pattern, however, the time restriction is an implied time restriction that exists because the beneficiary cannot determine the timing and amount of distributions from the recipient to the beneficiary, rather than an implied time restriction that exists because a promise to give is due in a future period or because of an explicit donor stipulation. Accordingly, in this fact pattern, temporarily restricted net assets with implied time restrictions are available to support expenditures made before the expiration of the time restrictions and the net assets should be reclassified from temporarily restricted to unrestricted in the period in which the last remaining restriction has expired. In other words, in this fact pattern, if the expenditure that meets the purpose restriction is made before meeting the implied time restriction that exists because the beneficiary cannot determine the timing and amount of distributions from the recipient to the beneficiary, all the restrictions should be considered met once the implied time restriction is met.

¹¹ In this fact pattern, ABC Hospital’s interest in the net assets of ABC Foundation is subject to an implied time restriction that exists because ABC Hospital cannot determine the timing and amount of distributions from ABC Foundation to ABC Hospital and a purpose restriction. Because the net assets arose from cash contributions with no other donor-imposed time restrictions, no time restrictions other than those imposed by ABC Foundation exist. If instead the net assets arose from promises to give rather than from cash contributions, the net assets might be subject to donor-imposed time restrictions in addition to the time restriction imposed by ABC Foundation and the purpose restriction. In determining whether net assets that arose from promises to give are subject to donor-imposed time restrictions in addition to the time restrictions imposed by ABC Foundation, NPEs should consider the guidance in section 6140.04, *Lapsing of Restrictions on Receivables if Purpose Restrictions Pertaining to Long-Lived Assets are Met Before the Receivables are Due*, which discusses whether restrictions on net assets arising from promises to give that are restricted by donors for investments in long-lived assets are met when the assets are placed in service or when the receivables are due. In circumstances in which the net assets are subject to (a) donor-imposed time restrictions in addition to the (b) implied time restrictions that exist because ABC Hospital cannot determine the timing and amount of distributions from ABC Foundation to ABC Hospital and (c) purpose restrictions, the last remaining time restriction should be considered in applying the guidance in FASB ASC 958-205-45-11 that provides that temporarily restricted net assets with time restrictions are not available to support expenses until the time restrictions have expired.

purpose restriction and the implied time restriction are met. If both the purpose restriction and the implied time restriction are met, ABC Hospital should decrease its interest in the net assets of ABC Foundation and increase cash (or a receivable, if the Foundation has merely obligated itself to make the distribution) by the amount of the distribution, and simultaneously reclassify the same amount from temporarily restricted net assets to unrestricted net assets. The reclassification should be reported separately from the performance indicator in the statement of operations in accordance with the guidance in FASB ASC 954-10, FASB ASC 954-205, FASB ASC 954-310, FASB ASC 954-405, and FASB ASC 954-605.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.42 Application of FASB ASC 958—Classification of a Beneficiary’s Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (Recipient Entity)—Accounting for Unrealized Gains and Losses on Investments Held by the Foundation

Inquiry—FASB ASC 958 provides that if entities are financially interrelated, the balance sheet of the beneficiary entity should reflect that entity’s beneficial interest in the net assets of the recipient entity, and that that interest should be adjusted periodically to reflect the changes in the net assets of the recipient entity. This accounting is similar to the equity method of accounting. FASB ASC 954-10, FASB ASC 954-205-45, FASB ASC 954-320-45, FASB ASC 954-320-55, and FASB ASC 954-605 provide guidance pertaining to the classification of investment returns in the financial statements of health care entities.

ABC Hospital and ABC Foundation are financially interrelated entities. How should changes in ABC Hospital’s interest in the net assets of ABC Foundation attributable to unrealized gains and losses on Foundation’s investments be classified in ABC Hospital’s financial statements?

Reply—In circumstances in which ABC Hospital can influence the financial decisions of ABC Foundation to such an extent that ABC Hospital can determine the timing and amount of distributions from Foundation to ABC Hospital, changes in ABC Hospital’s interest in the net assets of ABC Foundation attributable to unrealized gains and losses on investments should be classified in the same manner that they would have been had ABC Hospital held the investments and had the transactions itself. In accordance with the guidance in FASB ASC 954-10, FASB ASC 954-205-45, FASB ASC 954-320-45, FASB ASC 954-320-55, and FASB ASC 954-605, ABC Hospital should include in the performance indicator the portion of the change attributable to unrealized gains and losses on trading securities that are not restricted by donors or by law, and should exclude from the performance indicator the portion of the change attributable to all other unrealized gains and losses.

In circumstances in which ABC Hospital cannot influence the financial decisions of Foundation to such an extent that ABC Hospital can determine the timing and amount of distributions ABC Hospital receives from Foundation, an implied time restriction exists on ABC Hospital’s net assets attributable to its interest in the net assets of Foundation (in addition to any other restrictions that may exist). Accordingly, ABC Hospital should classify all changes in that interest, including the portion of the change attributable to unrealized gains and losses on investments, as changes in temporarily restricted net assets (unless donors placed permanent restrictions on investment gains and losses pertaining to their contributions) and therefore should exclude those changes from the performance indicator.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.43 Application of FASB ASC 958—Classification of Distributions From a Financially Interrelated Fund-Raising Foundation (Recipient Entity) to a Health Care Beneficiary

Inquiry—How should a fund-raising foundation (recipient), a not-for-profit entity subject to FASB ASC 958, report (in its separately issued financial statements) distributions to a financially interrelated beneficiary that is a health care entity? In other words, should such distributions be reported following (a) the guidance on reporting transfers among affiliated health care entities in FASB ASC 954-10, FASB ASC 954-205, FASB ASC 954-605, and FASB ASC 954-810 or (b) the guidance in FASB ASC 958.

Reply—FASB ASC 958 applies to all not-for-profit entities, except those that are providers of health care services (FASB ASC 958-10-15-3). Therefore, the guidance in FASB ASC 954 generally does not apply to financial statements of recipient entities that are financially interrelated fund-raising foundations. The foundation should follow the accounting and reporting requirements of FASB ASC 958 rather than FASB ASC 954 in the foundation's separately issued financial statements. The foundation should report distributions to beneficiary entities as expenses or distributions to related entities. The guidance in the previous sentence applies regardless of whether the recipient entity and the beneficiary are under common control or whether one controls the other in a parent-subsidary relationship.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.44] Reserved

.45 Applicability of FASB ASC 460—Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others

Inquiry—In order to attract a physician into a community to meet community needs, a hospital may loan the physician an amount to be forgiven over a set period as long as the physician remains in practice in the community. The hospital (generally a not-for-profit) is precluded from requiring the physician to refer patients to or treat patients at that facility, although the hospital hopes to be the primary referral location. Is this arrangement subject to FASB ASC 460, *Guarantees*?

Reply—No. The contract does not constitute a guarantee contract under FASB ASC 460-10-15-4.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.46 Applicability of FASB ASC 460—Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others—Mortgage Guarantees

Inquiry—In order to recruit a physician, a hospital may guarantee the physician's home mortgage. The physician may be recruited either as an employee of the hospital or as an independent contractor. Is this arrangement considered a guarantee under FASB ASC 460?

Reply—If the physician becomes an employee of the hospital, the arrangement is not covered by FASB ASC 460; see the discussion of "other employment-related costs" in FASB ASC 460-10-55-17. If the physician is not an employee, then the arrangement is considered a guarantee under FASB ASC 460. The

contract requires the guarantor (hospital) to make a payment (in cash) to the guaranteed party (mortgage lender) based on changes in an underlying (occurrence or nonoccurrence of a specified event such as a scheduled payment under mortgage contract not made by physician) that is related to an asset (mortgage loan) of the guaranteed party (mortgage lender).

As an example, a physician obtains a mortgage guarantee from a hospital. The presence of the hospital's guarantee, obtained through a local bank, reduces the interest rate on the physician's mortgage loan by one-half point. No loan default is expected to occur (and as a result, no cash is expected to be paid out). At inception, the hospital would record an obligation to stand ready to perform in an amount equal to the fair value of the guarantee. FASB ASC 460 does not prescribe where the offsetting debit should go (for example, expense, asset, or adjustment to a gain or loss on sale), instead stating that it depends on the circumstances in which the guarantee was issued (FASB ASC 460-10-55-23).

FASB ASC 460 does not describe in detail how the guarantor's liability for its obligations under the guarantee would be measured subsequent to initial recognition, but notes (paragraph 12) that the liability typically would be reduced by a credit to earnings as the guarantor is released from risk under the guarantee. In the situation described previously, the hospital would be released from risk as the physician's outstanding mortgage obligation is reduced.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.47 Application of Accounting Standards Update No. 2011-07, *Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities, in Consolidated Financial Statements*

Inquiry—Health System consists of a parent holding company and two operating subsidiaries. Subsidiary A is an acute care hospital that has a policy of providing services to patients regardless of their ability to pay. Subsidiary A records patient service revenue at the time services are rendered and, thus, typically recognizes significant amounts of patient service revenue associated with uninsured self-pay patients prior to assessing its collectability. Subsidiary B is an ambulatory surgery center that does not have a policy of providing services to patients regardless of their ability to pay; thus, its provision for bad debts is a reflection of its credit risk. Health System issues consolidated financial statements. In addition, each subsidiary issues standalone financial statements.

FASB Accounting Standards Update (ASU) No. 2011-07, *Health Care Entities (Topic 954): Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities (a consensus of the FASB Emerging Issues Task Force)*, amended FASB ASC 954-605-45 to require that a health care entity present all bad debts associated with patient service revenue as a deduction from revenue if a significant amount of patient service revenue is recognized at the time services are rendered and the entity does not assess the patient's ability to pay. Thus, in the separate subsidiary statements, Subsidiary A's statement of operations presents bad debts associated with patient service revenue as a deduction from patient service revenue, while Subsidiary B's statement of operations displays bad debts related to patient service revenue as an operating expense.

In determining how to present bad debts in Health System's consolidated statement of operations, should the assessment of significance be made at the

consolidated reporting entity level (regardless of the presentation in the separate subsidiary financial statements), or should the determinations made at the separate subsidiary reporting level be retained in consolidation?

Reply—Because ASU No. 2011-07 does not address this issue, the determination of whether the presentation of bad debts at the consolidated reporting entity level should be based on an entity-wide assessment of significance or on significance determined at the level of each individual subsidiary is an accounting policy election. If Health System decides to retain the presentations determined based on assessments made at the individual subsidiary reporting level (based on FASB ASC 810-10-25-15, which states that the application of guidance in an industry-specific topic of FASB ASC to a subsidiary within the scope of that topic shall be retained in consolidation), the consolidated statement of operations would reflect bad debts related to Subsidiary A's patient service revenue as a deduction from patient service revenue and the bad debts related to Subsidiary B's patient service revenue as an operating expense.

Alternatively, Health System may elect to assess "significance" at the consolidated reporting entity level regardless of the presentations used in the separate subsidiary financial statements. In that case, if consolidated patient service revenues are deemed to include a significant amount of revenue recognized under a policy in which services are provided to patients regardless of their ability to pay, then the entire provision for bad debts related to consolidated patient service (that is, the combined bad debts of Subsidiaries A and B) would be presented as a deduction from the consolidated net patient service revenues. If such revenues are not deemed to be significant at the consolidated reporting entity level, the entire provision for bad debts related to consolidated patient service revenues should be presented as an operating expense.

Application of the disclosure requirements would be consistent with the policy that is elected. Whichever policy is elected should be disclosed in the notes to the financial statements in accordance with FASB ASC 230-10-50-1 and consistently applied.

It is recommended that Securities and Exchange Commission (SEC) registrants consider consultations with the SEC staff if they are considering accounting for transactions similar to those described in this inquiry.

[Issue Date: February 2012. Revised, March 2012.]

.48 Accounting for Costs Incurred During Implementation of ICD-10

Inquiry—The U.S. health care system is scheduled to transition from the International Classification of Diseases, 9th Edition (ICD-9) code sets used to report medical diagnoses and inpatient procedures to the International Classification of Diseases, 10th Edition (ICD-10). ICD-10 expands the number of available codes from 24,000 to greater than 155,000. With its expanded capacity and complexity, ICD-10 enables the documentation of many different types of diseases and conditions and the capture of diagnostic information with a higher level of specificity. The transition from ICD-9 to ICD-10 is expected to produce several distinct benefits for health care entities, including the following:

- Improved precision in documentation of clinical care, which is expected to result in greater accuracy in the processing of claims and reimbursements
- Higher quality and more specific data that can be tracked and used to improve disease management programs and clinical outcomes

Implementing ICD-10 by October 1, 2013, is mandatory.¹² Health care entities that do not comply are expected to be unable to submit claims to third-party payors for payment. Costs expected to be incurred in connection with the conversion include those to (a) modify existing computer systems to accept the ICD-10 fields or to replace systems that cannot be made ICD-10 compliant, (b) enhance electronic medical records, (c) train clinical coders to use ICD-10, and (d) train clinicians to improve their documentation practices so that medical documentation contains the details necessary to support the higher level of specificity that ICD-10 enables.

How should a health care entity account for costs incurred in connection with the implementation of ICD-10?

Reply—ICD-10 conversion is expected to require changes to both business processes and information systems. When a project involves both process engineering and software development or modification, the guidance in FASB ASC 720-45 should be considered. FASB ASC 720-45 requires that project costs be segregated among process reengineering activities, activities that develop or modify software, and costs associated with acquisition of fixed assets. The costs associated with process reengineering (for example, assessing the current state of business processes, process redesign or reengineering, or work force restructuring) are expensed as incurred. The costs associated with developing or modifying internal-use software are capitalized or expensed based on FASB's internal-use software guidance (discussed further in the text that follows). Costs associated with acquisition of fixed assets are accounted for in accordance with an entity's policy for capitalizing long-lived productive assets. If an outside consultant is engaged to conduct the project, the total consulting contract price should be allocated among these activities based on the relative fair values of each component (which are not necessarily the separate prices stated within the contract for each element). FASB ASC 720-45-55-1 provides a helpful table that summarizes the accounting for typical components of a business process reengineering and information technology transformation project and the guidance that applies to each component.

Significant expenses also are likely to be incurred in connection with training coders and clinicians to comply with the ICD-10 requirements. According to paragraphs 4 and 6 of FASB ASC 350-40-25, all training costs should be expensed as incurred, even those that are incurred during the application development stage.

The guidance set forth in FASB ASC 350-40 should be followed when accounting for the portion of project costs associated with either acquisition of new ICD-10 compliant systems or modification of existing software to become ICD-10 compliant. Health care entities should determine the extent to which those modifications result in "additional functionality"—that is, whether the modifications enable the software to perform tasks that it was previously incapable of performing.

The specific facts and circumstances of each entity should be considered in evaluating whether any of the modifications result in additional functionality, and professional judgment should be applied in assessing whether modifications to an entity's system result in additional functionality beyond the original

¹² In April 2012, the U.S. Department of Health and Human Services officially proposed delaying the International Classification of Diseases, 10th Edition implementation deadline to October 1, 2014. More information on the proposed rule is available on fact sheets at www.cms.gov/apps/media/fact_sheets.asp. The proposed rule may be viewed at www.ofr.gov/inspection.aspx.

software's capabilities and qualify as an upgrade or enhancement. Factors to consider in the assessment might include, but are not limited to, the following:

- The extent and types of changes being made to the software design. A significant amount of changes may be indicative of additional functionality.
- The amount of additional software coding required and the new software processes developed. Less software coding or few additional software processes may point toward maintenance rather than additional functionality.
- The extent to which billing system data will be used for new purposes, including its ability to use the additional coding capabilities beyond submitting claims to Medicare (for example, to track data in order to improve disease management programs and clinical outcomes or to enhance the quality of patient care or pay-for-performance contracts), may be indicative of additional functionality.
- Whether the changes are part of normal maintenance provided by the vendor at no additional cost. If the entity was billed separately for an upgrade, or if the maintenance fee with the vendor significantly increased in the period of the change, that may be indicative of additional functionality.
- The entity's historical experience with clinical coding system upgrades (for example, the number of years since the last upgrade, the amount of changes made, whether that upgrade qualified for capitalization). An entity should consider the criteria applied to previous upgrades, including its experience to determine whether they resulted in additional functionality, and compare those criteria to the facts and circumstances associated with the proposed or planned upgrade.
- Increase in the number and complexity of the interfaces between the central billing system and downstream departmental systems. The greater the complexity of the system, the more likely that significant changes will be required, resulting in additional functionality.

Modifications of software that do not result in additional functionality are expensed as maintenance costs. Modifications that result in additional functionality are considered upgrades or enhancements of the existing system and are expensed or capitalized in accordance with the criteria set forth in paragraphs 1–6 of FASB ASC 350-40-25.

[Issue Date: July 2012.]

.49 Presentation of Claims Liability and Insurance Recoveries—Contingencies Similar to Malpractice

Inquiry—ASU No. 2010-24, *Health Care Entities (Topic 954): Presentation of Insurance Claims and Related Insurance Recoveries (a consensus of the FASB Emerging Issues Task Force)*, addressed the presentation of a health care entity's insurance claims and related insurance recoveries. The ASU specifically addressed malpractice claims but also referenced similar contingent liabilities. What is meant by *similar contingent liabilities*?

Reply—Similar contingent liabilities within the scope of ASU No. 2010-24 include liabilities of a similar nature, such as workers compensation and director and officers claims.

[Issue Date: October 2012.]

.50 Accrual of Legal Costs Associated With Contingencies Other Than Malpractice

Inquiry—FASB ASC 954-450 requires health care entities to estimate and accrue the legal costs that are expected to be incurred in connection with litigating a malpractice claim in the period the malpractice incident arises. In accounting for legal costs associated with contingency claims other than malpractice, some health care entities have followed guidance in FASB ASC 450-20-S99-2 that permits making a policy election to either expense claims-related legal fees in the period(s) in which the costs are actually incurred or to estimate and accrue them in the period in which the associated claim arises. Although that guidance specifically applies to entities required to apply the SEC's rules and regulations, other entities have also looked to that guidance as a basis for establishing an accounting policy election.

Health System GHI has contingent liabilities associated with workers compensation claims. Based on the guidance in FASB ASC 450-20-S99-2, Health System GHI established an accounting policy of expensing legal costs incurred in connection with its workers compensation claims in the periods in which the legal costs are actually incurred. Does the adoption of ASU No. 2010-24 require Health System GHI to change its method of accounting for legal costs incurred in connection with its workers compensation claims to be consistent with the method used for legal costs associated with its malpractice claims?

Reply—The adoption of ASU No. 2010-24 should not cause an entity to change its accounting for legal costs associated with contingencies other than medical malpractice liabilities. Because Health System GHI's established accounting policy is to expense such costs in the period(s) in which they are actually incurred, it would continue to apply that policy subsequent to its adoption of ASU No. 2010-24. Similarly, an entity that utilized FASB ASC 450-20-S99-2 as a basis for establishing a policy of estimating and accruing expected legal costs in the period in which the incident that gives rise to the claim occurs would continue to apply its policy election subsequent to adoption of the ASU. The appropriateness of any changes by an entity in its policy for accounting for legal costs incurred in connection with contingent liabilities other than malpractice would be evaluated in accordance with FASB ASC 250-10.

[Issue Date: October 2012.]

.51 Presentation of Insurance Recoveries When Insurer Pays Claims Directly

Inquiry—Prior to the issuance of ASU No. 2010-24, most health care entities that carried professional liability insurance only reported liabilities related to malpractice claims that were not covered by insurance (in effect, netting anticipated insurance recoveries against the related liability). ASU No. 2010-24 amended FASB ASC 954-450-25-2 to provide that a health care entity should not net insurance recoveries against related insurance claim liabilities and that the claim liability should be determined without consideration of insurance recoveries. The amendments are consistent with the guidance on netting receivables and payables in FASB ASC 210-20 that are more broadly applicable for other industries.

ABC Hospital's medical malpractice insurance policy provides that the insurer will handle all aspects of claims handling and settlement for ABC Hospital's covered malpractice claims, including making payments to plaintiffs directly on behalf of ABC Hospital. Thus, ABC Hospital neither pays its own malpractice claims nor receives insurance recoveries. How do the amendments

to FASB ASC 954-450-25-2 made by ASU No. 2010-24 apply to ABC Hospital's malpractice liabilities?

Reply—Unless ABC Hospital has a valid right of setoff (which is not common), as described in FASB ASC 210-20-45, ABC Hospital should report the gross amount of its claims liabilities (including legal costs) as its obligations, regardless of whether covered by insurance, and should record a receivable as if it were entitled to receive insurance recoveries to offset those obligations, as discussed in FASB ASC 954-450-25-2. It is expected that in most cases, this results in reporting a receivable that mirrors the amount of estimated losses accrued that are covered by insurance.

This situation is discussed in paragraph BC4 of ASU No. 2010-24. Despite the fact that an insurance entity is paying for the defense of the claim and ultimately paying for some or all of the award or settlement, ABC Hospital is the primary obligor for payment of the claim (because if the insurer was unable to pay, ABC Hospital would still be liable). Thus, the guidance in the amendments made by ASU No. 2010-24 applies to ABC Hospital's malpractice liabilities.

[Issue Date: October 2012.]

.52 Insurance Recoveries From Certain Retrospectively Rated Insurance Policies

Inquiry—GHI Health System's (GHI's) program of medical malpractice risk management includes a retrospectively rated insurance policy (that is, a policy with a premium that is adjustable based on actual claims experience during the policy term). The total annual premium consists of a minimum premium (representing the insurance company's expenses and profits) and an additional amount for estimated claims that is adjusted based on GHI's actual malpractice loss experience. The policy is also subject to a maximum premium amount. How would GHI apply the guidance in ASU No. 2010-24 to claims that are covered by an insurance policy with a retrospectively related premium that reflects GHI's own experience?

Reply—ASU No. 2010-24 requires GHI to report the gross amount of liability for its estimated malpractice claims without regard to any insurance coverage that may exist and to record a receivable to the extent it is indemnified against risk of financial loss through an insurance policy. The existence of an insurance policy, in itself, is no assurance that GHI has been indemnified against risk of financial loss. To the extent that an insurance contract does not, despite its form, provide for indemnification of the insured against loss, the insured entity must account for it as a deposit (financing) arrangement rather than insurance, as discussed in FASB ASC 720-20 and 340-30.

Therefore, at policy inception, GHI should determine the extent to which its retrospectively rated policy actually provides indemnification against risk of financial loss associated with malpractice claims. Because the premium is based on GHI's own loss experience, the economic substance of the arrangement may more closely resemble a claims funding mechanism than a contract that indemnifies GHI against risk of financial loss. The facts and circumstances of the terms of the insurance arrangement must be carefully evaluated in making this assessment. For example, a premium that adjusts dollar for dollar to ultimate loss experience during the coverage period and for which the loss experience has only a remote chance of exceeding the maximum premium is likely indicative of a self-insurance funding program and would be accounted for as a financing arrangement based on the guidance in FASB ASC 340-30. In that situation, there would typically be no insurance recoveries to record because claims are being paid from GHI's own resources on deposit with the

insurer. This is consistent with FASB ASC 954-720-25-1 that states that “[i]nsurance recoveries from a retrospectively rated insurance policy whose ultimate premium is based primarily on the health care entity’s loss experience shall not be recognized until the estimated losses exceed the stipulated maximum premium.” However, if it is reasonably possible that GHI’s ultimate loss experience will exceed the maximum premium, the policy is more likely to have indemnified GHI against a certain level of loss. In that situation, insurance recoveries associated with that indemnification, if any, would be determined and presented separately as a receivable.

[Issue Date: October 2012.]

[The next page is 5841.]

Section 6500

Extractive Industries

[.01-.03] Reserved

[The next page is 5941.]

Section 6600

Real Estate

.01 Method of Recognizing Revenue From Commissions by Real Estate Brokerage Firm

Inquiry—A client is a real estate broker and also manages real estate. The client is the exclusive broker for all its affiliates and acts as broker for outside parties as well. All of the affiliates invest in raw land for appreciation and occasionally improve and subdivide parcels. None of the properties are extensive enough to be considered “retail land sales companies.” Sales are probably half for second home sites and half for larger parcels bought for investment. Sales are usually for cash with an occasional mortgage taken by the seller. The client usually receives a gross brokerage commission of 10 percent to 15 percent, which is shared with its salesmen and cobrokers, retaining an average of 5 percent. Commissions are received at closing and cobrokers are paid shortly after the closing. Salesmen draw against firm purchase and sale agreements and are credited with the commission on closing. If a buyer fails to complete a purchase, his deposit is usually retained by the client in lieu of the brokerage commission, which legal counsel indicates is permitted under law.

The client records brokerage commission income when a firm purchase and sale agreement is accepted. This is an agreement which specifies price and all terms of sale, has no unusual or difficult conditions, and is secured by a deposit of 10 percent or more of the purchase price. This method was adopted by the client to more closely match revenues and expenses. Indirect selling expenses, including advertising, are treated as period costs. The costs of cobrokerage and salesmen’s commissions are also accrued at that time. The client’s contention is that the earnings process has been substantially completed, and the wait until closing (usually 30–90 days but occasionally longer) is a legal formality rather than an integral part of the broker’s work. Very few sales are not closed, and the price and terms of sale rarely change. From an audit point of view, many of the open sales at year-end have closed by completion of the audit field work. The client’s financial statements do disclose the method of accounting employed for brokerage commissions.

Is this present method of accounting for brokerage commissions considered acceptable?

Reply—Revenue recognition is discussed in Financial Accounting Standards Board (FASB) Concepts Statement No. 5, *Recognition and Measurement of Business Enterprises*, paragraphs 83–84. Paragraph 83 states in part:

“Revenues are not recognized until earned. An entity’s revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations, and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues.”

Therefore, the client’s method of accounting for commission income at the time when a firm purchase and sale agreement is entered into would be acceptable. However, because of state laws governing real estate operations, recognition of commission income might have to be postponed, depending on the particular legal requirements of a given state, until such time as the broker is legally entitled to receive that commission.

[.02] Reserved**.03 Accounting for Sale of Property With Option to Repurchase**

Inquiry—A corporation sold a parcel of land to a bank. The corporation has an option to repurchase the land for a period of three years. The corporation received the full purchase price at the time of sale.

What is the proper accounting treatment for this transaction?

Reply—The conclusion in FASB *Accounting Standards Codification* (ASC) 360-20-40-38 is that a transaction whereby a seller has an obligation or an option to repurchase the property must be accounted for as a financing, leasing, or profit sharing arrangement. A right of first refusal based on a bona fide offer by a third party is ordinarily not an obligation or an option to repurchase.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.04 Method of Recognizing Profit on Sale of Undeveloped Land With a Release Provision

Inquiry—One hundred acres of undeveloped land was sold for \$10,000 per acre for a total consideration of \$1,000,000. The buyer made a cash down payment of \$250,000, and the balance of \$750,000 is payable in three annual installments of \$250,000. The agreement has a release provision that title to the acreage will be released to the buyer on a basis of 115 percent of the sales price. Therefore, of the \$250,000 down payment, \$217,000 would be applicable to the release of 21.7 acres, and the balance of \$33,000 would be applicable to the remaining acreage. At this point, there would be a balance due on the sales agreement of \$750,000 against which \$33,000 would apply. The buyer would have this privilege every year, and the only security would be the land underlying the agreement.

What is the proper accounting treatment?

Reply—FASB ASC 360-20-40-23 states the following:

If the amounts applied to unreleased portions do not meet the initial and-continuing-investment criteria as applied to the sales value of those unreleased portions, profit shall be recognized on each released portion when it meets the criteria in paragraph 360-20-40-5 as if each release were a separate sale.

FASB ASC 360-20-40-5 states, in part:

Profit on real estate sales 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.

Presumably, the tests referred to would have to be met continuously; that is, at the time of closing and at each release date.

The relationship of the \$33,000 to the \$750,000 is not sufficient "to constitute an adequate initial and continuing investment" related to the

unreleased property. Therefore, “profit shall be recognized on each released portion when it meets the criteria in paragraph 360-20-40-5 as if each release were a separate sale” as stated in FASB ASC 360-20-40-23.

[Amended; Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.05] Reserved

[.06] Reserved

[.07] Reserved

[.08] Reserved

[The next page is 6151.]

Section 6700

Construction Contractors

.01 Distinction Between Long-Term and Short-Term Construction Contracts

Inquiry—A construction company considers all contracts that are less than one year in duration as short-term contracts and accounts for them on a completed contract method. Long-term contracts are accounted for on the completed-contract method or the percentage of completion method depending on other factors.

Does the distinction made by the company conform with generally accepted accounting principles?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 605-35-25-92 states that the completed-contract method may be used as the basic accounting method only if the financial position and results of operations reported on that basis would not vary from those resulting from the use of the percentage-of-completion method, “for example, in circumstances in which an entity has primarily short-term contracts.” FASB ASC 605-35-25-95 also states that an entity using the completed-contract method as its basic accounting method should depart from that policy for a single contract or a group of contracts not having the features described in paragraphs 92–93 of FASB ASC 605-35-25. Thus, it appears that the distinction made by the company conforms to generally accepted accounting principles.

[Amended; Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.02] Reserved

[.03] Reserved

[.04] Reserved

[.05] Reserved

[.06] Reserved

[.07] Reserved

[.08] Reserved

[.09] Reserved

.10 Payments for Landfill Rights

Inquiry—A construction contractor pays for rights allowing the contractor to extract a specified volume of landfill from a third party’s property for a period of three years. How should the payment for landfill rights be classified in the contractor’s balance sheet?

Reply—Until the landfill is extracted, the contractor should classify the payment for landfill rights as a deferred charge. The portion of the landfill payment related to the volume of landfill extracted should be reclassified as project costs. A deferred charge remaining at the termination of the agreement should be written off as an expense.

[The next page is 6351.]

Section 6910

Investment Companies

[.01] Reserved

[.02] Reserved

[.03] Reserved

[.04] Reserved

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[.07] Reserved

[.08] Reserved

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[.13] Reserved

[.14] Reserved

[.15] Reserved

.16 Presentation of Boxed Investment Positions in the Condensed Schedule of Investments of Nonregistered Investment Partnerships

Inquiry—Should long and short positions in the same security (*boxed positions*) be disclosed on a gross or net basis in the schedule of investments?

Reply—Although there may be a perfect economic hedge in boxed positions, the determination of which components of the boxed position would be required to be presented in the schedule of investments should be evaluated on a gross basis for the purposes of the 5 percent of net assets test as described in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 946-210-50-6. To the extent that one (or both) of the components is (are) required to be disclosed, such component(s) should be disclosed on the schedule of investments because there may be market risk if one position is removed before the other or experiences settlement costs or losses upon disposition. In the event that only one of the positions is required to be disclosed, a nonregistered investment partnership is not precluded from disclosing both positions.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.17 Disclosure of Long and Short Positions

Inquiry—If a nonregistered investment partnership has a long position that exceeds 5 percent of net assets and a short position in the same issuer that is less than 5 percent of net assets, is the investment partnership required to

disclose both the long and short position in the condensed schedule of investments?

Reply—No. The guidance in FASB ASC 946-210-50-6 indicates that, in applying the 5 percent test to determine the investments to be disclosed in the condensed schedule of investments, total long and total short positions in any one issuer should be considered separately. Because the value of the long position exceeds 5 percent of net assets, disclosure of the long position is required; however, disclosure of the short position is not required because the short position does not exceed 5 percent of net assets. Although not required, a nonregistered investment partnership is not precluded from disclosing both positions

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.18 Disclosure of an Investment in an Issuer When One or More Securities or One or More Derivative Contracts Are Held—Nonregistered Investment Partnerships

Inquiry—A nonregistered investment partnership may hold one or more securities of the same issuer and one or more derivative contracts for which the underlying is a security of the same issuer. How should such securities and derivative contracts be presented in the condensed schedule of investments when applying FASB ASC 946-210-50-6?

Reply—When applying the guidance in FASB ASC 946-210-50-6, the disclosure on the condensed schedule of investments relating to securities should be consistent with the classification of the securities on the statement of assets and liabilities. It is important to note, however, that derivative contracts may be netted for statement of assets and liabilities presentation when the right of offset exists under FASB ASC 210-20 and FASB ASC 815-10, although the disclosures in the condensed schedule of investments should reflect all open contracts by their economic exposure (that is, long exposure derivative versus short exposure derivative). The netting concepts allowed by FASB ASC 210-20 and FASB ASC 815-10 are not considered for purposes of presentation in the condensed schedule of investments. Those securities (market value) and derivative contracts (appreciation or fair value) that are classified as period-end assets on a gross basis (for derivative contracts, regardless of whether they represent long or short exposures) should be aggregated. To the extent that the sum constitutes more than 5 percent of net assets, the positions should be disclosed in accordance with FASB ASC 946-210-50-6. The investment company should similarly sum all of the positions classified as liabilities on a gross basis and determine whether they exceed 5 percent of net assets. Separate computations should be performed for assets and liabilities. The following are illustrative examples of how to apply the disclosure guidelines. Positions representing gross liabilities are presented in parentheses.

Example 1:

- U.S. Treasury Bond (long)—4 percent of net assets
- U.S. Treasury Bond (short)—(1 percent) of net assets
- U.S. Treasury Bond futures contract—Appreciation equals 2 percent of net assets

In the preceding example, the investment company should present separately the long bond and the futures contract in the condensed schedule of investments because, in aggregate, the gross asset position for this issuer exceeds 5 percent of net assets. The short bond position, which represents the

only liability position associated with the issuer, is not required to be disclosed separately because the gross liability position is not more than 5 percent of net assets. This assessment for derivatives is made regardless of whether the exposure to the underlying is long or short. Assessments are based solely on the value of the derivative contract (that is, either a long or short position with depreciation or a negative fair value would be considered a liability and aggregated with other liabilities for the purpose of this test). The preparer may consider whether disclosure of all positions, including those 5 percent or less, would be appropriate or meaningful to the reader in the circumstances.

Example 2:

- Various bonds of X company (long)—4 percent of net assets
- Stock of X company (short)—(3 percent) of net assets
- Long exposure equity swap (X company is the underlying)—Fair value equals 2 percent of net assets
- Short exposure equity swap (X company is the underlying)—Fair value equals (1 percent) of net assets

The guidance in paragraphs 6(e)–6(f) of FASB ASC 946-210-50 relates to 5 percent disclosures for any derivative position. That guidance states, “In applying the 5-percent test, total long and total short positions in any one issuer shall be considered separately.” This guidance contemplates situations such as the preceding example 2 in which an investment company holds both a long and short exposure to the same derivative without closing out either derivative position. In such cases, the long and short exposure to the same derivative should be considered separately and should not be netted for the purpose of the 5 percent issuer exposure calculation. This is consistent with the approach for boxed security positions.

In the preceding example 2, the investment company should present separately the various long bond positions and the long exposure equity swap contract in the condensed schedule of investments because, in aggregate, the gross asset position for this issuer exceeds 5 percent of net assets. Because none of the long bond positions is individually more than 5 percent of net assets, FASB ASC 946-210-50-6(c)(2) permits the reporting of all the long bond positions of that issuer in the aggregate (that is, naming the issuer but showing a range of maturities, interest rates, and other applicable bond disclosures as opposed to individually listing out the details of each of the long bond positions), although the preparer may consider whether disclosure of individual positions provides more meaningful information to the reader of the financial statements. The short stock position and the short exposure equity swap contract are not required to be disclosed separately because the gross liability position is, in aggregate, not more than 5 percent of net assets. Again, the investment company is not precluded from disclosing separately the short stock position and the short exposure equity swap position if the disclosure of such positions is deemed to provide more meaningful information to the reader. The preparer should consider both the long exposure and short exposure in the equity swaps separately and should not net them for the purpose of the 5 percent exposure calculation if both equity swap contracts have not been closed out.

Example 3:

- Bond of X company (long)—3 percent of net assets
- Stock of X company (short)—(1 percent) of net assets
- Swap (X company is the underlying)—Fair value equals (2 percent) of net assets

In the preceding example 3, the investment company would not be required to present separately any of the positions in the condensed schedule of investments because the gross asset position of the issuer (represented by the bond) is not more than 5 percent of net assets, and the gross liability position (represented by the combined total values of the short stock position and the swap) is also not more than 5 percent of net assets.

Example 4:

- Bond of X company (long)—4 percent of net assets
- Stock of X company (short)—(2 percent) of net assets
- Swap (X company is the underlying)—Fair value equals 2 percent of net assets
- Swap (X company is the underlying)—Fair value equals (4 percent) of net assets

In the preceding example 4, the investment company should present separately each of the positions in the condensed schedule of investments because the gross asset position of the issuer (represented by the combined total values of the bond and the appreciated swap) and the gross liability position of the issuer (represented by the combined total values of the short stock position and the depreciated swap) are both greater than 5 percent of net assets.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC; Revised, October 2010, by the Planning Subcommittee of FinREC.]

.19 Information Required to Be Disclosed in Financial Statements When Comparative Financial Statements of Nonregistered Investment Partnerships Are Presented

Inquiry—When comparative financial statements of a nonregistered investment partnership are presented, should the schedule of investment be presented as of the end of each period presented, or only as of the most recent date of the statement of assets and liabilities? Additionally, when comparative financial statements of a nonregistered investment partnership are provided, should the financial highlights be presented for each period provided, or only for the most recent period?

Reply—FASB ASC 946 does not require comparative financial statements for nonregistered investment partnerships. However, if an entity elects to prepare comparative financial statements, the general guidance for the presentation of comparative financial statements as found in paragraphs 2 and 4 of FASB ASC 205-10-45 indicate the following:

In any one year it is ordinarily desirable that the statement of financial position, the income statement, and the statement of changes in equity be presented for one or more preceding years, as well as for the current year.

Notes to financial statements, explanations, and accountants' reports containing qualifications that appeared on the statements for the preceding years shall be repeated, or at least referred to, in the comparative statements to the extent that they continue to be of significance.

Because the schedule of investments would continue to be considered of significance relative to the statement of assets and liabilities for the prior year, the schedule of investments for the prior year should be included as a part of the comparative statements. Additionally, FASB ASC 946-205-45-1 states that "at a minimum, a condensed schedule of investments (as discussed in paragraphs 946-210-50-4 through 50-10) should be provided for each statement of

assets and liabilities.” Therefore, comparative schedules of investments are required to be presented when comparative statements of assets and liabilities are reported.

Consistent with the requirements of FASB ASC 205-10-45, comparative financial highlights should be presented when comparative statements of operations are provided because they would also be considered a significant disclosure for the prior periods of operation included in the financial statements.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.20 Presentation of Purchases and Sales/Maturities of Investments in the Statement of Cash Flows

Inquiry—Should the value of securities purchased by a nonregistered investment partnership during the period presented be reported in the statement of cash flows separately from the proceeds received on the sale/maturity of securities by the nonregistered investment partnership or may the nonregistered investment partnership report only the net difference?

Reply—In general, a nonregistered investment partnership should present purchases and sales/maturities of long-term investments (securities purchased with no stated maturity or with a stated maturity of greater than one year at the date of acquisition) on a gross basis in the statement of cash flows pursuant to FASB ASC 230, *Statement of Cash Flows*, although the nonregistered investment partnership may consider the provisions in FASB ASC 230-10-45-9 in determining whether or not certain purchases and sales/maturities qualify for net reporting. Purchases and sales/maturities of short-term investments (securities purchased with a stated remaining maturity of one year or less at the date of acquisition), however, may be presented on a net basis, as described in FASB ASC 230-10-45-18. Additionally, proceeds and costs reported for transactions in short positions are reflected separately from proceeds and costs associated with long positions.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.21 Recognition of Premium/Discount on Short Positions in Fixed-Income Securities

Inquiry—An investment company enters into short positions on various fixed-income securities, where the short sale price is at a premium or discount to the par value of the bond. The Audit and Accounting Guide *Investment Companies* discusses, in chapter 2, the requirement that an investment company amortize premiums/discounts on its investments, referring to long positions, but is silent as to whether similar accounting is required for short positions. The investment company currently recognizes all payments of coupon interest as interest expense on its short positions. Is the investment company also required under generally accepted accounting principles to amortize the premium and discount on the short position?

Reply—Yes. As when recognizing interest income on long positions, when recognizing interest expense on short positions, the investment company should recognize all economic elements of interest, including premium and discount.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.22 Presentation of Reverse Repurchase Agreements

Inquiry—An investment company enters into a *reverse repurchase agreement*, which is defined in chapter 3 of the Audit and Accounting Guide *Investment Companies* as “the sale of a security at a specified price with an agreement to purchase the same or substantially the same security from the same counterparty at a fixed or determinable price at a future date.” The investment company receives cash and initially records the amount payable as a liability. Should reverse repurchase agreements be presented in the financial statements of investment companies at the amount payable or at fair value?

Reply—Investment companies present their debt obligations at amounts payable. Because reverse repurchase agreements represent a fixed, determinable obligation of the investment company, such agreements should also be presented 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.

.23 Accounting Treatment of Offering Costs Incurred by Investment Partnerships

Inquiry—According to FASB ASC 946-20-25-6 and FASB ASC 946-20-35-5, all open-end registered investment companies and those closed-end registered investment companies with a continuous offering period should defer offering costs and amortize them to expense over 12 months on a straight-line basis. However, FASB ASC 946-20-25 does not indicate whether an investment partnership should apply the same treatment. Should an investment partnership that continually offers its interests also defer and amortize such costs over 12 months?

Reply—Yes, 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.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.24 Meaning of “Continually Offer Interests”

Inquiry—How should an investment partnership determine if it continually offers its interests?

Reply—An investment partnership is deemed to continually offer its interests if an eligible, new investor may enter into an agreement to purchase an interest in the partnership on any business day or on a series of specified business days over a continuous period of time. A new investor is one that does not already own any interest in the investment partnership at the time of purchase.

Some investment partnerships may offer their interests at a single point in time and require new investors to commit to providing capital contributions over a period of time. As interests are not available for purchase over a continuous period, such investment partnerships would not be deemed to have a continuous offering period.

.25 Considerations in Evaluating Whether Certain Liabilities Constitute “Debt” for Purposes of Assessing Whether an Investment Company Must Present a Statement of Cash Flows

Inquiry—FASB ASC 230-10-15-4 exempts investment companies (both registered and unregistered) from the requirement to provide a statement of cash flows, if all of the following conditions are met:

- a. During the period, substantially all of the entity’s investments were carried at fair value and classified as level 1 or level 2 measurements in accordance with FASB ASC 820.^[1]
- b. *The enterprise had little or no debt, based on the average debt outstanding² during the period, in relation to average total assets. (emphasis added)*
- c. The enterprise provides a statement of changes in net assets.³

Because FASB ASC 230-10-15-4(c)(3) specifically states that covered options written would generally not be considered debt for purposes of determining whether an investment company meets these conditions, does that imply that *uncovered options* and *short sales of securities and reverse repos* must, by inference, be treated as debt? If not, under what circumstances may they be excluded from *debt* in determining whether the investment company must present a statement of cash flows?

Reply—Although presented in the liabilities section of the statement of assets and liabilities, options sold/written (whether covered or uncovered), short sales of securities, and other liabilities recorded as a result of investment practices are not necessarily debt; rather, their classification depends on the nature of the activity. Certain transactions (for example, securities lending, mortgage dollar rolls, or short sale transactions) may have a practice of being entered into solely for operating purposes (similarly to unsettled purchases of securities) or as an investing strategy (similarly to covered options written), and the investment company either retains the proceeds in cash accounts or uses them to invest in securities that are cash equivalents under FASB ASC 230. In such cases, the proceeds from the transaction would not be considered debt for purposes of assessing whether the conditions in FASB ASC 230 are met.

[Issue Date: May 2008; Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC; Revised, October 2013, to reflect conforming changes necessary due to the issuance of FASB ASU No. 2012-04.]

^[1] [Footnote deleted, October 2013, to reflect conforming changes necessary due to the issuance of FASB ASU No. 2012-04.]

² Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 230-10-15-4(c)(3) states, “For the purpose of determining average debt outstanding, obligations resulting from redemptions of shares by the entity from unsettled purchases of securities or similar assets, or from covered options written generally may be excluded. However, any extension of credit by the seller that is not in accordance with standard industry practices for redeeming shares or for settling purchases of investments shall be included in average debt outstanding.”

³ FASB ASC 946-205-45-5 states, “For investment partnerships, the statement of changes in net assets may be combined with the statement of changes in partners’ capital if the information in paragraph 946-205-45-3 is presented.”

.26 Additional Guidance on Determinants of Net Versus Gross Presentation of Security Purchases and Sales/Maturities in the Statement of Cash Flows of a Nonregistered Investment Company

Inquiry—Under what circumstances, if any, may purchases and sales/maturities of securities presented in the operating section of the statement of cash flows of a nonregistered investment company be shown on a *net*, rather than a *gross*, basis?

Reply—Chapter 7 of the AICPA Audit and Accounting Guide *Investment Companies* states:

Cash flows from operating activities should include the fund's investing activities. Cash flows from operating activities include (***bold italic*** added for emphasis)—

- a. Interest and dividends received.
- b. Operating expenses paid.
- c. ***Purchases of long-term investments*** (at cost).
- d. ***Sales of long-term investments*** (proceeds).
- e. ***Net sales or purchases of short-term investments***.
- f. Cash flows for other types of investing activities related to changes in margin accounts and collateral status, such as written options, financial futures contracts, securities lending, and so forth.

Section 6910.20 provides the following guidance:

In general, a nonregistered investment partnership should present purchases and sales/maturities of long-term investments (securities purchased with no stated maturity or with a stated maturity of greater than one year at the date of acquisition) on a gross basis in the statement of cash flows pursuant to FASB ASC 230, *Statement of Cash Flows*, although the nonregistered investment partnership may consider the provisions in FASB ASC 230-10-45-9 in determining whether or not certain purchases and sales/maturities qualify for net reporting. Purchases and sales/maturities of short-term investments (securities purchased with a stated remaining maturity of one year or less at the date of acquisition), however, may be presented on a net basis, as described in FASB ASC 230-10-45-18. Additionally, proceeds and costs reported for transactions in short positions are reflected separately from proceeds and costs associated with long positions.

One of the requirements of FASB ASC 230-10-45-9 is that the original maturity of assets and liabilities qualifying for net reporting is 3 months or less. However, FASB ASC 230-10-45-18 permits “banks, brokers and dealers in securities, and other entities [that] carry securities and other assets in a trading account” to classify cash receipts and cash payments from such activities as operating cash flows, while cash flows from transactions in “available for sale” securities are reported gross as investing activities.⁴ In other industries, operating cash flows relating to trading account securities typically are reported on a net basis.

If a nonregistered investment company presents a statement of cash flows, the investment company's trading style, investment objectives stated in its offering memorandum, and portfolio turnover should be the primary determinants of net versus gross reporting. Where the investment company's overall

⁴ Refer to paragraphs 11 and 18–20 of FASB ASC 230-10-45 and FASB ASC 310-10-45-11 for additional guidance.

activities comport with *trading*, as discussed in FASB ASC 230 and FASB ASC 320, *Investments—Debt and Equity Securities*,⁵ netting is permissible; otherwise, gross reporting of purchases and sales/maturities is required.

Regardless of whether net or gross reporting is appropriate based on the stated criteria, an entity should separately report its activity related to long positions from activity related to short positions; that is, changes/activity in account balances reported as assets should not be netted against changes/activity in account balances reported as liabilities.

[Issue Date: May 2008; Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.27 Treatment of Deferred Fees

Inquiry—The governing documents of an offshore fund provide that the investment adviser may elect to defer payment of its management fee, incentive fee, or both. Based on the documents, the deferred fees that are payable to the investment adviser do not take the form of a legal capital account and are settled exclusively in cash. Under this arrangement, the fund retains the fee amount and is obligated to pay the investment adviser the deferred fees at a later date adjusted for the fund's rate of return (whether positive or negative). How should the deferred fees and the appreciation or depreciation on the deferred fees be presented on the statement of assets and liabilities, on the statement of operations, and on the financial highlights? What additional disclosures, if any, should be included in the financial statements or the notes to the financial statements?

Reply—In accordance with guidance from paragraph 35 of FASB Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*, the fund should record the cumulative deferred fees as a liability. The indexing of this liability to the fund's rate of return represents a hybrid instrument that has a host debt instrument with an embedded derivative, which has attributes of a total return contract. Although FASB ASC 815-15-25-1 and FASB ASC 815-15-55-190 require the embedded total return contract to be bifurcated from the host debt instrument, the Securities and Exchange Commission staff has previously indicated⁶ that the bifurcation requirements of FASB ASC 815 do not extend beyond measurement to financial statement presentation, if the embedded derivative and host debt instrument, together, represent the principal and interest obligations of a debt instrument. While the fund should fair value the embedded return component of the deferral arrangement according to the guidance from FASB ASC 815-10-25-1, FASB ASC 815-10-30-1, and FASB ASC 815-10-35-1, generally, the fair value of such return component would be the same as the appreciated or depreciated return of the fund because (1) the fund fair values all of its investments, whether assets or liabilities, which generally represent substantially all of its net assets, and (2)

⁵ FASB ASC glossary defines *trading securities* as follows:

Securities that are bought and held principally for the purpose of selling them in the near term and therefore held for only a short period of time. Trading generally reflects active and frequent buying and selling, and trading securities are generally used with the objective of generating profits on short-term differences in price.

Although investment companies do not apply FASB ASC 320 and, therefore, do not normally categorize securities as trading, available for sale, or held to maturity, the concepts of whether the securities are held for trading purposes and whether the related cash flows would be classified as operating cash flows under paragraphs 11 and 18–20 of FASB ASC 230-10-45 and FASB ASC 310-10-45-11 are relevant in determining whether cash flows from purchases and sales of securities should be presented gross or net by investment companies.

⁶ Twenty-Eighth Annual National Conference on Current SEC Developments December 4–6, 2000. Remarks by E. Michael Pierce.

if the deferred fee liability was transferred, the transfer would likely be transacted at the current net asset value.⁷ The deferred fees and the embedded total return contracts associated with deferred fees that are at an appreciated or depreciated position as of the reporting date may be presented as one amount titled “Deferred incentive fees payable” on the statement of assets and liabilities.

FASB ASC 946-225-45-1 states, in part, “The objective of the statement of operations is to present the increase or decrease in net assets resulting from all of the company’s investment activities, by reporting investment income from dividends, interest, and other income less expenses, the amounts of realized gains or losses from investment and foreign currency transactions, and changes in unrealized appreciation or depreciation of investments and foreign-currency-denominated assets and liabilities for the period.” Because the fund directly earns or incurs the income, expenses, net realized gains or losses, and unrealized appreciation or depreciation on the deferred fee retained in the fund, such amounts should be presented within their respective line items in the investment company’s statement of operations. The net change in unrealized appreciation or depreciation on the total return contracts associated with the deferred fees should be reported in earnings; that is, reflected as an expense (appreciation of deferred fees) or negative expense (depreciation of deferred fees) of the fund rather than as an allocation of earnings or losses and, following the guidance from FASB ASC 850, *Related Party Disclosures*, should be presented separately from the current period management or incentive fee.

FASB ASC 946-205-50-7 states, in part, “the caption descriptions in the per-share data shall be the same captions used in the statement of operations . . . to allow the reader to determine which components of operations are included in or excluded from various per-share data.” FASB ASC 946-205-50-14 adds “generally, the determination of expenses for computing those ratios shall follow the presentation of expenses in the fund’s statement of operations.” The per share information, net investment income ratio, and net expense ratio included in the financial highlights should reflect the amounts presented on the statement of operations including the adjustment associated with the deferred fee amount. In order to reflect the effect of the adjustment on the fund’s expense ratio, the fund may also present an expense ratio that excludes the amount of deferred fee expense or negative expense reported in the statement of operations. Consistent with guidance from FASB ASC 946, *Financial Services—Investment Companies*, the fund should disclose the nature of the deferred fee arrangement, including the priority of claim in the event of liquidation, the current period and cumulative amounts deferred, the cumulative earnings or losses on the deferral, the terms of payment, the date that the deferral payments commence (or the next payment date), and the manner in which the deferral will be invested.

The following is an illustration of a deferred incentive fee presentation in the financial statements and the related disclosures:

⁷ All concepts of FASB ASC 820, *Fair Value Measurement*, should be considered.

Statement of Assets and Liabilities**Assets**

Cash and cash equivalents	\$206,000
Investments, at fair value	166,585,000
Total assets	<u>\$166,791,000</u>

Liabilities

Management fee payable	\$400,000
Redemptions payable	1,000,000
Accrued expenses	100,000
Deferred incentive fees payable	4,800,000
Total liabilities	<u>6,300,000</u>
Net assets	<u>\$160,491,000</u>

Statement of Operations**Investment income**

Interest income	\$5,576,000
Dividend income	1,766,000
Total investment income	<u>\$7,342,000</u>

Expenses

Incentive fee	\$2,680,000
Management fee	1,831,000
Change in net appreciation on deferred incentive fees	650,000
Administration fee	60,000
Professional fees and other	75,000
Total expenses	<u>5,296,000</u>
Net investment income	<u>\$2,046,000</u>

Realized and unrealized gains (losses) from investment activities

Net realized gain on securities	\$2,773,000
Net realized gain on swap and forward contracts	509,000
Net change in unrealized appreciation on securities	1,515,000
Net change in unrealized appreciation on swap and forward contracts	852,000
Net realized and unrealized gain from investment activities	<u>\$5,649,000</u>

Net increase in net assets resulting from operations \$7,695,000

Notes to Financial Statements**Note X—Investment Management and Incentive Fees**

Pursuant to an investment advisory agreement, the Fund pays to the Adviser a quarterly management fee of $\frac{1}{4}$ of 1 percent (1 percent per annum) of the net assets of the Fund on the last day of each quarter. The Adviser also is entitled to an annual incentive fee equal to 20 percent of the net profits attributable to each series of common shares, subject to a loss carry forward.

If there is a net loss for the year, the incentive fee will not apply to future years until such net loss has been recovered, adjusted for redemptions.

The Adviser may elect to defer receipt of all or a portion of the management or incentive fees earned for a particular fiscal year, and such amounts will be indexed to the Fund's return. In the event of liquidation of the Fund, any deferred amount, as adjusted for the appreciation or depreciation resulting from indexing, the deferred fee to the Fund's return has a priority claim over the interests of the equity holders of the Fund.

For the [year/period] ended December 31, 20XX, payment of 50 percent of the incentive fee incurred by the Fund was deferred for X years. Cumulative deferred incentive fees as of December 31, 20XX totaled \$3,850,000, and cumulative net appreciation on such amounts totaled \$950,000. The net change in appreciation or depreciation of deferred incentive fees is recorded on a separate line item under "Expenses" within the statement of operations. Distributions of 20XX and prior year deferred incentive fees are scheduled for the period from [DATE RANGE]. During the year ended December 31, 20XX, the distribution of previously deferred incentive fees amounted to \$500,000.

The following is an example disclosure of a roll forward of deferred incentive fees payable, which is a best practice disclosure.

The deferred incentive fees payable balance as of December 31, 20XX is comprised of the following:

Deferred incentive fees payable at January 1, 20XX	\$3,310,000
Appreciation on deferred incentive fees for the year ended December 31, 20XX	650,000
Incentive fees deferred for the year ended December 31, 20XX	1,340,000
Deferred incentive fees paid for the year ended December 31, 20XX	(500,000)
Deferred incentive fees payable at December 31, 20XX	<u>\$4,800,000</u>

Note X—Financial Highlights

The following represents the per share information, ratios to average net assets, and other supplemental information for the year ended December 31, 20XX:

	<i>Class A Initial series</i>	<i>Class B Initial series</i>
Per share operating performance:		
Beginning net asset value	\$1,130.35	\$1,123.80
Income from investment operations:		
Net investment income	11.01	6.76
Net realized and unrealized gain from investment activities	141.50	145.64
Total income from operations	<u>152.51</u>	<u>152.40</u>
Ending net asset value	<u>\$1,282.86</u>	<u>\$1,276.20</u>
Ratios to average net assets:		
Expenses other than incentive fee	1.43%	1.46%
Incentive fee	<u>1.46</u>	<u>1.49</u>
Total expenses	2.89	2.95

	<i>Class A</i> <i>Initial</i> <i>series</i>	<i>Class B</i> <i>Initial</i> <i>series</i>
Change in net appreciation on deferred incentive fees	(0.40)	(0.43)
Total expense excluding change in net appreciation on deferred incentive fees	2.49%	2.52%
Net investment income	1.12%	1.09%
Total return prior to incentive fee	17.07%	16.93%
Incentive fee	(3.58)	(3.37)
Total return after incentive fee	13.49%	13.56%

The per share operating performance and total return are calculated for the initial series of each share class. The ratios to average net assets are calculated for each class taken as a whole. An individual investor's per share operating performance, total return, and ratios to average net assets may vary from these per share amounts and ratios based on participation in new issues and different management fee and incentive fee arrangements and the timing and amount of capital transactions.

[Issue Date: May 2008; Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.28 Reporting Financial Highlights, Net Asset Value (NAV) Per Share, Shares Outstanding, and Share Transactions When Investors in Unitized Nonregistered Funds Are Issued Individual Classes or Series of Shares

Inquiry—Some unitized nonregistered funds issue a separate series of shares to each individual investor in the fund, which remains outstanding so long as the investor maintains its investment in the fund and is not closed until the investor fully redeems. These series may be issued within multiple classes of shares with each series within a class bearing the same economic characteristics. The shares are legally issued and outstanding until redemption (that is, they are not notional interests), but will not be converted or otherwise consolidated into an identifiable “permanent” series of shares in a “series roll-up.”⁸ Essentially, these unitized funds apply partnership accounting.

How should financial highlights (per share data, ratios, and total return) be presented in this situation, and how should each series of shares outstanding at period-end and share transactions during the period be disclosed in the financial statements?

Reply—

Presentation of Financial Highlights

The issuance of a separate series of shares to each individual investor is done for operational purposes because this enables a fund to allocate profit and loss to each investor in the same manner as a limited partnership allocates profit and loss to an individual partner's capital account. The definition of *nonregistered investment partnership—financial highlights* in the FASB ASC glossary—states, in part, that for unitized funds, “permanent series of a class of share shall be the basis for which that share's financial highlights are

⁸ A series roll up typically occurs at the end of the year when a temporary series of shares has increased above its high watermark (for example, the highest level in value a series has achieved, adjusted for subscriptions and redemptions) at which time the outstanding shares of a temporary series of shares are converted (or rolled up) into the permanent series of shares.

determined and presented.” When a separate series of shares is issued to each individual investor and remains outstanding until the investor fully redeems, reporting the financial highlights for each outstanding series of shares could result in financial highlights presented for up to 500 investors and would be the substantive equivalent of presenting the financial highlights in a limited partnership for each limited partner.

The financial highlights should be presented at the aggregate level for the entire permanent series of shares from which the individual series of shares has been issued. Because the fund operates like a partnership, the financial highlights should include only those financial highlights applicable to a partnership, which are the ratios to average net assets and total return, but not per share data.

When a separate series of shares is issued to each individual investor and remains outstanding until the investor fully redeems, the permanent series of shares will be the fund as a whole, excluding managing investor interests, if the shares otherwise have substantially similar terms. There are situations when a fund will issue multiple classes of shares, which contain multiple series of shares, due to differing fee arrangements or restrictions affecting an investor’s ability to participate in the profits and losses generated by “new issue” securities. When a fund issues multiple classes of shares, and in each class of shares, a series of shares is issued to each individual investor and remains outstanding until the investor fully redeems, financial highlights should be presented at the aggregate level for each permanent class of shares from which the individual series of shares have been issued. For example, if a fund has outstanding, at year-end, Class A shares, Series 1–40, which have a 1 percent management fee; Class B shares Series 1–300, which have a 2 percent management fee; and Class C shares, which are only held by the managing investor, the fund would present financial highlights information for Class A, taken as a whole and Class B, taken as a whole. There is no requirement to present financial highlights for Class C because FASB ASC 946-205-50-4 requires financial highlights to be presented only for nonmanaging investors.

It would be acceptable for a fund to present supplemental financial highlights data for a single series of shares, which the fund determines to be “representative.” Such financial highlights may be labeled as representing supplemental information and may only be presented in addition to those financial highlights that are required. Factors to consider when determining the representative series of shares include the following:

1. The series of shares was outstanding for the entire fiscal period (or, if all units of a series of shares outstanding at the beginning of the fiscal period were redeemed during the period, the series of shares at period-end outstanding for the longest period of time).
2. The fees and other offering terms of the series of shares most closely conform to those which may be described in the fund’s offering documents.
3. The series of shares represent the largest ownership interest in the fund.

The basis of presentation of the financial highlights and the criteria used to determine the most representative series of shares should be disclosed in a note to those highlights and should be consistently applied.

If appropriate, a fund may present other supplemental information if determined to be informative and not misleading.

Presentation of Shares Outstanding and Share Transactions

FASB ASC 946-210-45-4 indicates that net asset value per share and shares outstanding should be reported for each class. Because a fund which issues a separate series of shares to each investor operates like a partnership, presenting the net asset value per share and the shares outstanding for each series of shares would be the substantive equivalent of presenting each partner's capital balance in the financial statements of a partnership, which is not required by FASB ASC 946 for nonunitized partnership interests. Chapter 7 of the guide discusses the requirement for the unitized funds to disclose units of capital, including the title and par value of each class of shares, and the number of shares authorized, outstanding, and dollar amount of such shares. FASB ASC 946-505-50-2 requires disclosure of the number and value of shares sold, the number and value of shares issued in reinvestment of distributions, the number and cost of shares reacquired, and the net change in shares. For funds which issue a separate series of shares to each investor, such funds should satisfy the disclosure requirements in FASB ASC 946-210-45-4 and 946-505-50-2 by presenting such disclosures on an aggregate share basis. For funds which issue multiple classes of shares which contain multiple series of shares, such disclosure requirements should be presented at the aggregate level for each permanent class of shares from which the individual series of shares have been issued.

EXAMPLE

A fund issues Class A and Class B nonvoting shares to investors and, within each class, a separate series of shares is issued to each individual investor. Class A shares have a 1 percent management fee and a 20 percent incentive fee, while Class B shares are issued to related party investors and, therefore, are not charged a management fee or an incentive fee. Class C voting shares are management shares and do not participate in the profits or losses of the fund. As of December 31, 20X7, there are 15,100 total shares outstanding totaling \$1,517,600. The following shows such amounts outstanding as of December 31, 20X7 by class and series:

Class A Series 1–5,000 shares outstanding, NAV \$500,000

Class A Series 2–7,500 shares outstanding, NAV \$765,000

Class B Series 1–2,500 shares outstanding, NAV \$252,500

Class C–100 shares outstanding, NAV \$100

In the prior year, as of December 31, 20X6, there were 10,100 total shares outstanding totaling \$970,100. The following shows such amounts outstanding as of December 31, 20X6 by class and series:

Class A Series 1–6,000 shares outstanding, NAV \$588,000

Class B Series 1–3,000 shares outstanding, NAV \$288,000

Class B Series 2–1,000 shares outstanding, NAV \$94,000

Class C–100 shares outstanding, NAV \$100

Example Statement of Assets and Liabilities**Statement of Assets and Liabilities
December 31, 20X7****Assets**

Cash and cash equivalents	\$100,100
Investments, at fair value	<u>1,550,000</u>
Total assets	<u>\$1,650,100</u>

Liabilities

Redemptions payable	94,000
Management fees payable	4,000
Incentive fee payable	3,000
Accrued expenses	31,500
Total liabilities	<u>132,500</u>
Net assets (based on 12,500 Class A shares, 2,500 Class B shares, and 100 Class C shares outstanding)	<u>\$1,517,600</u>

Example Footnote Disclosures**Capital Share Transactions**

As of December 31, 20X7, 5,000,000 shares of capital stock were authorized. Class A and Class B shares have \$0.01 par value, and Class C shares have \$1.00 par value. Transactions in capital stock were as follows:

Class A	<i>Shares</i>		<i>Amount</i>	
	<i>20X7</i>	<i>20X6</i>	<i>20X7</i>	<i>20X6</i>
Shares sold	7,500	6,000	\$750,000	\$600,000
Shares redeemed	(1,000)	—	\$(99,500)	—
Net increase	<u>6,500</u>	<u>6,000</u>	<u>\$650,500</u>	<u>\$600,000</u>

Class B	<i>Shares</i>		<i>Amount</i>	
	<i>20X7</i>	<i>20X6</i>	<i>20X7</i>	<i>20X6</i>
Shares sold	—	4,000	—	\$400,000
Shares redeemed	(1,500)	—	\$(148,750)	—
Net increase	<u>(1,500)</u>	<u>4,000</u>	<u>\$(148,750)</u>	<u>\$400,000</u>

Class C	<i>Shares</i>		<i>Amount</i>	
	<i>20X7</i>	<i>20X6</i>	<i>20X7</i>	<i>20X6</i>
Shares sold	—	100	—	\$100
Shares redeemed	—	—	—	—
Net increase	<u>—</u>	<u>100</u>	<u>—</u>	<u>\$100</u>

Financial Highlights

The ratios to average net assets and total return are presented below for each class taken as a whole, excluding managing shareholder interests, for the year ended December 31, 20X7. The ratios and total return are not annualized. The computation of similar financial information for other participating shareholders may vary based on the timing of their respective capital transactions.

Annual ratios to average net assets and total return for the year ended December 31, 20X7 are as follows:

	<i>Class A</i>	<i>Class B</i>
Ratios to average net assets:		
Expenses other than incentive fee	2.26%	1.26%
Incentive fee	0.31%	0.00%
Total expenses	<u>2.57%</u>	<u>1.26%</u>
Net investment income	<u>0.93%</u>	<u>1.93%</u>
Total return prior to incentive fee	3.48%	5.02 %
Incentive fee	<u>(0.40)%</u>	<u>(0.00)%</u>
Total return after incentive fee	<u>3.08%</u>	<u>5.02%</u>

[Issue Date: May 2008; Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.29 Allocation of Unrealized Gain (Loss), Recognition of Carried Interest, and Clawback Obligations

Inquiry—The governing documents of some nonregistered investment partnerships (as defined in chapter 7 of the AICPA Audit and Accounting Guide *Investment Companies*), may contain provisions which do not allow allocations of unrealized gains or losses, or do not require the recognition of carried interest (also referred to as *carry*, *incentive*, or *performance fees and allocations*), and clawback obligations (also referred to as *lookback*, *negative carried interest*, or *general partner⁹ giveback*) until a specified date or time (for example, at the time of the partnership's liquidation or termination), or until the occurrence of a specific event (such as the actual disposition of an investment). Often, in these cases, the partnership's investments are either not marketable or are of such limited liquidity that interim valuations are highly subjective, and the intent of the provision is to delay the general partner's receipt of incentive allocations in cash until the gains can be measured objectively. In preparing financial statements of an investment partnership in accordance with U.S. generally accepted accounting principles, in which capital is reported by investor class, how should cumulative unrealized gains (losses), carried interest, and clawback be reflected in the equity balances of each class of shareholder or partner at the balance sheet date? In particular, should cumulative period-end unrealized gains and losses, nonetheless, be allocated as if realized in accordance with the partnership's governing documents prior to the date, time, or event specified in the partnership agreement?

⁹ Various terms may be used by different legal structures as the equivalents of *general partner* and *limited partner* (for example, *managing member* and *member* for limited liability companies). For convenience, the terms *partnership*, *general partner*, and *limited partner* are used throughout, but are intended to refer to any equivalent structure.

Reply—If a nonregistered investment partnership reports capital by investor class, cumulative unrealized gains (losses), carried interest, and clawback provisions would be reflected in the equity balances of each class of shareholder or partner at the balance sheet date, as if the investment company had realized all assets and settled all liabilities at the fair values reported in the financial statements, and allocated all gains and losses and distributed the net assets to each class of shareholder or partner at the reporting date consistent with the provisions of the partnership’s governing documents. Further discussion of the presentation of each item follows.

Certain partnerships record an expense for fees (including incentive fees) due a general partner, whereas others allocate net income from limited partner capital accounts to the general partner capital account. These amounts could either be considered a disproportionate income allocation or a compensation arrangement, and the accounting should conform to the structure of the partnership agreement, with the financial statement disclosures set forth in FASB ASC 946.

A basic premise for the preparation and presentation of the financial statements of an investment company is to reflect each class of shareholders’ or partners’ interest in the net assets of the reporting entity as of the reporting date. Another objective is to present total return for nonmanaging investor classes after incentive allocations and fees, as expressed in FASB ASC 946.

Other accounting literature related to the presentation of data similar to total return is consistent with FASB ASC 946. FASB ASC 260, *Earnings per Share*, refers to allocating earnings or undistributed earnings for a period to participating securities “as if all of the earnings for the period had been distributed.”

Although this guidance does not relate specifically to the presentation of capital accounts, measuring period-end capital balances for those classes under the same methodology appears consistent with this guidance. Accordingly, if an entity reports capital by investor class, cumulative unrealized gains (losses), carried interest, and clawback provisions would be reflected in the equity balances of each class of shareholder or partner at the balance sheet date, as if the investment company had realized all assets and settled all liabilities at the fair values reported in the financial statements, and allocated all gains and losses and distributed the net assets to each class of shareholder or partner at the reporting date consistent with the provisions of the partnership’s governing documents. Further discussion of the presentation of each item follows.

Cumulative Unrealized Gains (Losses)

Cumulative unrealized gains (losses) would be included in the ending balances of each class of shareholders’ or partners’ interest in the reporting entity at the reporting date, and the changes in such amounts would be reported in the changes in net asset value and partners’ capital for the reporting period.

Carried Interest

The carried interest generally is due to the investment manager, an affiliated entity, or both, and is either in the form of a fee (usually for offshore funds) or as an allocation from the limited partners’ capital accounts, pro rata, to the general partner’s capital account (usually for domestic funds). Although many variations exist, the investment manager is often entitled to receive its carry on a “deal-by-deal” basis. On this basis, as individual investments are sold, the investment proceeds are allocated based on a specific methodology defined in the governing documents to determine the amount of carry, if any, to which the investment manager is entitled.

In presenting each class of shareholders' or partners' interest in the net assets as of the reporting date, the financial statements would consider the carry formula as if the investment company had realized all assets and settled all liabilities at their reported fair value, and allocated all gains and losses and distributed the net assets to each class of shareholder or partner at the reporting date.

Clawback

Although all classes of shareholder or partner may be subject to clawback provisions in the governing documents, a clawback most frequently involves an obligation on the part of the investment manager to return previously received incentive allocations to the investment fund due to subsequent losses. Such clawback amounts, when paid, are typically distributed to other investors.

Consistent with the previously discussed principle to reflect each class of shareholders' or partners' interest in the net assets of the reporting entity as of the reporting date, the impact of a clawback would be calculated as of each reporting date under the methodology specified in the fund's governing documents.

Consistent with FASB ASC 310-10-45-14, such an obligation would not be recognized as an asset (receivable) in the entity's financial statements unless substantial evidence exists of ability and intent to pay within a reasonably short period of time. Rather, in most instances, the obligation would be reflected as a deduction from the general partner's capital account.

The specific circumstances, including whether the clawback represents a legal obligation to return or contribute funds to the reporting entity, require consideration before determining whether a clawback, resulting in a negative general partner capital balance (that is, contra-equity), is recognized in the financial statements. A careful reading of the governing documents ordinarily is required. Additionally, it may not be appropriate to reflect a negative general partner capital balance (and a corresponding increase to limited partner capital balances) if the general partner does not have the financial resources to make good on its obligation. It may be helpful to consult with the entity's legal counsel for clarification before recording a negative general partner capital balance.

Even if not recognized within the capital accounts, at a minimum, it would be appropriate to disclose the existence of a clawback in the footnotes to the financial statements because in almost all cases, the existence of the clawback would modify the manner in which future distributions are made.

[Issue Date: January 2009; Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.30 Disclosure Requirements of Investments for Nonregistered Investment Partnerships When Their Interest in an Investee Fund Constitutes Less Than 5 Percent of the Nonregistered Investment Partnership's Net Assets

Inquiry—Nonregistered investment partnerships (as defined in the AICPA Audit and Accounting Guide *Investment Companies* [the guide]) are subject to the disclosure requirements of FASB ASC 946-210-50-6 related to investments in the partnership's portfolio. These disclosures require reporting investment partnerships to individually disclose an investment by name, type, and so on if the reporting investment partnership's investment constitutes more than 5 percent of its net assets. In accordance with paragraphs 8–9 of FASB ASC 946-210-50, nonregistered investment partnerships that own interests in another investment partnership¹⁰ (investee fund) are required to disclose the

¹⁰ Such investment partnerships include, but are not limited to, investment partnerships, funds of funds, special purpose vehicles, disregarded entities, and limited liability companies.

investment partnership's proportional share of any underlying investment owned (either directly or through an investee fund) in any issuer that exceeds 5 percent of the reporting investment partnership's net assets at the reporting date. If the nonregistered investment partnership owns an interest in an investee fund that constitutes less than 5 percent of the nonregistered investment partnership's net assets, should the reporting investment partnership apply the guidance in paragraphs 8–9 of FASB ASC 946-210-50?

Reply—Yes. Even though the amount of the investment in the investee fund does not exceed 5 percent of the reporting investment partnership's net assets, the reporting investment partnership's proportional share of the investee fund's investments in an individual issuer may nonetheless exceed 5 percent of the reporting investment partnership's net assets because an investee fund may have issued debt (recourse or nonrecourse) to purchase investments or may have significant short positions or other liabilities. Paragraphs 8–9 of FASB ASC 946-210-50 do not establish any minimum investment size below which a reporting investment company need not determine its proportional share of an investment owned by an individual investee. Rather, paragraph 9 states that if such proportional share “of *any* investment owned by any individual investee exceeds 5 percent of the reporting investment company's net assets at the reporting date, each such investment shall be named and categorized” (*emphasis added*). The intent of the disclosure of positions exceeding 5 percent of net assets, as documented in paragraph .18 of Statement of Position 95-2, *Financial Reporting by Nonpublic Investment Partnerships* (AICPA, *Technical Practice Aids*, ACC. sec. 10,660 par. .18), in which this guidance originally appears, and paragraph 7.17 of the guide, is to “enable users to make their decisions focusing on the risk and opportunities associated with the type of investment, a geographical area, and industry by investee.” In situations when the information about the investee fund's portfolio is not available, that fact shall be disclosed, which is consistent with the guidance in FASB ASC 946-210-50-10.

[Issue Date: July 2009.]

.31 The Nonregistered Investment Partnership's Method for Calculating Its Proportional Share of Any Investments Owned by an Investee Fund in Applying the “5 Percent Test” Described in TIS Section 6910.30

Inquiry—What method should a nonregistered reporting investment partnership (as defined in the AICPA Audit and Accounting Guide *Investment Companies*) use to calculate its proportional share of any investments owned by an investee fund in applying the “5 percent test” described in TIS section 6910.30, “Disclosure Requirements of Investments for Nonregistered Investment Partnerships When Their Interest in an Investee Fund Constitutes Less Than 5 Percent of the Nonregistered Investment Partnership's Net Assets,” and where should the disclosure be located within the financial statements?

Reply—The reporting investment partnership should calculate its proportional share of any investments owned by the investee fund as its percentage ownership of the investee fund. Additionally, consistent with the provisions related to direct investments, indirect long and short positions of the same issuer held by the investee fund should not be netted. The disclosure of investments in issuers exceeding 5 percent of reporting investment partnership net assets should be made either on the face of the (condensed) schedule of investments or within the financial statement footnotes.

[Issue Date: July 2009.]

.32 Additional Financial Statement Disclosures for Nonregistered Investment Partnerships When the Partnership Has Provided Guarantees Related to the Investee Fund's Debt

Inquiry—What additional disclosures should a nonregistered reporting investment partnership (as defined in the AICPA Audit and Accounting Guide *Investment Companies*) consider within the financial statements when the reporting investment partnership has provided guarantees related to the investee fund's debt (also see TIS section 6910.30)?

Reply—In addition to considering the recognition provisions described in FASB ASC 460-10-50, the reporting investment partnership should further disclose any guarantees it has provided on investee fund debt even though the risk of loss may be remote. These disclosure requirements are described in FASB ASC 460-10-50 and FASB ASC 946-20-50 and include the following:

- Loss contingencies, such as guarantees of indebtedness of others, including indirect guarantees of indebtedness of others and the nature and amount of the guarantee
- Guarantor's obligation, including the nature of the guarantee, the approximate term of the guarantee, the primary reasons for providing the guarantees, and the events or circumstances that would require the guarantor to perform under the guarantee

[Issue Date: July 2009; Revised, April 2014, to reflect conforming changes necessary due to revisions to FASB ASC.]

.33 Certain Financial Reporting, Disclosure, Regulatory, and Tax Considerations When Preparing Financial Statements of Investment Companies Involved in a Business Combination

Inquiry—FASB ASC 805-10-50 requires the following, among other things, when a transaction or other event meets the definition of a *business combination*:

- The identification of the acquiree
- Recognizing and measuring identifiable assets acquired and liabilities assumed, at the acquisition date, generally at their fair values
- Disclosure, by the acquirer, of information that enables users of its financial statements to evaluate the nature and financial effect of a business combination that occurs during the current reporting period

What are some of the financial reporting, disclosure, regulatory, and tax guidance that should be considered in preparing financial statements of investment companies involved in a business combination?

Reply—When investment companies engage in a business combination, shares of one company typically are exchanged for substantially all the shares or assets of another company (or companies). Most mergers of registered investment companies are structured as tax-free reorganizations. Following a business combination, portfolios of investment companies are often realigned, subject to tax limitations, to fit the objectives, strategies, and goals of the surviving company. Typically, shares of the acquiring fund are issued at an exchange ratio determined on the acquisition date, essentially equivalent to the acquiring fund's net asset value (NAV) per share divided by the NAV per share of the fund being acquired, both as calculated on the acquisition date. Adjusting the carrying amounts of assets and liabilities is usually unnecessary because virtually all assets of the combining investment companies (investments) are

stated at fair value, in accordance with FASB ASC 820, *Fair Value Measurement*, and liabilities are generally short-term so that their carrying values approximate their fair values.¹¹ However, conforming adjustments may be necessary when funds have different valuation policies (for example, valuing securities at the bid price versus the mean of the bid and asked price) in order to ensure that the exchange ratio is equitable to shareholders of both funds.

Only one of the combining companies can be the legal survivor. In certain instances, it may not be clear which of the two funds constitutes the acquirer for financial reporting purposes. Although the legal survivor would normally be considered the acquirer, continuity and dominance in one or more of the following areas might lead to a determination that the fund legally dissolved should be considered the acquirer for financial reporting purposes:

- Portfolio management
- Portfolio composition
- Investment objectives, policies, and restrictions
- Expense structures and expense ratios
- Asset size

A registration statement on Form N-14 is often filed in connection with a merger of management investment companies registered under the Investment Company Act of 1940 (the Act), or of business development companies as defined by the Act. Form N-14 is a proxy statement in that it solicits a vote from the (legally) acquired fund's shareholders to approve the transaction, and a prospectus, in that it registers the (legally) acquiring fund's shares that will be issued in the transaction. Form N-14 frequently requires the inclusion of pro forma financial statements reflecting the effect of the merger.

Tax implications must be considered and monitored carefully in the planning, execution, and postmerger stages of a business combination. The tax rules that must be considered include those related to the determination that the transaction is tax-free to the funds involved and their shareholders,¹² the qualification tests affecting regulated investment companies (RICs),¹³ and the accounting for tax attributes of specific accounts such as earnings and profits,¹⁴ capital loss carryforwards, and methods of tax accounting.¹⁵ Management may consider obtaining a private letter ruling from the IRS or an opinion of counsel on the tax-free treatment. Upon completion of the acquisition, the portfolio securities obtained from the acquiree generally should be monitored because substantial turnover of the acquiree's portfolio securities may jeopardize the tax-free status of the reorganization. There are important differences in the tax rules affecting business combinations of RICs and non-RIC investment companies.

Merger-related expenses (mainly legal, audit, proxy solicitation, and mailing costs) are addressed in the plan of reorganization and are often paid by the fund incurring the expense, although the adviser may waive or reimburse certain merger-related expenses. Numerous factors and circumstances should be considered in determining which entity bears merger-related expenses.

¹¹ If the carrying value of the acquired investment company's liabilities differs materially from fair value on the acquisition date, refer to FASB ASC 805-30-30-8 for guidance on recognition of the liabilities by the surviving entity.

¹² See Internal Revenue Code (IRC) Section 368(a) and IRS Notice 88-19.

¹³ See IRC Section 851.

¹⁴ See section 1.852-12(b) of Title 26, Internal Revenue, of U.S. *Code of Federal Regulations*.

¹⁵ See IRC Section 381.

In accordance with FASB ASC 805-10-25-23, acquisition related costs are accounted for as expenses in the periods in which the costs are incurred and the services are received, except that costs to issue equity securities are recognized in accordance with other applicable U.S. generally accepted accounting principles.

If the combination is a taxable reorganization, the fair value of the assets acquired on the date of the combination becomes the assets' new cost basis. For financial reporting purposes, assets acquired in a tax-free reorganization may be accounted for in the same manner as a taxable reorganization. However, investment companies carry substantially all their assets at fair value as an ongoing reporting practice and cost basis is principally used and presented solely for purposes of determining realized and unrealized gain and loss. Accordingly, an investment company, which is an acquirer in a business combination structured as a tax-free exchange of shares, may make an accounting policy election to carry forward the historical cost basis of the acquiree's investment securities for purposes of measuring realized and unrealized gain or loss for statement of operations presentation in order to more closely align the subsequent reporting of realized gains by the combined entity with tax-basis gains distributable to shareholders. The basis for such policy election should be disclosed in the notes to the financial statements, if material.

Instructions to Forms N-1A and N-2 state that, for registered investment companies, costs of purchases and proceeds from sales of portfolio securities that occurred in the effort to realign a combined fund's portfolio after a merger should be excluded in the portfolio turnover calculation. The amount of excluded purchases and sales should be disclosed in a note.¹⁶

FASB ASC 805-10-50-1 states that disclosures are required when business combinations occur during the reporting period or after the reporting date but before the financial statements are issued.

In accordance with FASB ASC 805-10-50, 805-20-50, and 805-30-50, disclosures for all business combinations should include a summary of the essential elements of the combination; that is, the name and description of the acquiree, the acquisition date, the percentage of voting equity interests acquired, the primary reasons for the combination and the manner in which control was obtained, the nature of the principal assets acquired, the number and fair value of shares issued by the acquiring company, and the exchange ratio. In addition, public business enterprises are required to disclose supplemental pro forma information consisting of the revenue and earnings of the combined entity for the current reporting period as though the acquisition date for all business combinations had been as of the beginning of the acquirer's annual reporting period.

Public business enterprises are also required to report, if practicable, the amounts of revenue and earnings of the acquiree since the acquisition date included in the combined entity's income statement for the reporting period. In many cases, investments acquired are absorbed into and managed as an integrated portfolio by an investment company upon completion of an acquisition; therefore, providing this information will not be practicable. That fact, along with an explanation of the circumstances, should be disclosed.

Because of the importance of investment company taxation to amounts distributable to shareholders, certain additional disclosures are recommended for combinations of investment companies, including the tax status and attributes of the merger. Additionally, if the merger is a tax-free exchange, separate disclosure of the amount of unrealized appreciation or depreciation and the

¹⁶ See Form N-1A, Item 13, Instruction 4(d)(iii) and Form N-2, Item 4, Instruction 17c.

amount of undistributed investment company income of the acquiree at the date of acquisition, if significant, may provide meaningful information about amounts transferred from the acquiree, which may be distributable by the combined fund in future periods.

See the following exhibits under “Illustrative Financial Statement Presentation for Tax-Free Business Combinations of Investment Companies” for an example of the calculation of an exchange ratio in an investment company merger, as well as merger-related financial statement disclosures.

Illustrative Financial Statement Presentation for Tax-Free Business Combinations of Investment Companies

The following financial statements and disclosures illustrate a tax-free business combination of an investment company. The illustrative notes are unique to a business combination. The exhibits assume that Fund B merges into Fund A as of the close of business on December 31, 20X4, and that both Fund A and Fund B have a January 31 fiscal year-end. Exhibit 1 presents the financial position of each fund immediately before the acquisition and of the combined fund immediately after the acquisition. Exhibit 2 presents the results of operations and changes in net assets of each fund for the 11-month fiscal period immediately before the acquisition, and the results of operations and summary changes in net assets information for the combined fund for the 1-month period subsequent to the acquisition. Exhibit 3 presents the statement of operations, statement of changes in net assets, and appropriate notes of the combined entity immediately after the acquisition. (The January 31, 20X5, statement of net assets of the combined entity is not presented as it will be identical in form to the December 31, 20X4, statement.)

Exhibit 1

Financial Position of Each Fund Immediately Before Acquisition

Statement of Net Assets December 31, 20X4

	<i>Fund A</i>	<i>Fund B</i>
Investments in securities, at fair value		
(Cost: Fund A—\$18,000,000		
Fund B—\$ 9,000,000)	\$20,000,000	\$10,000,000
Other assets	1,000,000	500,000
	<u>21,000,000</u>	<u>10,500,000</u>
Liabilities	1,000,000	500,000
Net assets	<u>\$20,000,000</u>	<u>\$10,000,000</u>
Shares outstanding	2,000,000	1,000,000
Net asset value per share	<u>\$ 10.00</u>	<u>\$ 10.00</u>

Calculation of Exchange Ratio:

Net assets of Fund B	\$10,000,000
Divided by Fund A net asset value per share	\$10.00
Fund A shares issuable	1,000,000
Fund B shares outstanding	1,000,000
Exchange ratio (Fund A shares issuable/Fund B shares outstanding)	1-for-1

Financial Position of Combined Entity Immediately After Acquisition
Statement of Net Assets
December 31, 20X4

Investments in securities, at fair value (Cost—\$27,000,000)		\$30,000,000
Other assets		1,500,000
		31,500,000
Liabilities		1,500,000
Net assets		\$30,000,000
Shares outstanding		3,000,000
Net asset value per share		\$10.00

Note: The individual components of net assets (paid-in capital, undistributed income and capital gains, and unrealized appreciation and depreciation) are not presented in this example but are similarly combined.

Exhibit 2

Statement of Operations
Eleven Months Ended December 31, 20X4

	<i>Fund A</i>	<i>Fund B</i>
Dividend and interest income	\$3,200,000	\$1,600,000
Management fee	100,000	50,000
Transfer agent fee	50,000	25,000
Other expenses	50,000	25,000
	200,000	100,000
Investment income—net	3,000,000	1,500,000
Realized and unrealized gain on investments		
Net realized gain on investments	1,000,000	500,000
Change in unrealized appreciation	1,000,000	500,000
Net realized and unrealized gain on investments	2,000,000	1,000,000
Net increase in net assets resulting from operations	\$5,000,000	\$2,500,000

**Statement of Changes in Net Assets
Eleven Months Ended December 31, 20X4**

	<i>Fund A</i>	<i>Fund B</i>
Increase (decrease) in net assets		
Operations		
Investment income—net	\$3,000,000	\$1,500,000
Net realized gain on investments	1,000,000	500,000
Change in unrealized appreciation	1,000,000	500,000
	5,000,000	2,500,000
Dividends to shareholders from		
Investment income—net	(3,000,000)	(1,500,000)
Net realized gain on investments	(1,000,000)	(500,000)
Capital shares transactions	2,000,000	250,000
Total increase	3,000,000	750,000
Net assets		
Beginning of year	17,000,000	9,250,000
End of year	\$20,000,000	\$10,000,000

**Statement of Operations of Combined Entity
Month Ended January 31, 20X5**

Dividend and interest income	\$ 400,000
Management fee	15,000
Transfer agent fee	5,000
Other expenses	5,000
	25,000
Investment income—net	\$ 375,000
Realized and unrealized gain on investments	
Net realized gains on investments	100,000
Change in unrealized appreciation	100,000
Net gain on investments	200,000
Net increase in net assets resulting from operations	\$ 575,000

**Other Changes in Net Assets Information
Month Ended January 31, 20X5**

- a) No dividends were paid during the month.
b) Capital shares transactions were as follows:

	<i>Shares</i>	<i>Amount</i>
Shares sold	20,000	\$200,000
Shares redeemed	(10,000)	(\$100,000)
	10,000	\$100,000

Exhibit 3**Statements of Operations and Changes in Net Assets of the Combined Entity Immediately After Acquisition****Fund A****Statement of Operations
Year Ended January 31, 20X5**

Dividend and interest income (\$3,200,000 + \$400,000)		\$3,600,000
Management fee (\$100,000 + \$15,000)	\$ 115,000	
Transfer agent fee (\$50,000 + \$5,000)	55,000	
Other expenses (\$50,000 + \$5,000)	<u>55,000</u>	
		<u>225,000</u>
Investment income—net		<u>3,375,000</u>
Realized and unrealized gain on investments		
Net realized gain on investments (\$1,000,000 + \$100,000)	1,100,000	
Change in unrealized appreciation (\$1,000,000 + \$100,000)	<u>1,100,000</u>	
Net gain on investments		<u>2,200,000</u>
Net increase in net assets resulting from operations		<u>\$5,575,000</u>

Fund A**Statement of Changes in Net Assets
Year Ended January 31, 20X5**

	<u>20X5</u>	<u>20X4</u>
Increase (decrease) in net assets		
Operations		
Investment income—net	\$3,375,000	\$2,400,000
Net realized gain on investments	1,100,000	700,000
Change in unrealized appreciation	<u>1,100,000</u>	<u>300,000</u>
	5,575,000	3,400,000
Dividends to shareholders from		
Investment income—net	(3,000,000)	(2,400,000)
Net realized gain on investments	(1,000,000)	(700,000)
Capital share transactions (Notes 6 and 7)	<u>12,100,000</u>	<u>1,100,000</u>
Total increase	13,675,000	1,400,000
Net assets		
Beginning of year	<u>17,000,000</u>	<u>15,600,000</u>
End of year	<u>\$30,675,000</u>	<u>\$17,000,000</u>

Notes to Financial Statements of the Combined Entity Immediately After Acquisition**Note 6—Acquisition of Fund B**

On December 31, 20X4, Fund A acquired all of the net assets of Fund B, an open-end investment company, pursuant to a plan of reorganization approved by Fund B shareholders on December 26, 20X4. The purpose of the transaction was to combine 2 funds managed by Investment Advisor C with comparable

investment objectives and strategies. The acquisition was accomplished by a tax-free exchange of 1 million shares of Fund A, valued at \$10 million, for 1 million shares of Fund B outstanding on December 31, 20X4. The investment portfolio of Fund B, with a fair value of \$10 million and identified cost of \$9 million at December 31, 20X4, was the principal asset acquired by Fund A. For financial reporting purposes, assets received and shares issued by Fund A were recorded at fair value; however, the cost basis of the investments received from Fund B was carried forward to align ongoing reporting of Fund A's realized and unrealized gains and losses with amounts distributable to shareholders for tax purposes.¹⁷ Immediately prior to the merger, the net assets of Fund A were \$20 million.

Note: The following paragraph is required for public business enterprises, as defined in the FASB ASC glossary, only. For purposes of this disclosure and consistent with FASB ASC 805-10-50-2(h), assume that, had the acquisition occurred February 1, 20X4, the beginning of Fund A's fiscal year, \$10,000 of the transfer agent fee and \$15,000 of other expenses—a total of \$25,000—would have been eliminated.

Assuming the acquisition had been completed on February 1, 20X4, the beginning of the annual reporting period of Fund A, Fund A's pro forma results of operations for the year ended January 31, 20X5,¹⁸ are as follows:

Net investment income	\$4,900,000 ¹⁹
Net gain (loss) on investments	\$3,200,000 ²⁰
Net increase (decrease) in net assets resulting from operations	\$8,100,000

Because the combined investment portfolios have been managed as a single integrated portfolio since the acquisition was completed, it is not practicable to separate the amounts of revenue and earnings of Fund B that have been included in Fund A's statement of operations since December 31, 20X4.

Note 7—Capital Share Transactions

As of January 31, 20X5, 100 million shares of \$1 par value capital stock were authorized. Transactions in capital stock were as follows:

	<i>Shares</i>		<i>Amount</i>	
	<i>20X5</i>	<i>20X4</i>	<i>20X5</i>	<i>20X4</i>
Shares sold	520,000	300,000	\$5,000,000	\$3,000,000
Shares issued in connection with acquisition of Fund B	1,000,000		10,000,000	

¹⁷ If material amounts of undistributed net investment income or undistributed realized gains are transferred to the acquirer (which the acquirer will be required to distribute), those amounts should also be disclosed. Material acquired loss carryovers should also be disclosed or cross-referenced to related income tax disclosures.

¹⁸ FASB ASC 805-10-50-2 states that, if comparative financial statements are presented, supplemental pro forma information should be presented as if the business combination had occurred as of the beginning of the comparable prior annual reporting period. Investment companies should base application of this provision on whether they are required to present comparative statements of operations in their financial statements. Typically, business development companies registered with the Securities and Exchange Commission are required to present comparative statements of operations, but other registered open-end and closed-end investment companies are not required to do so.

¹⁹ \$3,375,000 as reported, plus \$1,500,000 Fund B premerger, plus \$25,000 of pro-forma eliminated expenses.

²⁰ \$2,200,000 as reported plus \$1,000,000 Fund B premerger.

	Shares		Amount	
	20X5	20X4	20X5	20X4
Shares issued in reinvestment of dividends	300,000	250,000	3,000,000	2,400,000
	1,820,000	550,000	18,000,000	5,400,000
Shares redeemed	610,000	450,000	5,900,000	4,300,000
Net increase	1,210,000	100,000	\$12,100,000	\$1,100,000

[Issue Date: December 2009.]

.34 Application of the Notion of Value Maximization for Measuring Fair Value of Debt and Controlling Equity Positions

Inquiry—Private equity funds or business development companies (collectively, a fund) may hold a controlling interest in an investee company and hold both equity and debt instruments issued by the investee. From a business strategy perspective, in this circumstance, the fund's management generally views their investment in the debt and equity instruments as an aggregate position rather than as separate financial instruments. The fund's management rarely, if ever, exits an investment by selling an individual financial instrument (that is, debt separate from equity or vice versa); rather, the instruments are generally exited in their entirety as a group (and the debt is typically redeemed at the amount owed, which we will assume to be par). When a fund has a controlling²¹ interest in an investee and holds both debt and equity positions in that investee for which there are not observed trades,²² is it appropriate to apply the notion of value maximization discussed in paragraph BC49 of Accounting Standards Update (ASU) No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*, and, as a result, value the debt and equity positions together using an enterprise value approach?²³

Reply—This inquiry relates to the unit of account for investments within the scope of FASB ASC 946 and was discussed at a joint meeting between FASB and the International Accounting Standards Board during their deliberations of the fair value project.²⁴ Specifically, the boards considered whether to provide unit of account guidance for investments within the scope of FASB ASC 946. The boards concluded that unit of account guidance was outside the scope of the fair value project. However, the boards agreed to include language in paragraph BC49 of ASU No. 2011-04 that indicated that an entity assumes that

²¹ This question and answer does not address facts and circumstances in which an entity does not have a controlling financial interest in an investee company.

²² Observed trades would be an indicator that market participants may transact separately for the debt and equity; thus, further consideration of the facts and circumstances would be necessary to conclude whether the fair value maximization guidance is relevant. FASB ASC 820-10-35-41 indicates that "a quoted price in an active market provides the most reliable evidence of fair value and shall be used without adjustment to measure fair value whenever available."

²³ Such an approach might result in a fair value of the debt and equity positions that differs from the result from selling the debt and equity positions in separate transactions. See footnote 24 of this question and answer that references Agenda Paper 2E that includes an example that illustrates how fair value might differ.

²⁴ Refer to the International Accounting Standards Board (IASB)/FASB Agenda Paper 2E prepared for the October 2010 IASB/FASB joint meeting. (See www.ifs.org/Current-Projects/IASB-Projects/Fair-Value-Measurement/Summaries/Pages/IASB-October-2010.aspx.)

market participants seek to maximize the fair value of a financial or nonfinancial asset or to minimize the fair value of a financial or nonfinancial liability by acting in their economic best interest in a transaction to sell the asset or to transfer the liability in the principal (or most advantageous) market for the asset or liability. Such a transaction might involve grouping assets and liabilities in a way in which market participants would enter into a transaction, if the unit of account specified in other Topics does not prohibit that grouping.

This language provides fair value measurement guidance in situations when the unit of account is not specified. Because FASB ASC 946 does not specify the unit of account for measuring fair value, it might be appropriate to consider how fair value would be maximized, which may be in a transaction that involves both the debt and controlling equity position if this is how market participants would transact.²⁵ Consistent with the guidance in paragraph BC49 of ASU No. 2011-04, this transaction (and, thus, fair value) might be measured using an enterprise value approach measured in accordance with the guidance in FASB ASC 820 (that is, an exit price from the perspective of market participants under current conditions at the measurement date).

Because the enterprise value approach results in a fair value for the entire capital position (that is, both debt and equity), an allocation to the individual units of account would be necessary. FASB ASC 820 does not prescribe an allocation approach, but FASB ASC 820-10-35-18F discusses that a “reporting entity shall perform such allocations on a reasonable and consistent basis using a methodology appropriate in the circumstances.” Facts and circumstances, such as relevant characteristics of the debt and equity instruments, must be considered when making this allocation. Generally, the allocation method should be consistent with the overall valuation premise used to measure fair value.

[Issue Date: February 2013.]

.35 Assessing Control When Measuring Fair Value

Inquiry—Is it appropriate to aggregate positions across multiple reporting entities (multiple funds) to assess control²⁶ for purposes of whether a control premium might be appropriate in a fair value measurement, or does control have to reside in a single fund for the enterprise value approach to be acceptable? Also, is it appropriate to consider “club deals” in which a group of unrelated investors jointly make an investment when assessing control?

Reply—Control of an investee company may be achieved by virtue of a single fund holding a controlling financial interest, through multiple funds in the same fund complex²⁷ under common control being allocated financial interests in the investee company, or through “club deals” in which a group of unrelated investment managers jointly make controlling investments in a private company on behalf of funds they manage. For example, a single adviser may decide to make a controlling financial investment in an investee and then allocate that investment across multiple legal and reporting entities. Individually, no one entity may control the investee (this question and answer assumes

²⁵ This assessment would include a consideration of the entity’s prior history in selling similar investments. Consideration of specific terms of the instruments that are considered characteristics, as discussed in FASB ASC 820, is also necessary (for example, change in control provisions).

²⁶ This question and answer does not address consolidation matters. Control in this question and answer refers to the ability to cause a controlling financial interest in the investee to be sold.

²⁷ Fund complex refers to a group of funds managed by the same investment adviser.

this is the case); however, the entities in aggregate may have a controlling financial interest in the investee.

It is not consistent with the fair value measurement framework in FASB ASC 820 for a reporting entity to aggregate positions across multiple reporting entities (multiple related funds or unrelated club deals) to assess control²⁸ for purposes of whether a control premium might be appropriate in a fair value measurement. However, when determining the fair value of the position the reporting entity holds, that determination should consider whether other premiums and discounts (relative to the price of a noncontrolling interest) are appropriate. For example, observed transaction data for similar investments may indicate that market participants pay a premium multiple relative to the multiples observed for the guideline companies because some market participants place additional value on being part of the controlling group that has the right to determine the company's strategy.

A reporting entity should consider all available evidence about how a market participant would exit the investments (and the prices it would receive) in determining the principal (or most advantageous) market and whether premiums to noncontrolling interests are appropriate.

[Issue Date: February 2013.]

[The next page is 6471.]

²⁸ This is not consistent because it does not consider that, for example, kick-out rights may prevent a reporting entity from having unilateral control (even though the fund is part of a complex with the same adviser). Said another way, control is not a characteristic of the individual fund's investment in these assumed facts and circumstances.

Section 6930

Employee Benefit Plans

.01 When Does a Plan Have to File a Form 11-K?

Inquiry—When is a plan subject to the requirements of the Securities Act of 1933, thus requiring a Form 11-K filing under the Securities Exchange Act of 1934?

Reply—Section 3(a)(2) of the Securities Act of 1933 provides exemptions from registration requirements for defined benefit plans and defined contribution plans not involving the purchase of employer securities with employee contributions. All other plans are subject to the requirements, provided they are both voluntary and contributory. For further guidance, see the “Securities and Exchange Commission Reporting Requirements” section in chapter 12 of the AICPA Audit and Accounting Guide *Employee Benefit Plans*. Advice of ERISA counsel should be obtained to determine if the registration requirements apply to the plan.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.02 Defined Benefit Plan Measurement of a Life Insurance Policy

Inquiry—How should a defined benefit plan measure a cash value life insurance policy?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 715-30-35-60 indicates that for defined benefit plans, insurance contracts with insurance entities (other than those that are, in substance, annuities) should be accounted for as investments and measured at fair value.

FASB ASC 715-30-35-60 also states that for some contracts, the best available evidence of fair value may be contract value; if a contract has a determinable cash surrender value or conversion value, that is presumed to be its fair value.

[Issue Date: May 2010.]

[The next page is 6475.]

Section 6931

Financial Statement Reporting and Disclosure—Employee Benefit Plans

.01 Computation of Net Appreciation/Depreciation in Fair Value of Investments

Inquiry—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 960-30-45-2 requires the statement of changes in net assets available for benefits to include separate disclosure of the net appreciation (depreciation) in fair value for each significant class of investments. FASB ASC 962-205-45-7 requires the same disclosure for defined contribution plans and employee health and welfare benefit plans. How can this amount be computed?

Reply—FASB ASC 960-30-45-2 states that the net appreciation (depreciation) in the fair value of investments should include both realized and unrealized gains (losses). This amount may be computed by aggregating the realized and unrealized gains and losses for each individual security. However, this would be quite time-consuming if the plan has a large portfolio of investments. As an alternative, the following formula may be used to compute the net appreciation (depreciation) in the fair value of each type of investment:

Market value at 12/31/X1.....	\$ XXX
Total proceeds of assets sold in 20X2.....	<XX>
Add: Total cost of assets purchased in 20X2.....	XX
Market value at 12/31/X2.....	<XXX>
Net appreciation/depreciation in fair value of investments ...	<u>\$ XXX</u>

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.02 Benefits Payable to Terminated Participants of a Defined Contribution Plan

Inquiry—Should benefits payable to terminated participants of a defined contribution [such as profit sharing or 401(k)] plan be classified as a liability in the plan financial statements?

Reply—No. Classifying benefits payable to participants as a liability is inappropriate because, by definition, net assets available for benefits (the difference between plan assets and liabilities) represent benefits owed to all participants—both active and terminated. Therefore, only amounts owed to nonparticipants (that is, third parties) should be classified as liabilities.

However, benefits payable to terminated participants should be disclosed in accordance with FASB ASC 962-205-50-1, which states the following, in part:

The financial statements shall also disclose, if applicable,

- i. Amounts allocated to accounts of persons who have elected to withdraw from the plan but have not yet been paid. These amounts shall not be reported as a liability on the statement of net assets available for benefits in financial statements prepared in accordance with generally accepted

accounting principles (GAAP). A footnote to reconcile the audited financial statements to Form 5500 may be necessary to comply with the Employee Retirement Income Security Act.

[Amended, June 1995; Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126; Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC; Revised, April 2014, to reflect conforming changes necessary due to revisions to FASB ASC.]

.03 Should the Sale of Real Estate Investments Held by Employee Benefit Plans Be Treated as Discontinued Operations?

Inquiry—Many employee benefit plans invest directly in real estate (for example, a building) that generates rental income and operating expenses for the plan. Generally, these plans are defined benefit plans but certain defined contribution plans may also hold these investments.

The FASB ASC glossary provides that a *component of an entity* comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. A component of an entity may be a reportable segment or an operating segment, a reporting unit, a subsidiary, or an asset group.

FASB ASC 205-20-45-1 provides that the results of operations of a component of an entity that either has been disposed of or is classified as held for sale shall be reported in discontinued operations in accordance with FASB ASC 205-20-45-3 if both of the following are met:

- a. The operations and cash flows of the component have been (or will be) eliminated from the ongoing operations of the entity as a result of the disposal transaction and
- b. The entity will not have any significant continuing involvement in the operations of the component after the disposal transaction.

FASB ASC 205-20-45-3 states that in a period in which a component of an entity either has been disposed of or is classified as held for sale, the income statement of a business enterprise (or statement of activities of a not-for-profit entity) for current and prior periods shall report the results of operations of the component, including any gain or loss recognized in accordance with FASB ASC 360-10-35-40, in discontinued operations.

Because employee benefit plans are not specifically scoped out of FASB ASC 360, if an employee benefit plan invests in real estate that generates rental income and operating expenses for the plan and then sells that property, is the sale of the real estate investment considered a discontinued operation of the plan?

Reply—No. For many entities, an investment in real estate (such as a building) that generates rental income and operating expenses would meet the definition of a *component of an entity* (as defined in the FASB ASC glossary) and, therefore, any gains or losses relating to the disposal of that *component* would be reported in discontinued operations. However, employee benefit plan financial statements show financial status or net assets available for benefits and changes in financial status or net assets available for benefits. Because they do not show a statement of operations or activities, distinguishing between continuing and discontinued operations is not meaningful. Rather, real estate in an employee benefit plan should be treated as an investment carried at fair value and the related income/expenses and net appreciation/depreciation should be included in the statement of changes in financial status or statement

of changes in net assets available for benefits. No distinction should be made between continuing and discontinued operations.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.04 Depreciation of a Real Estate Investment Owned by a Defined Benefit Pension Plan

Inquiry—A defined benefit pension plan has invested in real estate which owns and receives rents from various stores in a shopping center. The financial statements include an expense for depreciation based on original cost. FASB ASC 960-325-35-1 requires that plan investments in real estate be presented at their fair value at the reporting date. Consequently, by providing for depreciation expense, the unrealized appreciation on this asset is increased.

Should depreciation expense be reflected for this plan investment?

Reply—No. Depreciation expense is normally an adjustment of the valuation of fixed assets reported at cost, in accordance with FASB ASC 960-360-35-1, which requires plan assets used in plan operations to be presented at cost less accumulated depreciation or amortization. Accordingly, since plan investments in real estate are to be reported at fair value, there is no requirement to provide for depreciation expense.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.05 Accounting and Disclosure Requirements for Single-Employer Employee Benefit Plans Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003

Inquiry—On December 8, 2003, the president signed into law the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the act) for employers that sponsor postretirement health care plans that provide prescription drug benefits. The act introduces a prescription drug benefit under Medicare (Medicare Part D) as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to Medicare Part D.1. FASB ASC 715-60 and FASB ASC 740-10 address the issue of whether an employer that provides postretirement prescription drug coverage should recognize the effects of the act on its accumulated postretirement benefit obligation (APBO) and net postretirement benefit costs and, if so, when and how to account for those effects. FASB ASC 715-60 and FASB ASC 740-10 say that the APBO and net periodic postretirement benefit costs should reflect the effects of the act. FASB ASC 715-60 and FASB ASC 740-10 do not address accounting for the subsidy by health and welfare benefit plans.

For a single-employer health and welfare benefit plan, should the effects of the plan sponsor's (employer's) Medicare prescription drug subsidy (Medicare subsidy) be taken into consideration when calculating the health and welfare plan's postretirement benefit obligation?

Reply—No, the effects of the employer's Medicare subsidy should not be reflected in the plan's obligations. The primary objective of the financial statements of a health and welfare benefit plan is to provide financial information that is useful in assessing the plan's present and future ability to pay its benefit obligations when due. The Medicare subsidy amount is paid to the plan sponsor and does not flow into the plan. The plan sponsor is not required to use the subsidy amount to fund the postretirement benefits and may use the subsidy for any valid business purpose. As a result, the Medicare subsidy does not reduce the amount of benefits that need to be covered by plan assets and

future employer contributions. Therefore, the APBO, without reduction for the Medicare subsidy, is a more meaningful measure of the benefits. Further, the information necessary to calculate the gross measure should be readily available for sponsors who are subject to income taxes, because those plan sponsors should maintain gross and net measures of the APBO in order to properly account for income taxes under FASB ASC 740.

Disclosures

The plan should disclose the following:

- a. The existence of the act
- b. The fact that the APBO and the changes in the benefit obligation do not reflect any amount associated with the Medicare subsidy because the plan is not directly entitled to the Medicare subsidy
- c. Until the plan sponsor (employer) is able to determine whether benefits provided by its plan are actuarially equivalent to Medicare Part D.1, that the employer is not able to determine whether the benefits provided by its plan are actuarially equivalent to Medicare Part D.1. If the plan sponsor (employer) has included the effects of the Medicare subsidy in measuring its APBO and changes in benefit obligation, the plan should disclose the fact that the amount of the APBO differs from that disclosed by the plan sponsor (employer) because the plan sponsor's amounts are net of the Medicare subsidy.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.06 Accounting and Disclosure Requirements for Multiemployer Employee Benefit Plans Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003

Inquiry—On December 8, 2003, the president signed into law the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the act) for employers that sponsor postretirement health care plans that provide prescription drug benefits. The act introduces a prescription drug benefit under Medicare (Medicare Part D) as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to Medicare Part D.1. FASB ASC 715-60 and FASB ASC 740-10 address the issue of whether an employer that provides postretirement prescription drug coverage should recognize the effects of the act on its APBO and net postretirement benefit costs and, if so, when and how to account for those effects. FASB ASC 715-60 and FASB ASC 740-10 say that the APBO and net periodic postretirement benefit costs should reflect the effects of the act. FASB ASC 715-60 and 740-10 do not address accounting for the subsidy by multiemployer health and welfare benefit plans or by the sponsors or participating employers of those plans.

For multiemployer health and welfare benefit plans, should the effects of the Medicare prescription drug subsidy (Medicare subsidy) be taken into consideration when calculating the health and welfare plan's postretirement benefit obligation?

Reply—Yes, the multiemployer plan's benefit obligations should be reduced by the effects of the Medicare subsidy because the multiemployer plan trust receives the subsidy amount directly and not the individual employers. Because the primary objective of the financial statements of a health and welfare benefit plan is to provide financial information that is useful in assessing the plan's present and future ability to pay its benefit obligations when due, and because

the Medicare subsidy amount flows into the multiemployer plan trust, the APBO net of the Medicare subsidy is a more meaningful measure of those benefits.

Disclosures

Until the multiemployer plan is able to determine whether benefits provided by its plan are at least actuarially equivalent to Medicare Part D.1, the plan should disclose the following in the notes to its financial statements:

- a. The existence of the act
- b. The fact that measures of the APBO and changes in the benefit obligation do not reflect any amount associated with the subsidy because the plan is unable to conclude whether the benefits provided by the plan are actuarially equivalent to Medicare Part D under the act.

If the multiemployer plan has included the effects of the Medicare subsidy in measuring its APBO and changes in the benefit obligation, the plan should disclose the following:

- a. The existence of the act
- b. The reduction in the APBO for the subsidy related to benefits attributed to past service
- c. The effect of the subsidy on the changes in the benefit obligation for the current period
- d. An explanation of any significant change in the benefit obligation or plan assets not otherwise apparent in the other disclosures
- e. The gross benefit payments (paid and expected, respectively) including prescription drug benefits, and separately the gross amount of the subsidy receipts (received and expected, respectively)

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.07 Financial Statement Presentation of Underwriting Deficits

Inquiry—The administrator of an employee health and welfare benefit plan has questioned an item on the plan’s statement of net assets available for benefits. The item appears in the liabilities section as follows:

Reserve for underwriting deficit—(Note 3) \$10,000

Note 3 reads as follows:

Reserve for underwriting deficit represents a liability with the XYZ Life Insurance Company for claims paid in excess of premiums during the current policy year. This liability will be applied to reduce any refunds which may accrue in the future. Such a refund was received during the current year.

The related debit to the credit setting up the liability was to “Underwriting Deficit,” and is included in health claims deductions in the “Statement of Changes in Net Assets Available for Benefits.”

The administrator takes the position that this item should be excluded entirely from the financial statements because:

1. The policy provides that any underwriting deficit in one policy year is not immediately recoverable by the insurance company but only recoverable against underwriting “gains” of succeeding years, if any.

2. Upon cancellation of the policy by the underwriter, the fund is relieved of any liability for any unrecovered underwriting deficit existing on date of cancellation.
3. Although there were usually underwriting “gains” in past years, there is no assurance that future underwriting “gains” will occur to permit recovery of the deficit.

Should the underwriting loss be reflected in the financial statements in the year in which it occurs?

Reply—Yes, if certain criteria are met. FASB ASC 965-30-25-5 states experience ratings determined by the insurance company or by estimates, may result in a premium deficit. Premium deficits should be included in the benefit obligations if (a) it is probable that the deficit will be applied against the amounts of future premiums or future experience-rating refunds and (b) the amount can be reasonably estimated. If no obligation is included for a premium deficit because either or both of the conditions are not met, or if an exposure to loss exists in excess of the amount accrued, disclosure of the premium deficit should be made if it is reasonably possible that a loss or an additional loss has been incurred. They should not be shown as liabilities on the plan’s statement of net assets available for benefits.

Considerations in determining whether it is probable that a premium deficit will be applied against future premiums or refunds include (a) the extent to which the insurance contract requires payment of such deficits and (b) the plan’s intention, if any, to transfer coverage to another insurance company.

[Amended, June 1995; Amended, June 2001; Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC; Revised, April 2014, to reflect conforming changes necessary due to revisions to FASB ASC.]

.08 Types of Investments Subject to FASB ASC 962

Inquiry—What types of investments are subject to the financial statement presentation and disclosure requirements of FASB ASC 962?

Reply—FASB ASC 946-210-45-10 refers to investment contracts as (a) a traditional or separate account guaranteed investment contract (GIC contract), (b) a bank investment contract (BIC contract), (c) a synthetic GIC contract composed of a wrapper contract and the underlying wrapped portfolio of individual investments, or (d) a contract with similar characteristics.

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), then there should be a trust declaration for that CCT, which would generally have audited financial statements.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.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 paragraphs 2–3 of FASB ASC 962-205-45 apply to a plan’s investment in a CCT, or master trust that holds fully benefit-responsive investment contracts?

Reply—Yes. Paragraphs 2–3 of FASB ASC 962-205-45 require the following presentation for fully benefit-responsive investment contracts:

The statement of net assets available for benefits of the plan shall present amounts for all of the following:

- a. Total assets
- b. Total liabilities
- c. Net assets reflecting all investments at fair value
- d. Net assets available for benefits.

The amount representing the difference between net assets reflecting all investments at fair value and net assets available for benefits 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.

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, stand-alone financial statements, and are considered investment companies subject to FASB ASC 946.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.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’s financial statements, the disclosures in FASB ASC 962-325-50-3?

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 FASB ASC 946-210-50-14.

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 paragraphs 2–3 of FASB ASC 962-205-45 related to the fully benefit-responsive investment contracts held by the master trust. These disclosures are necessary because, unlike a CCT (as discussed in section 6931.09), master trust financial statements are not required, and the related disclosure information would not be readily available.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.11 Fair Value Measurement Disclosures for Master Trusts

Inquiry—Employee benefit plans often hold investments under master trust arrangements. According to the Department of Labor's Form 5500 instructions, a *master trust* is a trust for which a regulated financial institution 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.

In a typical master trust arrangement, the plan does not hold units or shares of the master trust but has an undivided interest in the assets of the master trust. However, for participant directed defined contribution plans, the plan typically has a divided interest in the individual assets of the master trust based upon participant direction. The "Additional Financial Statement Disclosures" sections in chapters 2 and 3 of the AICPA Audit and Accounting Guide *Employee Benefit Plans* (guide) discusses the requirement for investments in master trusts to be shown as a single line item on the statement of net assets available for benefits; however, the plan does not "purchase" and "dispose" of its interest in the master trust but is allocated an interest once the plan sponsor chooses to transfer the plan's assets into the master trust. The guide also discusses the requirement for master trust investments to be shown by general type in the footnotes.

For employee benefit plan financial statements, are the disclosure requirements of FASB ASC 820-10-50 required for the plan's total interest in the master trust or the individual investments under the master trust arrangement?

Reply—The disclosures required by FASB ASC 820-10-50 are required for individual investments under a master trust arrangement and are not required for the plan's total interest in the master trust.

According to FASB ASC 820-10-50, for assets that are measured at fair value on a recurring basis in periods subsequent to initial recognition, the reporting entity shall disclose information that enables users of its financial statements to assess the valuation techniques and inputs used to develop those measurements, and for recurring fair value measurements using significant unobservable inputs (level 3), the effect of the measurements on earnings (or changes in net assets) for the period.

Because of the nature of the plan's ownership interest in the master trust—that is, the plan does not hold units or shares of a master trust—the disclosures in FASB ASC 820 should be presented for the underlying master trust investments.

Consideration should be given to combining, or reconciling, or both, the master trust FASB ASC 820 disclosures as described previously with the current master trust disclosures as described in chapters 2–3 of the guide.

[Issue Date: March 2009; Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC; Revised, April 2010.]

.12 Accounting and Disclosure Requirements for Health and Welfare Plans Related to the COBRA Premium Subsidy Included in the American Recovery and Reinvestment Act of 2009

Inquiry—On February 17, 2009, President Obama signed into law the American Recovery and Reinvestment Act of 2009 (Recovery Act), which imposes new temporary Consolidated Omnibus Budget Reconciliation Act (COBRA) rules for employers sponsoring group health plans. The Recovery Act reduced the amount to be paid by a former employee to 35 percent of the plan's average cost, with the remaining 65 percent of the cost to be covered by the federal government through a payroll tax credit to the employer (COBRA premium subsidy). The 65 percent COBRA premium subsidy applies to certain former employees who become eligible for, and who elect, COBRA coverage between February 17, 2009, and February 28, 2010. The maximum length of time the COBRA premium subsidy will be provided is 15 months.

How should the effects of the COBRA premium subsidy be reflected when calculating a health and welfare plan's postemployment benefit obligation?

Reply—When calculating a health and welfare plan's postemployment benefit obligation, the COBRA premium subsidy should be considered a replacement of a portion of the employee COBRA contribution and, therefore, should be recorded consistent with how employee contributions are currently required to be recorded.

FASB ASC 965, *Plan Accounting—Health and Welfare Benefit Plans*, provides that the postemployment benefit obligation recorded in a plan's financial statements should be measured in accordance with FASB ASC 712, *Compensation—Nonretirement Postemployment Benefits*, with disclosure of information about the former employee's relative share of the plan's estimated cost of providing postemployment benefits. FASB ASC 712 provides for benefits that do not vest or accumulate to be accounted for using the principles of FASB ASC 450, *Contingencies*. Application of FASB ASC 450 to COBRA benefits results in the accrual of a liability for the present value of future benefits to be provided by the employer to the former employees who are currently receiving COBRA benefits, offset by the present value of contributions to be received from the affected former employees.

Accordingly, the amount of the present value of the former employee contributions, along with the present value of the COBRA premium subsidy, would have an offsetting effect on the COBRA liability when calculating the COBRA postemployment obligation to be included in the plan's financial statements. Also, disclosure should be made about the portion of the plan's estimated cost that is funded by the COBRA premium subsidy.

The accounting for the COBRA subsidy in a single employer plan differs from the accounting for the Medicare Part D subsidy for prescription drugs in section 6931.05, "Accounting and Disclosure Requirements for Single-Employer

Employee Benefit Plans Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003,” because under the Medicare Part D subsidy, the employer is not obligated to transfer the subsidy to the plan, whereas with the COBRA subsidy, the employer has already incurred the cost of providing COBRA benefits (either by payment of a premium to an insurance company or by paying future claims if self-insured) and has paid benefits prior to receiving the subsidy. The COBRA premium subsidy is intended to subsidize the former employee’s cost, not the employer’s cost. Further, the COBRA premium subsidy is temporary, but the Medicare Part D subsidy can be anticipated for many years into the future. Actuarial valuations of postretirement medical plans make projections for 50 years or more. The COBRA subsidy has a maximum projection period of 15 months following the expiration date of the Recovery Act provision. Changing the measurement of the COBRA post-retirement obligation for the periods impacted by the COBRA premium subsidy would affect comparability of the financial statements.

[Issue Date: July 2010.]

.13 Health and Welfare Plan Accounting for Reimbursements Received Under the Patient Protection and Affordable Care Act’s Early Retiree Reinsurance Program When the Reimbursement Is Not Remitted to the Trust

Inquiry—The Early Retiree Reinsurance Program (ERRP) was established by the Patient Protection and Affordable Care Act (PPACA). The PPACA was passed by Congress and signed into law in March 2010, providing for comprehensive health insurance reforms. Congress appropriated funding of \$5 billion for this temporary program to provide financial assistance to employers, unions, and state and local governments to help them maintain coverage for early retirees age 55 and older who are not yet eligible for Medicare, including their spouses, surviving spouses, and dependents. Employers could apply for the ERRP beginning June 29, 2010. The ERRP ceased accepting applications after May 5, 2011.

Employers may receive various notifications from the ERRP Center, including notification that the application was received, notification that the application was approved, and notification that the reimbursement request was approved. The notification indicating that the reimbursement request was approved will also include the amount of the reimbursement. Employers may be able to estimate the reimbursement amount when they submit their reimbursement request; however, realization of the reimbursement request is subject to approval, and approval is contingent upon the availability of funds in the ERRP.

If a reimbursement is received under the ERRP, the employer must use the proceeds to reduce (a) the employer’s health benefit premiums or costs; (b) plan participants’ health benefit premium contributions, copayments, deductibles, coinsurance, or other out-of-pocket costs or any combination of these costs; or (c) any combination of the costs specified in (a) and (b). Proceeds received pursuant to the ERRP may not be used as general revenue of the employer. Thus, to the extent that an employer decides to use the reimbursement for its own purposes, it may use the reimbursement only to offset increases in the employer’s health benefit premiums or costs. The ERRP states that it is expected that sponsors will continue to provide at least the same level of contribution to support the applicable plan as they did before the program.

Should the health and welfare plan’s financial statements reflect reimbursements that were not remitted to the trust?

(The following reply would be applicable to both single employer and multiemployer plans.)

Reply—Yes. If a reimbursement is received under the ERRP, the employer must use the proceeds to reduce (a) the employer’s health benefit premiums or costs; (b) plan participants’ health benefit premium contributions, copayments, deductibles, coinsurance, or other out-of-pocket costs or any combination of these costs; or (c) any combination of the costs specified in (a) and (b).

As stated in paragraph 4.13 of the Audit and Accounting Guide *Employee Benefit Plans*, plan transactions, including contributions, benefit payments, and expenses paid through the voluntary employee beneficiary association trust or otherwise, should be recorded in a plan’s financial statements and subject to audit procedures.

[Issue Date: December 2011.]

.14 Health and Welfare Plan Accounting for Reimbursements Received Under the PPACA’s ERRP Described in TIS Section 6931.13

Inquiry—How should the health and welfare plan’s financial statements reflect reimbursements received under the ERRP described in TIS section 6931.13, “Health and Welfare Plan Accounting for Reimbursements Received Under the Patient Protection and Affordable Care Act’s Early Retiree Reinsurance Program When the Reimbursement Is Not Remitted to the Trust?”

(The following reply would be applicable to both single employer and multiemployer plans.)

Reply—Reimbursements from the ERRP, although used to reduce contributions from the employer or participants (or a combination of both), are considered contributions from other identified sources. FASB ASC 965 states that the statement of changes in net assets available for benefits shall be presented in enough detail to identify the significant changes during the year, and it includes the following types of contributions:

- a. Contributions from employers segregated between cash and noncash contributions
- b. The nature of noncash contributions described either parenthetically or in a note
- c. Contributions from participants, including those collected and remitted by the sponsor
- d. Contributions from other identified sources (for example, state subsidies or federal grants)

[Issue Date: December 2011.]

.15 Health and Welfare Plan Accounting for Reimbursements Applied for Prior to Year-End but Not Approved Until After Year-End Under the PPACA’s ERRP Described in TIS Section 6931.13

Inquiry—Should the health and welfare plan’s financial statements record a receivable if the employer filed for reimbursement under the ERRP described in TIS section 6931.13 prior to year-end but did not receive approval of the reimbursement request until after year-end?

(The following reply would be applicable to both single employer and multiemployer plans.)

Reply—No, the health and welfare plan’s financial statements should not reflect a receivable until an approval of the reimbursement is received. As noted

in TIS section 6931.13, the notification indicating approval of the reimbursement request will also include the amount of the reimbursement. Employers may be able to estimate the reimbursement amount when they submit their reimbursement request; however, realization of the reimbursement request is subject to approval, and approval is contingent upon the availability of funds in the ERRP.

The FASB ASC glossary defines a *contribution receivable* as the amounts due, as of the date of the financial statements, to the plan from employers, participants, and other sources of funding (for example, state subsidies or federal grants). They include amounts due pursuant to firm commitments, as well as legal or contractual requirements. Receipt of approval of the reimbursement request will generally constitute the commitment by the ERRP. If the reimbursement request approval notification is received after the plan's year-end, the reimbursement should not be accrued. Further, if an employer applies for additional reimbursements that are not approved prior to the plan's year-end, these amounts should not be accrued because approval of these additional reimbursements are contingent upon the availability of funds in the ERRP.

The plan may consider disclosing the following (also see the disclosures in TIS section 6931.17, "Health and Welfare Plan Disclosures About the PPACA's ERRP Described in TIS Section 6931.13"):

- a. The existence of the PPACA and the ERRP
- b. The fact that the employer applied for reimbursements from the ERRP prior to year-end

In addition, the plan should consider whether subsequent event disclosures are required if the reimbursement amounts are received after year-end (see FASB ASC 855, *Subsequent Events*).

[Issue Date: December 2011.]

.16 Accounting for the Effects of the Reimbursement on the Health and Welfare Plan's Postretirement Benefit Obligations Under the PPACA's ERRP Described in TIS Section 6931.13

Inquiry—How do the reimbursed amounts from the ERRP described in TIS section 6931.13 affect the health and welfare plan's postretirement benefit obligation?

(The following reply would be applicable to both single employer and multiemployer plans.)

Reply—Consulting with the plan actuary is important in determining the effect of the reimbursed amounts on the health and welfare plan's postretirement benefit obligation. FASB ASC 965 provides that the postretirement benefit obligation recorded in a plan's financial statements should be measured in accordance with FASB ASC 715, *Compensation—Retirement Benefits*, which provides that measurement of the expected postretirement benefit obligation is based on the expected amount and timing of future benefits, taking into consideration the expected future cost of providing the benefits and the extent to which those costs are shared by the employer; the employee (including consideration of contributions required during the employee's active service period and following retirement, deductibles, coinsurance provisions, and so forth); or others (such as through governmental programs).

[Issue Date: December 2011.]

.17 Health and Welfare Plan Disclosures About the PPACA's ERRP Described in TIS Section 6931.13

Inquiry—What disclosures might a health and welfare plan consider including in its financial statements relating to the ERRP described in TIS section 6931.13?

(The following reply would be applicable to both single employer and multiemployer plans.)

Reply—The plan might consider including the following disclosures:

- a. The existence of the PPACA and the ERRP
- b. Whether the plan has applied for reimbursements that have not been received and the amount of the reimbursements requested, if known
- c. The amount of reimbursements received by the plan
- d. How the reimbursements were used or are intended to be used
- e. How the reimbursements are reflected in the plan's financial statements

The following is an illustrative disclosure for a plan that applied for reimbursement under the ERRP in 2010, and the reimbursement request was approved in 2011:

The Early Retiree Reinsurance Program (ERRP) was established by the Patient Protection and Affordable Care Act. Congress appropriated funding of \$5 billion for this temporary ERRP to provide financial assistance to employers, unions, and state and local governments to help them maintain coverage for early retirees age 55 and older who are not yet eligible for Medicare, including their spouses, surviving spouses, and dependents. The ERRP ceased accepting applications after May 5, 2011.

The plan sponsor submitted an application for reimbursement from the ERRP in 2010 and received reimbursements of \$XX in 2011. These reimbursements are not reflected in the accompanying 2010 financial statements because the reimbursement request was not approved until 2011. Reimbursements will be used to offset increases in the employer's costs of maintaining health care coverage.

[Issue Date: December 2011.]

[The next page is 6491.]

Section 6932

ERISA Reporting and Disclosures

.01 Employee Benefit Security Administration Guidance on Insurance Company Demutualizations

Inquiry—During the past few years there have been a number of insurance companies that have demutualized, resulting in the insurance contract policyholder receiving demutualization proceeds. What alternatives are available with respect to receipt by policyholders of demutualization proceeds?

Reply—On February 15, 2001, Employee Benefit Security Administration (EBSA) issued a letter regarding alternatives available under the trust requirement of Title I of ERISA with respect to receipt by policyholders of demutualization proceeds belonging to an ERISA-covered plan in connection with the proposed plan of demutualization of an insurance company (the company). In its letter, the DOL noted that the application of ERISA's trust requirements would depend on whether demutualization proceeds received by a policyholder constitute plan assets. The DOL stated that, in the case of an unfunded or insured welfare plan in which participants pay a portion of the premiums, the portion of the demutualization proceeds attributable to participant contributions must be treated as plan assets. In the case of a pension plan, or where any type of plan or trust is the policyholder or where the policy is paid for out of trust assets, the DOL stated that all of the proceeds received by the policyholder in connection with the demutualization would constitute plan assets. Auditors should take care to identify those plans with contracts with insurance companies that have demutualized and ensure that the proceeds are properly recorded as plan assets. Plan sponsors may not be familiar with EBSA's letter regarding alternatives available with respect to receipt by policyholders of demutualization proceeds. In addition, it has been noted that demutualization proceeds are often deposited into a separate account or trust and may be overlooked in financial reporting for the plan.

.02 When Should Participant Contributions Be Considered Late Remittances?

Inquiry—For purposes of reporting on line 4(a) of Form 5500, from what date should remittances be deemed late; the date the remittances can reasonably be made, or 15 days after the end of the month in which the funds were withheld?

Reply—Participant contributions are required to be remitted as soon as they can reasonably be segregated from an employer's general assets. DOL Regulation 2510.3-102 states that an employer is required to segregate employee contributions from its general assets as soon as practicable, but in no event more than (a) 90 days after the contributions are paid by employees or withheld from their wages for a welfare benefit plan or (b) the 15th business day following the end of the month in which amounts are contributed by employees or withheld from their wages for a pension benefit plan. The definition of what constitutes as soon as practicable will vary from plan sponsor to plan sponsor. DOL Field Assistance Bulletin 2003-2 states that the process for segregating participant contributions must be taken into account when determining when participant contributions can be reasonably segregated from the employer's general assets. Plan sponsors, under their fiduciary responsibility, also should consider how costly to the plan a more expeditious process

would be. Those costs should be balanced against any additional income and security the plan and plan participants would realize from a faster system.

In considering whether remittances are delinquent, an understanding of the plan sponsor's process to segregate and remit contributions should be obtained. If the plan has several entities and payroll processes that comprise the remittance process, their timeframe to remit may be longer than a plan sponsor with only one location and one payroll system. Similarly, facts and circumstances that occur in the year (for example, a change in payroll processing or new service provider) may change the timeframe in which remittances are made. If a process has been established and the plan sponsor deviates from such a process, an understanding of the reasons why the remittance of the contributions for the period or periods did not comply with the established process should be obtained. Based on that understanding, a determination as to whether the plan sponsor remitted contributions as soon as it could reasonably segregate them from general assets should be made. The plan sponsor also may want to consult ERISA counsel in making that determination. In any case, any contributions remitted after the 15th business day after the end of the month in which the funds were withheld should be reported on Form 5500, Schedule H, Line 4a.

.03 How Should Delinquent Loan Remittances Be Reported on the Form 5500?

Inquiry—How should delinquent loan remittances be reported on the Form 5500?

Reply—In Advisory Opinion 2002-02A, the DOL stated that 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 participant contribution regulation for purposes of determining when such repayments become assets of the plan. Delinquent forwarding of participant loan repayments is eligible for correction under the Voluntary Filer Correction Program and PTE 2002-51 on terms similar to those that apply to delinquent participant contributions. 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 independent public accountant disclosure requirements to the loan repayments as apply to delinquent transmittals of participant contributions. If the plan does not report delinquent loan remittances on Line 4a, those payments should be reported on Schedule G.

.04 How Should Participant Loans Be Reported on Defined Contribution Plan Master Trust Form 5500 Filings?

Inquiry—How should participant loans be reported on defined contribution plan master trust Form 5500 filings?

Reply—The face of Schedule H Form 5500 instructs master trust investment accounts not to complete line 1c(8) participant loans. In practice, many master trusts for defined contribution plans include participant loans as part of their master trust agreement. However, even though these loans may be included as part of the master trust agreement, the Form 5500 instructs the preparer not to include them as part of the master trust assets. Thus, the plan's financial statements would require a supplemental schedule, Schedule of Assets (Held at End of Year), to report participant loans as a nonmaster trust

investment. The plan's Form 5500 filing would require the participant loans to be broken out separately from the investment in the master trust on the Schedule H.

.05 How Should Investments in Brokerage Accounts Be Reported in the Financial Statements and Form 5500?

Inquiry—Investments in individually directed brokerage accounts can be aggregated in a single line item on the Form 5500. Can they be listed as a single line item on the supplemental schedule of assets, or do the individual underlying investments have to be listed?

Reply—As described in the Form 5500 instructions, individually directed brokerage accounts may be aggregated in a single line item on the statement of net assets available for benefits and on the supplemental schedule of assets, provided the investments are not loans, partnership or joint-venture interests, real property, employer securities, or investments that could result in a loss in excess of the account balance of the participant or beneficiary who directed the transaction. However, the notes to the financial statements must disclose any individual investment that is over 5 percent of net assets available for benefits at the end of the year. In addition, the total investment income or loss for individually directed brokerage accounts may be aggregated in a single line item in the Form 5500; however, the financial statements must separate interest and dividends from net appreciation (depreciation) in fair value on the statement of changes in net assets available for benefits and disclose net appreciation (depreciation) by type of investment in the notes to the financial statements.

.06 Do All Types of Reconciling Items Between the Financial Statements and the Form 5500 Require a Reconciling Footnote in the Financial Statements?

Inquiry—Does ERISA require a footnote to the audited financial statements reconciling amounts reported in the Statement of Changes in Net Assets Available for Benefits to those reported in the Form 5500 for differences in the way income and expense amounts are classified in the two reports?

Reply—Generally, a reconciliation would be required for differences occurring because certain income and expense items are netted against each other and disclosed as one amount in one statement and reported separately in the other (for example, the amount reported as contributions in the financial statements may differ from that reported in the 5500 because excess contributions are recorded net on the financial statements but gross on the Form 5500). However, frequently the classification of line items comprising certain income and expense items (for example, investments and investment interest, dividends, gains and losses, and self-directed brokerage accounts) reported in the Form 5500 differ from the classifications shown in the financial statements. In such situations, a reconciling footnote may not be necessary.

For further guidance, see the “Reports Issued Prior to Form 5500 Filing” section in chapter 12 of the AICPA Audit and Accounting Guide *Employee Benefit Plans*.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.07 What is the Requirement to Report Certain Transactions Under Individual Account Plans on the Schedule of Reportable Transactions?

Inquiry—Under Form 5500 (Schedule H, Part IV, line 4j), there is a special rule whereby transactions under an individual account plan that a participant directs should not be taken into account for purposes of preparing the Schedule

of Reportable Transactions. What about situations where an individual account plan is participant-directed but has certain transactions that appear to be nonparticipant-directed (for example, pass-through account for contributions)?

Reply—If the plan is an individual account plan and the overall structure of the plan is participant-directed, pass-through account transactions would not be required to be included on the Schedule of Reportable Transactions. Another example would be a participant-directed individual account plan that liquidates its investment options as a result of a plan termination, merger, or change in service provider. Often such changes result in the plan sponsor directing the plan trustee to liquidate the current balance in the participant-directed investment options into a short-term fund before the transfer to new investment options. Such transactions would not be required to be included on the Schedule of Reportable Transactions.

.08 Is Noninterest-Bearing Cash an Asset on the Supplemental Schedule of Assets (Held at End of Year)?

Inquiry—Should noninterest-bearing cash be included as an asset on the supplemental Schedule of Assets (Held at End of Year)?

Reply—Generally, only assets held for investment are included on the supplemental Schedule of Assets (Held at End of Year); thus noninterest-bearing cash would not be included. Interest-bearing cash accounts would be included on the supplemental schedule.

.09 Is Netting of Investments on the Schedule of Assets (Held at End of Year) Permitted?

Inquiry—Can immaterial investments be netted together as “other” on the supplemental Schedule of Assets (Held at End of Year)?

Reply—No, each investment must be separately listed on the supplemental schedule.

.10 Is the Schedule of 5 Percent Reportable Transactions Required for Defined Benefit Plans?

Inquiry—Is the schedule of 5 percent reportable transactions required for defined benefit plans?

Reply—As defined benefit plans generally are not participant-directed, the reportable transactions schedule would be required.

[The next page is 6501.]

Section 6933

Auditing Employee Benefit Plans

.01 Initial Audit of a Plan

Inquiry—In an initial audit of a plan that has been in existence for several years, to what extent does the auditor need to audit information from previous years?

Reply—In an initial audit of a plan which has been in existence in previous years, ERISA requires that the audited financial reports contain a comparative Statement of Net Assets Available for Benefits and, as such, there should be some consideration of the accumulation of data from prior years, and the effect on current year balances. The auditor can choose to compile, review, or audit the opening Statement of Net Assets Available for Benefits. It is important to note, however, that if the opening Statement of Net Assets Available for Benefits is not audited, the auditor must satisfy himself or herself as to the reasonableness of the amounts reported in that statement because material errors in that information may materially impact the Statement of Changes in Net Assets Available for Benefits under audit.

The auditor should apply appropriate audit tests and procedures to the opening balances in the Statement of Net Assets Available for Benefits to determine that those balances are not materially misstated. The auditor should make inquiries of the plan's management and outside service organizations, as applicable, regarding the plan's operations during those earlier years. The auditor also may wish to obtain relevant information (for example, trust statements, recordkeeping reports, reconciliations, minutes of meetings, and service auditors' reports issued under Statement on Standards for Attestation Engagements [SSAE] No. 16, *Reporting on Controls at a Service Organization* [AICPA, *Professional Standards*, AT sec. 801], or Statement on Auditing Standards No. 70, *Service Organizations*, as amended (now superseded),¹ for earlier years, as applicable, to determine whether there appears to be any errors during those years that could have a material effect on current year balances. Further, the auditor should gain an understanding of the accounting practices that were followed in prior years to determine that they have been consistently applied in the current year. Based on the results of the auditor's inquiries, review of relevant information, and evidence gathered during the current year audit, the auditor would determine the necessity of performing additional substantive procedures (including detailed testing or substantive analytics) on earlier years' balances.

See the "Initial Audits of Plans" sections in chapters 5 and 13 of the AICPA Audit and Accounting Guide *Employee Benefit Plans*.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature; Revised, August 2011, to reflect

¹ Prior to the issuance of Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801), the requirements and guidance for service auditors reporting on controls at a service organization were contained in Statement on Auditing Standards No. 70, *Service Organizations*, as amended (now superseded). SSAE No. 16 is effective for service auditor's reports for periods ending on or after June 15, 2011, with earlier implementation permitted. [Footnote added, August 2011, to reflect conforming changes necessary due to the issuance of SSAE No. 16. Footnote revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

conforming changes necessary due to the issuance of SSAE No. 16; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.02 Investment Allocations Testing in an Electronic Environment

Inquiry—How should the auditor test for proper investment allocation in situations where changes may be made by participants electronically, via phone or internet, on a daily basis?

Reply—Where participants make contributions or investment elections by telephone or electronic means (such as the Internet), the auditor should consider confirming the contribution percentage, source, and investment election directly with the participant, or compare that information to detail of the transaction (for example, a copy of the transaction confirmation) if maintained by the plan sponsor or service organization. Alternatively, if a service organization has a type 2 SSAE No. 16 report that provides evidence that controls over the investment allocation process were operating effectively, the auditor may place some reliance on those controls to assess the risks of material misstatement at less than maximum and thereby reduce (not eliminate) substantive testing.

See the “General Auditing Procedures” section in chapter 7 of the AICPA Audit and Accounting Guide *Employee Benefit Plans*.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature; Revised, August 2011, to reflect conforming changes necessary due to the issuance of SSAE No. 16.]

.03 Auditor’s Responsibility for Detecting Nonexempt Transactions

Inquiry—What is the auditor’s responsibility for detecting nonexempt transactions resulting from participant contributions that are not remitted to the plan within the guidelines established by DOL regulations?

Reply—An audit performed in accordance with generally accepted auditing standards (GAAS) cannot be expected to provide assurance that all party-in-interest transactions will be discovered. Nevertheless, during the audit the auditor should be aware of the possible existence of party-in-interest transactions. During the planning phase of the audit, the auditor should inquire about the existence of any party-in-interest or nonexempt transactions. If any issues relating to late remittances are brought to the auditor’s attention, the auditor may consider obtaining a schedule of employee contributions detailing payroll withholding date and date of deposit to the plan. A sample of deposits can then be traced to the supporting payroll register and wire transfer advice or check. Further, the auditor should have the client include in the management representation letter a representation that there are no party-in-interest transactions that have not been disclosed in the supplemental schedules.

.04 Nonexempt Transactions

Inquiry—If a nonexempt transaction related to the preceding is noted, is materiality of the transaction taken into consideration in determining the need for the supplemental schedule of nonexempt transactions?

Reply—There is no materiality threshold for the inclusion on the supplemental schedule. All known events must be reported.

.05 Testing of Plan Qualification Tests Prepared by TPA

Inquiry—What responsibility does the auditor have in testing plan qualification tests (for example, ACP and ADP) prepared by a client’s third-party administrator?

Reply—An audit in accordance with generally accepted auditing standards (GAAS) is not designed to ensure compliance with all legislative and regulatory provisions. However, plans must be designed and comply with certain operating tests to maintain their qualified status. If specific information comes to the auditor's attention that provides evidence concerning the existence of possible violations affecting the financial statements, the auditor should apply auditing procedures specifically directed to ascertaining whether a violation has occurred. The auditor is also expected to inquire of, and obtain representation from, management concerning compliance with laws and regulations and the prevention of violations that may cause disqualification.

.06 Audit Procedures for Plan Mergers

Inquiry—What audit procedures should be performed for material plan mergers into a plan? What audit procedures are required when the prior plan was audited? What if the prior plan was never audited?

Reply—If the prior plan was audited, the auditor should obtain the audited financial statements to ensure that the balance transferred from the prior plan reconciles to the balance that is reflected on the new plan's financial statements. Also, the auditor will generally perform procedures to ensure that participant accounts were properly set up under the new plan. If the prior plan was not audited, the auditor will generally perform audit procedures to determine that the equity that is transferred from the prior plan is reasonable based upon an analysis of historical activity. (Other audit procedures relating to plan mergers can be found in the "Plan Mergers" section in chapter 12 of AICPA Audit and Accounting Guide *Employee Benefit Plans*.)

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.07 Audit Requirements for Remaining Portion of a Split Plan

Inquiry—For the year ended December 31, 20X1, an audit was performed for AB Plan with more than 100 participants that covered two related companies (Company A and Company B). In July 20X2, Company A was sold, and the plan assets related to those participants were transferred to a new unrelated plan (Plan C). What are the audit requirements for the remaining portion of the AB Plan which, as of July 20X2, covers only employees at Company B and had fewer than 100 participants?

Reply—Audit for the AB Plan is required for the year ended December 31, 20X2, because the plan had over 100 participants at the beginning of the plan year. For the year ended December 31, 20X3, an audit of plan AB may not be required if the number of participants at January 1, 20X3, is under 100 and the plan meets the criteria for the Small Pension Plan Audit Waiver.

.08 Audit Requirements for Frozen and Terminated Plans

Inquiry—Are frozen and terminated plans that are still paying out benefits required to have an audit?

Reply—An audit is required if the plan has more than 100 participants at the beginning of the plan year. Chapter 5 of the AICPA Audit and Accounting Guide *Employee Benefit Plans*, provides guidance with regard to the definition of "participants." When a plan has been terminated or frozen, complete and prominent disclosure of the relevant circumstances is essential in all subsequent financial statements issued by the plan. If the number of participants falls below 100, auditors should consider whether the plan meets the criteria for the Small Pension Plan Audit Waiver.

For further guidance, see the “Terminating Plans” section in chapter 2 and the “Small Pension Plan Audit Waiver (SPPAW) Summary” flowchart in chapter 5 of the guide.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.09 Audit Procedures When Plan Operates in a Decentralized Environment

Inquiry—When a plan operates in a decentralized environment, what additional audit procedures should be considered?

Reply—The auditor should consider the controls at each decentralized location as well as the overall mitigating controls that may be performed on a centralized basis. Taking into consideration the materiality of the activity at each decentralized location, the auditor may choose to expand participant level and substantive testing to incorporate these decentralized locations.

.10 Is the Master Trust Required to Be Audited?

Inquiry—Is the master trust required to be audited?

Reply—While the DOL does not require the master trust to be audited, the plan administrator normally engages an auditor to report only on the financial statements of the individual plans. If the master trust is not audited, the plan auditor should perform those procedures necessary to obtain sufficient audit evidence to support the financial statement assertions as to the plan’s investments or qualify or disclaim his or her report.

[The next page is 6511.]

Section 6934

Limited-Scope Audits—Employee Benefit Plans

.01 Certifications by “Agent of”

Inquiry—Can the plan sponsor accept a certification from the plan’s recordkeeper if the recordkeeper certifies the investment information to be complete and accurate on behalf of the plan’s trustee/custodian as “agent for”?

Reply—According to the Department of Labor, such a certification generally would be acceptable if there is in fact a legal arrangement between the trustee and the recordkeeper to be able to provide the certification on the trustee’s behalf. Care should be taken by the plan administrator to obtain such legal documentation. Additionally the plan auditor might consider adding wording to the standard limited-scope report to include reference to such an arrangement. Sample language might include the following: “... any auditing procedures with respect to the information described in Note X, which was certified by ABC, Inc., the recordkeeper of the Plan as agent for XYZ Bank, the trustee of the Plan, ... We have been informed by the plan administrator that the trustee holds the Plan’s investment assets and executes investment transactions. The plan administrator has obtained a certification from the agent on behalf of the trustee, as of and for the year ended December 31, 20XX, that the information provided to the plan administrator by the agent for the trustee is complete and accurate.” The third paragraph of the report should also be modified.

.02 Limited-Scope Audit on a Portion of the Plan’s Investments

Inquiry—Is it permissible to perform a limited-scope audit on a portion of the plan’s investments but not all (some investments did not meet the DOL 29 CFR 2520.103-8 criteria for a limited-scope audit)? If yes, what form does the auditors’ report take?

Reply—Yes, it is permissible to perform a limited-scope audit on only a portion of a plan’s investments and audit the remaining investments. The auditors’ report is the same as that used for a limited-scope audit. However, the note that is referenced in the auditor report should clearly identify the investments that were not audited.

.03 Limited-Scope Audit—Plan Certifications for Master Trusts

Inquiry—If a limited-scope audit is to be performed for a plan funded under a master trust arrangement or other similar vehicle, should separate individual plan certifications from the trustee or the custodian be obtained for the allocation of the assets and the related income activity to the specific plan?

Reply—Yes, if a limited-scope audit is to be performed for a plan funded under a master trust arrangement or other similar vehicle, separate individual plan certifications from the trustee or the custodian should be obtained for the allocation of the assets and the related income activity to the specific plan.

[DOL regulation 2520.103-8]

.04 In a Limited-Scope Audit Is it Necessary to Test the Allocation of Investment Earnings at the Participant Account Level?

Inquiry—For a DOL limited-scope audit, is it necessary to test the allocation of investment earnings at the participant account level?

Reply—The testing of allocation of investment earnings at the participant level is part of the participant data testing and is recommended for a limited-scope audit.

[The next page is 6515.]

Section 6935

SSAE No. 16 Reports—Employee Benefit Plans

.01 Audit Procedures When SSAE¹ No. 16 Reports Are Not Available

Inquiry—What procedures need to be performed in an audit of a plan if the service organization does not provide the plan with a type 1 or type 2 service auditor's report,² as described in Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801)?

Reply—Service organizations are not required to furnish SSAE No. 16 reports. However, this does not relieve the auditor of his or her responsibility to obtain a sufficient understanding of the plan and its environment, including components of the plan's internal control that are maintained by the service organization. This understanding enables the plan auditor to assess the risks of material misstatement of financial statement assertions affected by transactions executed by the service organization, and to design the nature, timing, and extent of further audit procedures. When an SSAE No. 16 report is not available, other sources, such as user manuals, system overviews, technical manuals, the contract between the user organization and the service organization, and reports on the service organization's controls issued by internal auditors or regulatory authorities, may provide sufficient information about the nature of the services provided by the service organization that are part of the plan's information system and the service organization's controls over those services. If both the services provided and the service organization's controls over those services are highly standardized, information obtained through the plan auditor's prior experience with the service organization may be helpful in assessing risk. The plan auditor may wish to consider the specific control objectives and selected controls outlined in exhibit B-1 of appendix B of the AICPA Accounting and Audit Guide *Employee Benefit Plans*, in obtaining his or her understanding. If the plan auditor concludes that the available information is not adequate to obtain a sufficient understanding of the service organization's controls to assess the risks of material misstatement of financial statement assertions affected by the service organization's services, consideration should be given to contacting the service organization through the user organization to obtain adequate internal control information, or request that a service auditor be engaged to perform procedures at the service organization.

¹ Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801), establishes the requirements and application guidance for a service auditor reporting on controls at a service organization that are relevant to user entities' internal control over financial reporting, and also describes the contents of such reports. AU-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization* (AICPA, *Professional Standards*), contains the requirements and guidance for auditors of the financial statements of entities that use a service organization. [Footnote revised, August 2011, to reflect conforming changes necessary due to the issuance of SSAE No. 16. Footnote revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

² In SSAE No. 16, a *type 1 report* is a report on management's description of a service organization's system and the suitability of the design of controls, and a *type 2 report* is a report on management's description of a service organization's system and the suitability of the design and operating effectiveness of controls. [Footnote added, August 2011, to reflect conforming changes necessary due to the issuance of SSAE No. 16.]

The level of substantive testing that should be performed depends on the amount of reliance the auditor can place on controls at the service organization. Thus, if a type 2 SSAE No. 16 report is not available, the auditor would need to increase substantive testing or consider testing controls at the service organization.

Auditing procedures applied to data maintained by the service organization may include tests of participant data, payroll data, or benefits data to determine that they agree with the information obtained and maintained by the employer. If the data is not available at the employer, consideration should be given to confirming the information directly with participants or to reviewing hard copy information obtained from the service organization, if available.

Individual participant accounts in 401(k) plans or other defined contribution pension plans should be tested for proper allocation of plan assets, contributions, income, and expenses. As such, the auditor should consider confirming contribution percentages and investment elections directly with the participants in situations where transactions are performed electronically or by phone. In addition, record keepers may maintain back up documentation of participant transactions, which may be requested as audit evidence to test participant data.

Procedures that should be considered in the audit of benefit payments, particularly those initiated by telephone or electronic methods, include confirming disbursements directly with participants, or comparing the disbursement to a transaction report if one is maintained, and testing the documentation underlying the benefit payment transactions.

For further guidance, see chapters 7 and 9–10 of the AICPA Audit and Accounting Guide *Employee Benefit Plans*.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature; Revised, June and August 2011, to reflect conforming changes necessary due to the issuance of SSAE No. 16.]

.02 Allocations Testing of Investment Earnings When a Type 2 SSAE No. 16 Report Is Available

Inquiry—In plan audits in which the auditor uses a type 2 SSAE No. 16 report, how extensively should the allocation of investment earnings at the participant level be tested? What are commonly used methods for testing this information?

Reply—In plan audits in which the plan auditor uses a type 2 SSAE No. 16 report, the extent of testing of the allocation of investment earnings at the participant level will be determined based on the plan auditor's assessment of the risk that earnings have not been allocated in accordance with the plan instrument. The type 2 SSAE No. 16 report can provide information about the service auditor's tests of the operating effectiveness of the service organization's controls over the investment allocation process and the results of those tests to help the auditor assess this risk. However, the auditor should not use the type 2 SSAE No. 16 report to completely eliminate substantive testing.

One commonly used method of testing this information is comparing the yield in the participants' accounts (selecting a sample of funds) for a certain

period of time to the yield that the plan reported as a whole (as compared to published sources) for those funds for the same period of time.

[Revised, June and August 2011, to reflect conforming changes necessary due to the issuance of SSAE No. 16.]

[The next page is 6521.]

Section 6936

Auditing Defined Contribution Plans

.01 Auditor's Responsibility for Testing a Plan's Compliance With Qualification Issues

Inquiry—What is the auditor's responsibility for testing a plan's compliance with top heavy rules, the Average Deferral Percentage Test, and other qualification issues?

Reply—An audit in accordance with generally accepted auditing standards (GAAS) is not designed to ensure compliance with all legislative and regulatory provisions. However, a plan must be designed to comply with all provisions, and must meet certain operating tests in order to maintain its qualified status. If specific information comes to the auditor's attention that provides evidence concerning the existence of possible violations of provisions that may affect the financial statements, he or she should apply auditing procedures specifically directed to ascertaining whether a violation has occurred. The auditor also is expected to inquire of, and obtain representation from, management concerning compliance with laws and regulations, and the controls in place to prevent violations of those laws and regulations that may cause the plan to lose its qualified status.

For further guidance, see chapter 11 and the "Plan Tax Status" section of chapter 12 of AICPA Audit and Accounting Guide *Employee Benefit Plans*.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.02 Merger Date for Defined Contribution Plans

Inquiry—If a defined contribution plan has an effective merger date, per the merger agreement, of December 31, 20X1, but a significant portion of the plan's assets have not been transferred as of December 31, 20X1, should the audit be done as of the December date, or when the majority of the assets were transferred? Would the answer be any different for a defined benefit plan? Would a liability representing the assets due to the acquiring plan be reflected on the statement of net assets if the audit date is December 31, 20X1?

Reply—For defined contribution plans, if there is a significant difference between the effective merger date per the merger agreement and the actual date assets were transferred, consideration should be given to performing an audit through the date of the actual transfer. However, all facts and circumstances should be considered, including management's intent, before determining the proper merger date.

For defined benefit plans, the merger typically is recorded on the effective merger date per the merger agreement because legal title to the assets, liabilities, and benefit obligations has transferred. In certain circumstances, it may be appropriate to record a liability representing the assets due the acquiring plan at year-end (for example, if the physical transfer from one plan to another has been requested and is pending).

[The next page is 6525.]

Section 6937

Auditing Defined Benefit Plans

.01 General Conditions Requiring an Audit of Pension Plan Financial Statements

Inquiry—What are the general conditions requiring an audit of pension plan financial statements?

Reply—An audit generally is required if the plan is covered under Title I of ERISA and there are over 100 participants as of the beginning of the plan year. Exhibit 5-2 in chapter 5 of the AICPA Audit and Accounting Guide *Employee Benefit Plans* provides guidance on determining who is considered a participant. In addition, DOL regulations permit plans that have between 80 and 120 participants at the beginning of the plan year to complete the Form 5500 in the same category (large plan or small plan) as was filed in the previous year.

[The next page is 6531.]

Section 6938

Auditing Health and Welfare Plans

.01 When Does a Health and Welfare Plan Require an Audit?

Inquiry—When does a health and welfare plan require an audit?

Reply—A health and welfare plan is required to have an audit when the plan has more than 100 participants at the beginning of the plan year (this can be expanded to 120 if the 80–120-participant rule applies) and the plan is funded. According to DOL Regulation 2520.104-44, the existence of a separate fund or account for the plan by the employer or a third-party administrator can cause the requirement that funds be paid directly from the general assets of the sponsor not to be met. For example, if a separate account is maintained that would be deemed to be a trust under state law, the related plan would be deemed to be funded under ERISA. It is not always easy to determine when a plan is considered funded. The auditor may wish to consult with legal counsel, plan actuaries, or the DOL to determine if a plan meets the definition of funded.

.02 Audit Requirements for Health and Welfare Plans

Inquiry—Assume a partially insured H&W plan where the employer pays claims to a certain level and then reinsurance assumes the liability. There are over 100 participants, and the employer and employees each pay a portion of the premiums. The employee's share is paid on a pretax basis through a Section 125 plan. There is no trust established, but at year end there may be a minimal payable to the third party administrator for regular monthly charges and a small reinsurance receivable, depending on timing. Does this plan require an audit?

Reply—No, the plan does not require an audit. According to the fact pattern described, no separate trust exists to hold the assets of this plan, and therefore it is not a funded plan for ERISA purposes. ERISA exempts unfunded plans from the requirement to perform an annual audit. Participant contributions made through a Section 125 cafeteria plan are not required to be held in trust per DOL Technical Release 92-1, and as long as no trust is being utilized, no audit requirement exists.

For further guidance, see the “Welfare Benefit Plans” and “PWBA Technical Release 92-1” sections in appendix A of the AICPA Audit and Accounting Guide *Employee Benefit Plans*.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.03 HIPAA Restrictions

Inquiry—In recent audits of health and welfare plans, our firm has been denied access to personnel files because of Health Insurance Portability and Accountability Act of 1996 (HIPAA) rules. In such cases, it has prohibited us from performing certain procedures necessary to render our opinion on the financial statements, such as testing of birth date, hire date, elections, and other such information. How can we overcome this obstacle?

Reply—The items mentioned (birth date, hire date, elections) are not “protected health information” (PHI) under the HIPAA rules.

PHI is individually identifiable health information that is created or received from a health care provider, health plan, employer, or health care

clearinghouse; that either identifies or can be used to identify an individual; and relates to the individual's past, present, or future physical or mental health, to the provision of health care to an individual, or to the payment for the provision of health care to the individual. In other words, there are two components to PHI: (a) the identification of an individual, and (b) health information. Identification of an individual without the corresponding health information is not PHI, nor is health information without identifying the corresponding individual to whom it relates.

The first step is to understand what information is needed for the audit and whether it constitutes PHI. If access to PHI is necessary for the audit, HIPAA regulations allow for that access.

HIPAA privacy regulations indicate that a plan sponsor may not use or disclose protected health information except as permitted or required by the regulations. The regulations permit use of the "minimum necessary" information for use in health care operations, including conducting audits. If the auditor has signed a business associate agreement with the plan sponsor, then that auditor is considered a business associate under the regulations, and access to such minimum necessary information required for the audit should not be restricted by HIPAA.

Discussion with the plan sponsor may be necessary to demonstrate that the requested information is the minimum necessary for the audit and, if such information is not obtained, would result in a disclaimer of opinion.

For more information, call the Department of Labor Office of Health Plan Standards and Compliance Assistance at (202) 693-8335, or call EBSA's toll free inquiry line at 1-866-444-EBSA (3272). Health and Human Service (HHS) also has a toll-free number dealing with HIPAA privacy related issues. That number is 1-866-627-7748. You also may wish to visit the HHS Web site, www.hhs.gov/ocr/hipaa.

.04 Is a Health and Welfare Plan Required to Be Audited if Participants Are Contributing to the Plan?

Inquiry—If participants are contributing to a health and welfare plan, is an audit required?

Reply—According to DOL Technical Release Nos. 88-1 and 92-1, participant contributions to a welfare plan that has an Internal Revenue Code (IRC) Section 125 cafeteria plan feature do not have to be held in trust. If contributions are not through a Section 125 plan and they are not used for the payment of insurance or health maintenance organization (HMO) premiums, generally, they will be required to be held in trust. If the plan is funded voluntarily or as required by DOL regulation, then the plan would require an audit.

.05 Audit Requirement When Only Medical Is Funded Through a VEBA Trust

Inquiry—If a plan offers several benefits under the plan document, and only the medical component is funded through the voluntary employees' beneficiary association (VEBA) trust, what is the audit requirement?

Reply—The reporting entity and thus the audit requirement is of the entire plan; not the trust. All benefits covered by the plan should be included in the audited financial statements.

.06 Audit of Plan When VEBA Trust Is a Pass-Through

Inquiry—If a VEBA trust is used as a pass-through for claims payment during the year, but there are no monies in the VEBA trust at year end, is an audit of the plan required?

Reply—If a plan is deemed to be funded for a part of a plan year, the entire plan year is subject to the audit requirement. All plan activity for the entire year would have to be included in the audited financial statements.

.07 When Multiple Plans Use a VEBA Trust, Can the Audit Be Performed At the Trust Level?

Inquiry—If multiple plans use a VEBA trust, can an audit be performed at the VEBA trust level?

Reply—The audit requirement is of the plan, not the trust. Each plan would require a separate audit if it individually met the audit requirement (see previous question). The auditor may be engaged to audit the VEBA trust in order to assist with the plan level allocation reporting, but this would not fulfill the plan level audit requirement.

.08 Audit Requirement for Health and Welfare Plan Funded Through a 401(h) Account

Inquiry—Does the funding of a health and welfare benefit plan through a 401(h) account, when the plan was otherwise unfunded, cause the plan to require an audit?

Reply—If the plan was otherwise unfunded, the 401(h) account association will not cause the health and welfare benefit plan to be considered funded for audit determination purposes.

[The next page is 6535.]

Section 6939

Auditor's Reports—Employee Benefit Plans

[.01] Reserved

.02 Audit Opinion to Be Issued When Discrimination Testing Has Not Been Completed

Inquiry—We have completed the audit of a plan except for reviewing the 401(k) and 401(m) discrimination testing, which has not yet been done and, quite possibly may not ever be done. If such testing is not performed, what type of audit opinion should be issued?

Reply—Independent auditors should inquire if the plan has complied with the annual limitation tests to determine if the plan has met the requirements in order to maintain its tax exempt status. Since the nondiscrimination requirements under 401(k) and 401(m) are required to be met annually, the independent auditor should understand the results of similar tests performed in the past and the reasons why the associated testing has not been performed in the current year. The auditor should be aware that any corrections, corrective distributions, or qualified nonelective contributions (QNECs) that would result from the failure of these compliance tests must be made before the end of the following plan year to preserve the plan's qualified status. If correction is to be made through refunds then a correction made within two and a half months after the plan's year end will avoid potential excise tax and preserve the plan's qualified tax status. In contrast, a refund after two and a half months triggers an excise tax payable by the plan sponsor. In the event that testing has not been completed for the year under audit, the auditor should consider the results of testing performed in the past and any corrections that were made and whether significant changes in the plan's demographics have occurred. The client should determine whether or not it is expected that a correction will be necessary, and should make an estimate for accrual purposes of the amount required for correction. Consideration should be given to modifying the tax note in the financial statements to indicate that the plan sponsor will take the necessary steps, if any, to bring the plan's operations into compliance with the Code. Similar wording also should be included in the management representation letter. If the results of the testing, when completed, are expected to be material based on similar issues in the past or discussions with the client and a correction amount cannot be reasonably estimated, the auditor should consider withholding his or her report until the testing is completed and the appropriate accruals recorded. If, however, the financial statements are issued and the client doesn't remedy or complete the tests by the next audit, the auditor should consider the effect on the financial statements as well as other implications as described in AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* (AICPA, *Professional Standards*), since the plan's tax qualified status may be in jeopardy.

For further guidance, see the "Plan Tax Status" section in chapter 12 of AICPA Audit and Accounting Guide *Employee Benefit Plans*.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[The next page is 6551.]

Section 6940

Franchisors

.01 Method of Accounting for Sale of Territorial Franchise Right

Inquiry—A client sells territorial franchise rights to region managers for \$30,000 with ten percent taken in cash and the remainder as a note. The region manager in turn sells franchises in his territory. The note is payable at the rate of \$1,000 per franchise sold in the territory but is due in three years regardless of the number of franchises sold.

The collectibility of the notes depends on the performance of the region managers. The company has been able to resell territories of managers who have been unsuccessful, and the down payments have been refunded in these instances.

What is the proper method of accounting for these franchise fees and the related costs of selling the territories?

Reply—In discussing initial franchise fees for area franchises, Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 952-605-25-5 states, in part: “. . . revenue ordinarily shall be recognized when all material services or conditions relating to the sale(s) have been substantially performed or satisfied by the franchisor.” FASB ASC 952-605-25-2 describes substantial performance as follows:

Substantial performance for the franchisor means that all of the following conditions have been met:

- a. The franchisor has no remaining obligation or intent—by agreement, trade practice, or law—to refund any cash received or forgive any unpaid notes or receivables.
- b. Substantially all of the initial services of the franchisor required by the franchise agreement have been performed.
- c. No other material conditions or obligations related to the determination of substantial performance exist.

Therefore, the sale of the regions is not a completed transaction which would allow the recognition of income when the sale is made (for example, when the down payment and notes are received) since the company’s practice of refunding down payments to region managers and, in effect, excusing nonpayment of their notes would violate item (a).

Since payment of the notes is on the basis of specific performance (for example, at the rate of \$1,000 per franchise sold in the region), as a practical matter, a reasonable basis for recognizing deferred revenue would be over the estimated number of franchises to be opened in a region.

With regard to the costs of selling the territories, paragraphs 1–3 of FASB ASC 952-340-25 state the following:

Direct (incremental) costs relating to franchise sales for which revenue has not been recognized shall be deferred until the related revenue is recognized.

Deferred costs shall not exceed anticipated revenue less estimated additional related costs.

Costs yet to be incurred shall be accrued and charged against income no later than the period in which the related revenue is recognized . . .

Therefore, deferral and amortization of costs “incurred to produce the region sales” could be accounted for in a manner similar to the deferral and recognition

of revenue discussed in the preceding paragraph. The operating expenses of the company should be charged off as a period cost.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.02 Revenue Recognition for Franchisors

Inquiry—A franchise agreement is entered into whereby the franchisor agrees to provide to a franchisee the technical information necessary to manufacture a product. In addition, the franchisor agrees to provide consultation needed to produce the product for the next five years. The agreement states that 80 percent of the franchise fee is to be paid in the first year of the agreement, and five percent is to be paid in each of the next four years. How should the franchisor recognize the revenue from this agreement?

Reply—This issue is addressed in FASB ASC 952. FASB ASC 952-605-25-4 states that “if it is probable that the continuing fee will not cover the cost of the continuing services to be provided by the franchisor and a reasonable profit on those continuing services, then a portion of the initial franchise fee shall be deferred and amortized over the life of the franchise. The portion deferred shall be an amount sufficient to cover the estimated cost in excess of continuing franchise fees and provide a reasonable profit on the continuing services.” The FASB ASC glossary defines *continuing franchise fees* as “consideration for the continuing rights granted by the franchise agreement and for general or specific services during its life.”

In the preceding situation, it is unlikely the five percent of revenues the franchisor will receive in years two through five is sufficient to cover the costs, and a reasonable profit, on the raw materials and services provided. Therefore, the franchisor should defer a portion of the first year’s franchise fee and amortize it over the next four years at a rate that will cover costs and provide a reasonable profit.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[The next page is 6601.]

Section 6950

State and Local Governments

[.01] Reserved

[.02] Reserved

[.03] Reserved

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[.09] Reserved

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[.14] Reserved

[.15] Reserved

[.16] Reserved

[.17] Reserved

.18 Accounting for the Issuance of Zero-Coupon Bonds and Other Deep Discount Debt by a Governmental Entity

Inquiry—A governmental entity issues zero-coupon bonds due in 10 years. Even though bond interest and principal is not due until the end of the bond's term, a sinking fund was established. When should interest expense be recognized and principal payments be deducted from the debt?

Reply—The treatment by governmental entities of the bond discount related to deep-discount debt has not been specifically addressed in authoritative literature. As discussed in *Governmental Accounting, Auditing and Financial Reporting*, by the Government Finance Officers Association, the accrual of principal and interest payments for zero-coupon bonds and other deep-discount debt is not recommended because the requirement that payments be due "early in the next year" is not met. The face amount of the debt less the discount presented as a direct deduction should be presented in the general long-term debt account group. The net value of the bonds should be accreted (the discount reduced) over the life of the bonds in the long-term debt account group. This presentation shows what amount would be payable if the debt were required to be paid today. The interest method provides an acceptable means of amortizing the discount. However, the straight line amortization method may also be used if its application would not produce amounts that differ materially from those that would be achieved if the interest method were applied.

[.19] Reserved

[.20] Reserved

.21 Auditor's Reports on Local Governments

Inquiry—A state law referring to the audit of local governments requires every auditor's report to state that the audit was conducted in accordance with generally accepted auditing standards and with the auditing standards prescribed by the state auditor. The law also requires the auditor's report to conform with the standard report form and to contain a reference to a report of comments and recommendations.

May a CPA include such wording in the opinion if he or she has followed the standards prescribed by the state auditor and he or she has included a report of comments and recommendations?

Reply—A CPA may state in the report that the audit has been conducted in accordance with generally accepted auditing standards and with the standards prescribed by the state treasurer if the audit was in fact conducted in accordance with these standards.

Also a CPA may include in the auditor's report a reference to a report of comments and recommendations if such a report has in fact been issued. [Amended June 1995; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.22 State Accounting Guide Differs From GAAP

Inquiry—Are reports on financial statements conforming to the State accounting guide requirements considered auditor's reports on special purposes financial statements in accordance with AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* (AICPA, *Professional Standards*)?

Reply—Yes. Reports on financial statements conforming to the State accounting guide requirements are considered auditor's reports on special purposes financial statements. Paragraph .07 of AU-C section 800 states that a basis of accounting that an entity uses to comply with the requirements or financial reporting provisions of a regulatory agency to whose jurisdiction the entity is subject is a special purpose framework. Paragraph .A35 of AU-C section 800 contains illustrations of auditor's reports on special purpose financial statements. In addition, chapter 14 of *Audit and Accounting Guide State and Local Governments* discusses auditor reporting when law or regulation requires a government to prepare and file with a regulatory agency financial statements that do not constitute a complete presentation of all the financial statements required by GASB Statement No. 34, *Basic Financial Statements— and Management's Discussion and Analysis—for State and Local Governments*, but that otherwise are prepared in accordance with GAAP.

[Amended, June 1995; Amended, December 2004; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[The next page is 6701.]

Section 6960***Colleges and Universities***

- [.01] Reserved
- [.02] Reserved
- [.03] Reserved
- [.04] Reserved
- [.05] Reserved
- [.06] Reserved
- [.07] Reserved
- [.08] Reserved
- [.09] Reserved
- [.10] Reserved
- [.11] Reserved

.12 Allocation of Overhead

Inquiry—A private college has many individual restricted programs funded from federal, state and private contributions. One of the programs was charged a \$97,000 overhead expense amount, with the credit going to revenue in another program. Is it appropriate under generally accepted accounting principles to record revenue based on the overhead allocation?

Reply—No, it is inappropriate. The allocation of overhead is an interprogram transaction that should not be reported as revenue of the program providing the services but rather as a reduction of expense of such program. For additional information related to this topic, see chapter 16 of Audit and Accounting Guide *Not-for-Profit Entities*.

[Amended, June 1995.]

[The next page is 6751.]

Section 6970

Entertainment Industry

.01 Changes in Film Impairment Estimates During Quarters Within a Fiscal Year (Part I)

Inquiry—Company A produced a film that is subject to the requirements of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 926, *Entertainment—Films*. In accordance with paragraphs 12–17 of FASB ASC 926-20-35, Company A determined at the end of the first quarter of 20X1 that the film was impaired. Company A wrote down the film’s cost basis by \$2 million, which represents the amount that the film’s net book value exceeded the film’s fair value. Company A determined the film’s fair value by using a discounted cash flow model. At the end of the second quarter of 20X1, Company A determines based on updated information that the film’s estimated net cash flows will be greater than anticipated at the end of the first quarter. Is the change in the estimated net cash flows a circumstance under FASB ASC 926 that requires Company A to restore all or a portion of the film’s cost basis that was written off in the first quarter of 20X1?

Reply—Yes. FASB ASC 926-20-35-3 requires that changes in estimates during the fiscal year be applied retroactively from the beginning of the fiscal year.

In this situation, Company A would use the new information regarding the film’s estimated net cash flows gathered in the second quarter as if it were available in the first quarter to determine what the amount of the impairment loss would have been in the first quarter. Company A would record this adjustment to the impairment loss in the second quarter. Company A also would adjust the film’s cost amortization for the first and second quarters to reflect the revised impairment loss. Company A should not restate the first quarter. In accordance with FASB ASC 926-20-35-13, the amount of the impairment write down restored cannot result in the adjusted net book value exceeding the film’s fair value at the end of the second quarter. For example, if the revised first quarter calculation indicates that the impairment loss was only \$1 million at the end of the first quarter, the actual adjustment at the end of the second quarter would be different than the \$1 million because of the effect on the film’s cost amortization using the individual-film-forecast-computation method, and possibly the film’s fair value at the end of the second quarter. In addition, restorations of impairment write downs on a film should not exceed previous impairment write downs taken on that film.

FASB ASC 270-10-45-14 requires that Company A disclose the effect of the change in estimate in the period that the change occurred. For public registrants, the Management Discussion and Analysis should address material restorations of prior impairment write downs.

Note that had the change in estimated net cash flows occurred in the subsequent fiscal year, FASB ASC 926-20-35-13 would prohibit Company A from adjusting the impairment write down taken in 20X1.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.02 Changes in Film Impairment Estimates During Quarters Within a Fiscal Year (Part II)

Inquiry—Assume the same facts in section 6970.01 with the following exception. The film's actual net cash inflow for the second quarter was as expected by Company A at the end of the first quarter. Company A, as expected, spent most of its advertising budget to promote the film during the second quarter. The film's estimated net cash inflow for subsequent periods also did not change. As a result of the advertising expenditures, using a discounted cash flow model at the end of the second quarter, the film's fair value increased from the amount determined at the end of the first quarter. Is that a circumstance under FASB ASC 926, for which Company A should restore all or a portion of the film's cost basis that was previously written off in the first quarter of 20X1?

Reply—No. In this situation the film's estimated net cash flows did not change from those used to estimate the film's fair value at the end of the first quarter. Accordingly, the guidance in FASB ASC 926-20-35-3 is not applicable.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[The next page is 6851.]

Section 6980

Brokers and Dealers

.01 Auditor's Report on Internal Control for Broker-Dealer [Amended]

Inquiry—Some state regulatory agencies are requesting that their name be included in the restrictive paragraph of the auditor's report on internal accounting control for broker-dealers. Because most broker-dealers must comply with Securities and Exchange Commission (SEC) regulations, the report on internal accounting control from their auditors includes a report on the additional requirements of Rule 17a-5(g) as well as a report on their study and evaluation as part of an audit. The restriction paragraph of the report illustrated in the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* appendix C therefore includes the SEC as a designated recipient of the report and reads as follows:

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 should not be used for any other purpose.

One state agency suggested revising the paragraph to reflect other agencies as recipients as follows:

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 and should not be used for any other purpose.

Is this proposed revised wording appropriate in view of the fact that not all regulatory agencies use the SEC's Rule 17a-5(g) criteria or other established criteria for the evaluation of the adequacy of internal accounting control procedures for their purposes?

Reply—No. The previous suggested wording is not appropriate because the report would then be distributable to all other non-SEC regulatory agencies, and as stated, most agencies, including those of the 50 states, do not establish criteria in reasonable detail and in terms susceptible to objective application for the auditor's study, evaluation and report on the control procedures for the agencies' purposes.

[Amended, September 1997.]

[.02] Reserved

[The next page is 6871.]

Section 6985

U.S. Department of Housing and Urban Development (HUD) Programs

[.01] Reserved

[The next page is 6901.]

Section 6990

Common Interest Realty Associations

.01 Personal Property of Timeshares

Inquiry—Should a common interest realty association (CIRA) that is a timeshare development report as assets personal property that it owns and uses as internal unit furnishings for timeshare units?

Reply—Yes. Financial Accounting Standards Board *Accounting Standards Codification* 972-360-25-5 states, “Common interest realty associations shall recognize common personal property, such as furnishings, recreational equipment, maintenance equipment, and work vehicles, that is used by the common interest realty association in operating, preserving, maintaining, repairing, and replacing common property and providing other services, as assets.” Personal property that is owned by a CIRA and used as internal unit furnishings for timeshare units is common personal property that is used by the CIRA in providing other services.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[The next page is 6911.]

Section 6995

Credit Unions

.01 Financial Reporting Issues Related to Actions Taken by the National Credit Union Administration on January 28, 2009 in Connection With the Corporate Credit Union System and the National Credit Union Share Insurance Fund

Inquiry—On January 28, 2009, the National Credit Union Administration (NCUA) announced certain actions it was taking to stabilize the corporate credit union system. The NCUA indicated that the expense of the actions would be passed on proportionately to all federally-insured credit unions through the partial (currently estimated by NCUA to be 51 percent) write-off of such credit unions' existing deposits with the National Credit Union Share Insurance Fund (NCUSIF), as well as the assessment of an insurance premium sufficient to return the NCUSIF's equity to insured shares ratio to 1.30 percent.

Federally insured credit unions (including corporate credit unions) are required to maintain a refundable deposit with the NCUSIF in an amount equal to one percent of the credit union's total insured shares. The amount on deposit in the insurance fund is periodically adjusted for changes in the balance of a credit union's insured shares. In addition, a credit union is required to pay an additional annual insurance premium equal to one-twelfth of one percent of its insured shares.

Credit unions also have their own financial system, the Corporate Credit Union Network, consisting of the U.S. Central Federal Credit Union (USC) and its member corporate credit unions. These state or regional corporate credit unions make available a wide range of investments and correspondent financial services for credit unions, and the USC serves as a financial intermediary for corporate credit unions. The USC and many of the corporate credit unions made investments in asset-backed securities that became impaired during 2008.

In a letter to federally-insured credit unions (NCUA Letter No. 09-CU-02) issued on January 28, 2009, the NCUA stated that the corporate credit union system is now facing unprecedented strains on its liquidity and capital due to credit market disruptions and the current economic climate, and that given the importance of the USC as a liquidity and payment systems provider to both corporate credit unions and, by extension, natural person credit unions, NCUA is taking decisive action to stabilize the USC's financial position and provide stability for the liquidity needs of the corporate system. In the letter, the NCUA announced two significant actions it was taking to address the current status of the corporate credit union system, as follows:

- The NCUA is injecting \$1 billion in cash from the NCUSIF into the USC in the form of capital. The NCUA has stated that while a capital infusion has cost implications for all credit unions, it is a lower cost alternative than liquidation and sale of the distressed securities held by the USC in today's market. The staff notes that in the *unaudited* January 2009 financial statements of the NCUSIF, this investment in the USC was immediately written off.
- The NCUA is offering a voluntary temporary NCUSIF guarantee of member shares in corporate credit unions through December 31, 2010. The guarantee will cover all shares, but does not include paid-in capital and membership capital accounts. The NCUA believes the guarantee

helps provide stability to meet the liquidity needs of the corporate system, which will allow for the orderly pay down of stressed securities and, in turn, reduces the overall resolution cost. The NCUA's initial estimate of the liability attributable to this guarantee is \$3.7 billion, based on current corporate credit union balance sheets (that is, the holdings of impaired asset-backed securities) and the modeling of various market scenarios. The NCUA has indicated that this estimate could change significantly depending on a host of factors including, but not limited to, credit loss estimates.

In consideration of AU-C section 560, *Subsequent Events and Subsequently Discovered Facts* (AICPA, *Professional Standards*), do the actions of the NCUA with regard to the valuation of a federally-insured credit union's NCUSIF deposit at December 31, 2008, constitute a subsequent event that provides evidence of conditions that existed at the date of the financial statements (commonly referred to as a "type 1" subsequent event), or of conditions that arose after the date of the financial statements (commonly referred to as a "type 2" subsequent event)? Secondly, when and how should the obligation for the insurance premium be recognized for financial reporting purposes?

Reply—

Issue 1: NCUSIF Deposit. The AICPA staff believes that there is diversity in opinion on this issue and based on the facts known at the time this question and answer was issued, the staff does not express a preference for either of the views discussed in the following paragraphs.

Existing authoritative guidance for the accounting for the NCUSIF deposit is in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 942-325-25-3, which states the following:

For credit unions and corporate credit unions, amounts deposited with the National Credit Union Share Insurance Fund shall be accounted for and reported as assets as long as such amounts are fully refundable.

FASB ASC 942-325-35-4 further states the following:

The refundability of National Credit Union Share Insurance Fund deposits shall be reviewed for impairment. When the refundability of a deposit is evaluated, the financial condition of both the credit union and of the National Credit Union Share Insurance Fund shall be considered. Deposits may be returned to solvent credit unions for a number of reasons, including termination of insurance coverage, conversion to insurance coverage from another source, or transfer of operations of the insurance fund from the National Credit Union Administration Board. However, insolvent or bankrupt credit unions shall not be entitled to a return of their deposits. To the extent that National Credit Union Share Insurance Fund deposits are not refundable, they shall be charged to expense in the period in which the deposits are made or the assets become impaired.

- Alternative A—Type 1 Subsequent Event

AU-C section 560 addresses the auditor's responsibilities relating to subsequent events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements. AU-C section 560 describes one type of subsequent event as an event that provides evidence of conditions that existed at the date of the financial statements.

Proponents of type 1 subsequent event accounting maintain that the actions taken by the NCUA on January 28, 2009 constitute additional evidence regarding strained liquidity and capital deterioration conditions

that existed at December 31, 2008, and that the NCUA announcement on January 28, 2009 of the partial write-off of the NCUSIF deposit is a confirmation of those conditions at December 31, 2008.

Proponents of this view also believe that Emerging Issues Task Force (EITF) Issue No. 87-22, "Prepayments to the Secondary Reserve of the FSLIC," addresses a situation that may be considered relevant. Similar to the NCUSIF, the Federal Savings and Loan Insurance Corporation (FSLIC) required insured institutions to make annual prepayments of their regular future insurance premiums. In May 1987, the Federal Home Loan Bank Board eliminated the secondary reserve of the FSLIC as of December 31, 1986. The Task Force reached a consensus that the impairment of the secondary reserve of the FSLIC was a type 1 subsequent event.

- **Alternative B—Type 2 Subsequent Event**

AU-C section 560 describes a second type of subsequent event as an event that provides evidence of conditions that arose after the date of the financial statements.

Proponents of type 2 subsequent event accounting refer to the NCUA's disclosures that it had no obligation to undertake the actions approved on January 28, 2009, and that the NCUSIF deposits were refundable under the circumstances noted in FASB ASC 942-325-25 and FASB ASC 942-325-35 until January 28, 2009. As such, proponents of this view believe that the NCUSIF deposits did not become impaired until January 28, 2009.

Proponents of this view also believe that EITF Topic No. D-47, "Accounting for the Refund of Bank Insurance Fund and Savings Association Insurance Fund Premiums," in which the Financial Accounting Standards Board (FASB) staff expressed their belief that insured institutions should not accrue a liability for a potential special assessment of deposit insurance premium until the period in which any proposed legislation is enacted, can be used by analogy to support their view regarding the NCUSIF deposit.

Issue 2: Premium Assessment.

- **View A—Record in 2009.** Proponents of this view support recognition of the obligation to pay the insurance premium when assessed, at January 28, 2009, and refer to FASB ASC 942-325-35-4(c), which states that to the extent that the NCUA Board assesses premiums to cover prior operating losses of the insurance fund or to increase the fund balance to "normal operating levels," credit unions should expense those premiums when assessed.

Further reference is made to the aforementioned EITF Topic No. D-47, in which the FASB staff expressed their belief that insured institutions should not accrue a liability for a potential special assessment of deposit insurance premium until the period in which any proposed legislation is enacted.

- **View B—Record in 2008.** If NCUSIF deposit impairment is recognized in 2008, proponents of view B believe that both the NCUSIF deposit impairment and the additional premium assessment relate to the same event and conditions that caused the deposit impairment that existed at December 31, 2008, and that both should be recorded as of December 31, 2008.

[Issue Date: March 2009; Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.02 Evaluation of Capital Investments in Corporate Credit Unions for Other-Than-Temporary Impairment

Inquiry—In a letter to its shareholders on February 2, 2009, the U.S. Central Federal Credit Union (USC) explained its financial position to other corporate credit unions that have direct capital investments in the USC in the form of membership capital shares (MCS) and paid-in capital (PIC). The letter also explained that on December 31, 2008, \$450 million of members' MCS were converted to a new form of capital, paid-in capital II (PIC II). On January 28, 2009, the USC announced that it would record other-than-temporary impairment (OTTI) charges of approximately \$1.2 billion for 2008 in relation to its portfolio of asset-backed securities as a result of severe deterioration in economic and market data during the fourth quarter of 2008, and that this charge resulted in an accumulated deficit (negative retained earnings) for the USC of approximately \$493 million. The staff notes that audited financial statements of the USC as of and for the year ended December 31, 2008 were not available at the time of issuance of this question and answer. On January 28, 2009, the National Credit Union Administration (NCUA) announced that it was injecting \$1.0 billion from the National Credit Union Share Insurance Fund (NCUSIF) in the form of new PIC to the USC, which is senior to all other forms of USC capital. The staff notes that in the *unaudited* January 2009 financial statements of the NCUSIF, this investment in the USC was immediately written off.

According to the NCUA Rules and Regulations, *membership capital* means funds contributed by members that are

- adjustable balance with a minimum withdrawal notice of three years or are term certificates with a minimum term of three years.
- available to cover losses that exceed retained earnings and PIC.
- not insured by the NCUSIF or other share or deposit insurers.
- cannot be pledged against borrowings.

Paid-in capital means accounts or other interests of a corporate credit union that are

- perpetual, noncumulative dividend accounts.
- available to cover losses that exceed retained earnings.
- not insured by the NCUSIF or other share or deposit insurers.
- cannot be pledged against borrowings.

How should a corporate credit union evaluate its MCS and PIC in the USC for OTTI at December 31, 2008? Similarly, how should a natural person credit union evaluate its MCS and PIC investments in other corporate credit unions for OTTI at December 31, 2008?

Reply—The staff believes the following authoritative literature is helpful in making that evaluation.

FASB ASC 320, *Investments—Debt and Equity Securities*, addresses equity securities that have readily determinable fair values. As there is no active market for MCS or PIC investments, FASB ASC 320 would not apply. FASB ASC 323, *Investments—Equity Method and Joint Ventures*, generally requires

that investments in common stock that result in the investor having the ability to exert significant influence over the issuer be accounted for using the equity method. Otherwise, the cost method would apply. FASB ASC 323 also indicates that a series of operating losses of an investee or other factors may indicate that a decrease in value of the investment has occurred, which is other than temporary and should accordingly be recognized, and reference is then made to FASB ASC 320. MCS and PIC do not represent common stock investments; however, the concepts of FASB ASC 323 can be considered. According to the aforementioned USC letter to corporate credit unions, the ownership of MCS or PIC, or both, by any particular corporate credit union would not provide it the opportunity to exert significant influence over the USC, particularly given “one member, one vote.” As such, it appears appropriate to consider investments in MCS and PIC cost method equity investments and that evaluation for impairment by corporate credit unions is required.

Although FASB ASC 320 does not specifically apply to MCS and PIC, FASB ASC 320 addresses issues of impairment and includes within its scope cost method equity investments. FASB ASC 958-325-35-8 states that the guidance in this Subtopic is applicable for investments in equity securities that are not subject to the scope of FASB ASC 320 and not accounted for under the equity method pursuant to FASB ASC 958-810-05-5. FASB ASC 320-10-35-25 provides guidance on how to determine impairment on such cost-basis investments without readily determinable fair values.

Step 1 of the impairment framework detailed in paragraphs 20–29 of FASB ASC 320-10-35 requires an investor to determine whether or not the fair value of the investment is less than its cost basis. FASB ASC 320-10-35-25 regarding cost-method investments (that have no readily determinable fair value) states the following:

Because the fair value of cost-method investments is not readily determinable, the evaluation of whether an investment is impaired shall be determined as follows:

- a. If an entity has estimated the fair value of a cost-method investment (for example, for disclosure under Section 825-10-50, that estimate shall be used to determine if the investment is impaired for the reporting periods in which the entity estimates fair value. If the fair value of the investment is less than its cost, proceed to Step 2.
- b. For reporting periods in which an entity has not estimated the fair value of a cost-method investment, the entity shall evaluate whether an event or change in circumstances has occurred in that period that may have a significant adverse effect on the fair value of the investment (an impairment indicator).

FASB ASC 320-10-35-27 further states the following:

Impairment indicators include, but are not limited to:

- a. A significant deterioration in the earnings performance, credit rating, asset quality, or business prospects of the investee
- b. A significant adverse change in the regulatory, economic, or technological environment of the investee
- c. A significant adverse change in the general market condition of either the geographic area or the industry in which the investee operates

- d. A bona fide offer to purchase (whether solicited or unsolicited), an offer by the investee to sell, or a completed auction process for the same or similar security for an amount less than the cost of the investment
- e. Factors that raise significant concerns about the investee's ability to continue as a going concern, such as negative cash flows from operations, working capital deficiencies, or noncompliance with statutory capital requirements or debt covenants.

FASB ASC glossary defines *fair value* as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." The staff understands that, in practice, fair value disclosures under FASB ASC 825-10-50 for MCS and PIC have generally reflected redemption values (at par), and have recognized that such investments were interest-earning at assumed market rates of interest. This is similar to historical fair value disclosures for investments in Federal Home Loan Bank stock.

FASB ASC 320-10-35-30 states the following:

When the fair value of an investment is less than its cost at the balance sheet date of the reporting period for which impairment is assessed, the impairment is either temporary or other than temporary. An entity shall apply the following guidance and other guidance that is pertinent to the determination of whether an impairment is other than temporary, such as the guidance in Section 325-40-35, as applicable. *Other than temporary* does not mean permanent.

The staff notes that entities holding MSC or PIC should first determine whether fair values are believed to be less than the cost bases of the respective holdings at the balance sheet date. If so, such impairment is assessed as either temporary or other than temporary. In this regard, SEC Staff Accounting Bulletin Topic 5M indicates the following:

The value of investments in marketable securities classified as either available-for-sale or held-to-maturity may decline for various reasons. The market price may be affected by general market conditions which reflect prospects for the economy as a whole or by specific information pertaining to an industry or an individual company. Such declines require further investigation by management. Acting upon the premise that a write-down may be required, management should consider all available evidence to evaluate the realizable value of its investment.

There are numerous factors to be considered in such an evaluation and their relative significance will vary from case to case. The staff believes that the following are only a few examples of the factors which, individually or in combination, indicate that a decline is other than temporary and that a write-down of the carrying value is required:

- a. The length of the time and the extent to which the market value has been less than cost;
- b. The financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer such as changes in technology that may impair the earnings potential of the investment or the discontinuance of a segment of the business that may affect the future earnings potential; or

- c. 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.

Unless evidence exists to support a realizable value equal to or greater than the carrying value of the investment, a write-down to fair value accounted for as a realized loss should be recorded. In accordance with the guidance of paragraph 16 of Statement 115, such loss should be recognized in the determination of net income of the period in which it occurs and the written down value of the investment in the company becomes the new cost basis of the investment.

Accordingly, investors should consider an evaluation of the financial position of the USC and its ability to redeem the MSC or PIC within anticipated time frames. The staff believes the audited financial statements of the USC as of and for the year ended December 31, 2008 would be useful evidence to appropriately evaluate MSC or PIC for other-than-temporary impairment. The evaluation for impairment should consider the specific facts and circumstances, including consideration of the regulatory capital requirements of the USC. However, the staff does not believe that regulatory capital requirements should be the primary consideration for assessing whether impairment is other than temporary. As noted earlier in this question and answer, the NCUSIF has immediately written off the investment in the USC. The staff believes this action by the NCUSIF should be considered in the assessment of whether impairment is deemed to be other than temporary.

The staff also notes that a natural person credit union that invests in a corporate credit union whose direct investment may be impaired, should evaluate that investment for other-than-temporary impairment using the same guidance noted earlier. The staff notes that the evaluation for impairment in any of these cases should be determined in view of the specific facts and circumstances.

[Issue Date: March 2009; Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

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TIS Section 7000

SPECIALIZED ORGANIZATIONAL PROBLEMS

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Section 7200

Partnerships

.01 Balance Sheet Presentation of Drawings in Excess of Capital Contributions

Inquiry—Two partners each contributed capital of \$100 to form a partnership for the construction of a shopping center. The partnership has obtained several loans to fund the construction, but no payments on these loans are due for two years. The partners each withdrew excess funds of \$50,000 from the partnership out of the proceeds of the loans.

How would the balance sheet show the \$200 of capital and \$100,000 of withdrawals?

Reply—Whether the \$50,000 payments to the partners are permissible depends on the terms of the construction loan commitment. If the partnership agreement is silent concerning these payments, and they are, in fact, not loans to the partners, the \$50,000 withdrawn by each partner represents drawings in anticipation of profits. As drawing accounts, they would normally be closed to the partners' capital accounts. In the situation presented, it would result in a "negative" capital account for each partner in the amount of \$49,900 in the partners' equity section of the balance sheet. Full disclosure of the circumstances causing the negative balance should also be included.

.02 Provision for Income Taxes on Partnership Income

Inquiry—A partnership agreement provides that in computing net profits, there will be a provision for income taxes, and the amount of the provision for income taxes will be considered an expense of the partnership. In the preparation of the income statement, would the net profit figure after income taxes be considered as having been determined according to generally accepted accounting principles?

Reply—Between themselves, partners may agree to compute net profits in any fashion they wish; but for financial presentation purposes, a provision for income taxes should not be set up. The absence of this item in the financial statement can be explained in the form of a footnote to the income statement. If the income statement shows a net profit figure after income taxes, the statement is not prepared in accordance with generally accepted accounting principles.

[.03] Reserved

[.04] Reserved

[.05] Reserved

[.06] Reserved

[.07] Reserved

.08 Income Allocation of Limited Partnership

Inquiry—A real estate limited partnership allocates the depreciation deduction entirely to the limited partners in accordance with the provisions of the partnership agreement. This is done in order to induce investment in the venture by the limited partners. Would such an allocation in the financial statements conform with generally accepted accounting principles (GAAP)?

Reply—Yes. Allocation of partnership income is determined by the partnership agreement. Therefore, in computing the income allocable to the limited and general partners, the depreciation deduction may be allocated entirely to the limited partners, in financial statements prepared in accordance with GAAP.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[The next page is 7351.]

Section 7400

Related Parties

[.01] Reserved

[.02] Reserved

[.03] Reserved

[.04] Reserved

[.05] Reserved

.06 Exchange of Interest Bearing Note for Non-Interest Bearing Note

Inquiry—Corporation A has an interest bearing note receivable from an officer/shareholder. Corporation A plans to exchange the present note for a non-interest bearing note. Should the non-interest bearing note be discounted in accordance with Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 835, *Interest*?

Reply—Yes. The non-interest bearing note should be discounted in accordance with FASB ASC 835, and there should be recognition of compensation or a dividend distribution, depending on what the unstated right or privilege represents.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[The next page is 7401.]

Section 7500

Estates and Trusts

[.01] Reserved

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Section 7600

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[.01–.09] Reserved

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Purchase Method

[.01-.24] Reserved

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Applicability of Pooling of Interests Method

[.01-.18] Reserved

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Section 7630

Application of Pooling of Interests Method

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AUDIT FIELD WORK

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Section 8100

Generally Accepted Auditing Standards

.01 Determining the Effective Date of a New Statement on Auditing Standards for Audits of a Single Financial Statement

Inquiry—The Auditing Standards Board issues a Statement on Auditing Standards (SAS) and the effective date is as follows: “This standard is effective for audits of financial statements for periods beginning on or after December 15, 2006.” If an auditor is engaged to perform an audit of only the balance sheet as of December 31, 2006, would the new standard be effective?

Reply—In determining whether the standard is effective to an audit of a single statement, the auditor needs to determine whether the standard would be effective if the auditor was engaged to audit the entity’s complete set of financial statements. If the standard would be effective when auditing a complete set of financial statements, the standard is effective when auditing a single statement. If the standard would not be effective when auditing a complete set of financial statements, the standard is not effective when auditing a single statement. To illustrate, refer to the following examples:

Example 1—Entity’s year began January 1, 2006, and ends December 31, 2006; would the standard apply to an audit of only the balance sheet as of December 31, 2006?

No, because the standard is not effective until periods beginning on or after December 15, 2006. Because the standard would not be effective if engaged to audit the complete set of financial statements, the standard is not effective if engaged to audit only the balance sheet.

Example 2—Entity’s year begins November 1, 2006, and ends October 31, 2007; would the standard apply to an audit of only the balance sheet as of June 30, 2007 (or as of any date during their year)?

No, for same reason as stated in Example 1.

Example 3—Entity’s year begins December 25, 2006, and ends December 21, 2007 (52–53 weeks); would the standard be effective if the auditor is engaged to audit only the balance sheet as of December 31, 2006?

Yes, because the fiscal period began after December 15, 2006, the standard would be effective if engaged to audit a complete set of financial statements for this period. Therefore, the standard is effective for an audit of the balance sheet only.

Example 4—Entity’s year begins January 1, 2007, and ends December 31, 2007; would the standard be effective if the auditor is engaged to audit only the balance sheet as of January 31, 2007?

Yes, for the same reason as stated in Example 3.

.02 Determining the Effective Date of a New Statement of Auditing Standards for Audits of Interim Periods

Inquiry—The Auditing Standards Board issues a SAS and the effective date is as follows: “This standard is effective for audits of financial statements for periods beginning on or after December 15, 2006.” If an auditor is engaged to perform an “interim audit” of an entity’s financial statements, would the standard apply?

Reply—The auditor would refer to the entity's normal fiscal year to determine whether the standard is effective. To illustrate, refer to the following examples:

Example 1—Entity's year begins January 1, 2007. The standard would be effective for an audit of financial statements for the three-month period ending March 31, 2007, because the interim period began after December 15, 2006.

Example 2—Entity's year begins October 1, 2006. The standard would not be effective for an audit of financial statements for the six-month period ending March 31, 2007, because the interim period began prior to December 15, 2006.

.03 Using Current Auditing Standards for Audits of Prior Periods

Inquiry—An auditor is engaged to perform an audit of financial statements that are as of or for a period that ended prior to the effective date of the clarified auditing standards. May an auditor use the clarified auditing standards that are currently effective at the time the audit is performed even though the standards were not effective for that prior period?

Reply—Yes. Because the clarified auditing standards are now effective and comprise auditing standards generally accepted in the United States of America (GAAS), the auditor may perform and report on an entity's prior period financial statements using the clarified auditing standards. The auditor's documentation should indicate whether the auditor followed GAAS currently in effect or whether the auditor followed GAAS that existed for the period under audit.

[Issue Date: December 2013.]

[The next page is 8371.]

Section 8200

Internal Control

.01 [Reserved]

.02 Determining Accuracy of Cash Collections for Coin-Operated Machines

Inquiry—How can the accuracy of the cash collections be determined for a chain of laundromats with several thousand machines? The coin-operated machines do not employ the use of meters, counters, locked boxes, or any other devices that would provide a basis for control.

Reply—One method to determine if the machines' receipts are being surrendered intact is to occasionally fill selected coin-operated machines with marked coins. The subsequent collections can then be reviewed to make sure the same coins have been turned in. It may also be possible to correlate revenues with consumption of water and electricity by these machines. Furthermore, it may be possible to determine the expected revenues from an installation and the extent to which the machines are being used by observation of the activities of selected installations.

.03 [Reserved]

.04 [Reserved]

.05 Testing the Operating Effectiveness of Internal Control

Inquiry—Where the auditor anticipates the entity may not have effective internal control, does AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), require the auditor to obtain an understanding of internal control even if the auditor intends to design a substantive audit approach and not rely on controls?

Reply—Yes. Paragraph .13 of AU-C section 315 states

The auditor should obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit.^[1]

Paragraph .14 of AU-C section 315 further states

When obtaining an understanding of controls that are relevant to the audit, the auditor should evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to inquiry of the entity's personnel.

The nature and extent of the auditor's understanding of relevant controls is described in paragraph .A68 of AU-C section 315, which states

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

^[1] [Footnote deleted, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

using it. Assessing the implementation of a control that is not effectively designed is of little use, and so the design of a control is considered first. An improperly designed control may represent a significant deficiency or material weakness in the entity's internal control.

When the auditor believes, based on the understanding of controls, that controls are capable of effectively preventing or detecting and correcting material misstatements at the assertion level, the auditor may initially assess control risk at a low level during the risk assessment phase of the audit. This initial assessment of control risk is subject to the satisfactory results of the tests of the operating effectiveness of those controls to support that control risk assessment. Whether an auditor initially assesses control risk at a low level, and the degree thereof, is a matter of professional judgment.

In contrast, when the auditor believes, based on the understanding of controls, that controls are not capable of preventing or detecting and correcting material misstatements, the auditor would assess control risk as high, and the auditor would plan and perform substantive procedures to appropriately respond to the identified risks. In this situation, the auditor may identify missing or ineffective controls. The auditor is required to evaluate identified control deficiencies and determine whether these deficiencies, individually or in combination, are significant deficiencies or material weaknesses. Control deficiencies identified during the audit that upon evaluation are considered significant deficiencies or material weaknesses under this section should be communicated in writing to management and those charged with governance.² Also, in this circumstance, the auditor needs to be satisfied that performing substantive procedures alone would enable the auditor to design and perform an appropriate audit strategy and provide sufficient appropriate audit evidence to support his or her audit opinion.

[Issue Date: February 2008; Revised, January 2010, to reflect conforming changes necessary due to the issuance of SAS No. 115; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.06 The Meaning of Expectation That the Controls Are Operating Effectively

Inquiry—Paragraph .08 of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), requires the auditor to design and perform tests of controls to obtain sufficient appropriate audit evidence about the operating effectiveness of relevant controls if the auditor's assessment of risks of material misstatement at the relevant assertion level includes an expectation that the controls are operating effectively or if substantive procedures alone cannot provide sufficient appropriate audit evidence at the relevant assertion level. What does *expectation that the controls are operating effectively* mean?

Reply—The phrase *expectation that the controls are operating effectively* means that the auditor's understanding of the five components of internal control has enabled him or her to initially assess control risk at a low level, and the auditor's strategy contemplates a combined approach of designing and performing tests of controls and substantive procedures. As stated above, the auditor's initial assessment of control risk is preliminary and subject to the satisfactory results of the tests of the operating effectiveness of those controls.

² See AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*). [Footnote revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.07 Considering a Substantive Audit Strategy

Inquiry—Paragraph .A4 of AU-C section 330 states, in part

The auditor may determine that performing only substantive procedures is appropriate for particular assertions, and therefore, the auditor excludes the effect of controls from the relevant risk assessment. This may be because the auditor's risk assessment procedures have not identified any effective controls relevant to the assertion or because testing controls would be inefficient, and therefore, the auditor does not intend to rely on the operating effectiveness of controls in determining the nature, timing, and extent of substantive procedures.

Does this mean that an all substantive audit approach may be followed even if the auditor's understanding of internal control causes him or her to believe that controls are designed effectively?

Reply—Yes. After the auditor identifies and assesses the risks of material misstatement, the auditor's decision about whether to test the operating effectiveness of controls may be considered within a cost-benefit framework. If the auditor believes that the benefit of testing control operating effectiveness—both in terms of audit efficiency and effectiveness—is less than the cost of testing controls, the auditor may be inclined to adopt an audit strategy (or modify a preliminary strategy) that excludes testing controls. If testing the operating effectiveness of controls would not be effective or efficient, it will then be necessary to perform substantive procedures that respond to the assessed risks for specific assertions.

However, even in smaller entities, there may be well-designed controls that are operating effectively. For example, there may be controls over revenues that, if tested, could reduce the extent of substantive procedures.

The extent of substantive testing cannot be reduced based on the premise of effective controls, unless the effective operation of such controls has been tested.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.08 Obtaining an Understanding of the Control Environment

Inquiry—In smaller entities, the control environment might be less formal than larger entities. Is the auditor required to obtain an understanding of these less formal controls, and when do these controls need to be tested?

Reply—AU-C section 315 addresses the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements through understanding the entity and its environment, including the entity's internal control as described in *Internal Control—Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission. This includes obtaining a sufficient understanding of the design of controls such as those that are part of the control environment to evaluate the design of controls relevant to an audit of financial statements and to determine whether they have been implemented.

Even in audits of smaller entities, auditors may rely on the control environment to determine the nature, timing, and extent of further auditor

procedures. If an auditor chooses to rely on these controls, then the auditor is presumptively required³ to test those controls.⁴

It is preferable to evaluate the control environment early on in the audit process. This is because the results of the auditor's evaluation of these controls could affect the nature, timing, and extent of other planned audit procedures. For example, weaknesses in the control environment may undermine the effectiveness of other control components and, therefore, be negative factors in the auditor's assessment of the risks of material misstatement, in particular in relation to the risks of fraud.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.09 Assessing Inherent Risk

Inquiry—Paragraph .14 of AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*), defines *inherent risk* as “the susceptibility of an assertion about a class of transaction, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.” In situations in which the auditor's methodology makes separate assessments of inherent risk and control risk, does this mean that an auditor can ignore the assessment of control risk in his or her assessment of the combined risks of material misstatement if inherent risk is assessed as low?

Reply—No. Paragraph .26 of AU-C section 315 states, in part

To provide a basis for designing and performing further audit procedures, the auditor should identify and assess the risks of material misstatement at^[5]

- b. the relevant assertion level for classes of transactions, account balances, and disclosures.

Because an auditor is required to assess the combined risk of material misstatement, an auditor can not ignore control risk regardless of his or her assessment of inherent risk. While auditing standards do not require separate assessments to be performed, they do require an assessment of risk of material misstatement that includes control risk.

While not required by generally accepted auditing standards, some audit methodologies may express the assessment of inherent risk in quantitative terms (for example, percentages) or nonquantitative terms (for example, high, medium, or low). Because the definition of *inherent risk* excludes the effect of any related controls, the auditor's assessment of inherent risk should exclude the effect of any related controls. Therefore, if an auditor assesses inherent risk as low, an auditor has to be careful whether his or her judgment was influenced by the effect of certain controls.

³ See paragraph .08 of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*). [Footnote revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

⁴ Chapter 4 of the AICPA Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* provides further guidance about obtaining an understanding of the entity and its environment, including its internal control, and about evaluating and testing entity level controls, including the control environment.

^[5] [Footnote deleted, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

For example, assume an auditor is auditing a balance sheet account that the auditor expects to have only one adjustment per month posted to it. The auditor believes that the monthly adjustment is relatively easy to calculate. Assume further that the auditor's methodology calls for the auditor, as part of performing risk assessment procedures, to assess inherent risk at the assertion level as high, medium, or low. The auditor assesses the susceptibility of inherent risk as low because the auditor believes that the amount is relatively easy to calculate, but also partially because the auditor has not identified a misstatement in this account in prior year audits and believes that the bookkeeper is capable of recording the correct monthly amount.

In this example, the auditor's professional judgment as to the assessment of inherent risk was influenced by the auditor's belief that the bookkeeper is competent and has never made an error in prior years in posting the monthly adjustment. As a result, the auditor's assessment of inherent risk did not assume that there are no controls because there are some controls in place that the bookkeeper applies in making his or her monthly adjustment.

Therefore, an auditor has to be careful when assessing inherent risk as "low" because the auditor may be assuming that certain basic controls are in place and operating effectively. In such cases, the auditor may actually be making a combined assessment of the risks of material misstatement rather than assessing only inherent risk.

As discussed in section 8200.05, *Testing the Operating Effectiveness of Internal Control*, an initial assessment of effective controls (even a basic control) is subject to the satisfactory results of the tests of the operating effectiveness of those controls.

[Issue Date: March 2008; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.10 Assessing Control Risk

Inquiry—Is defaulting to a high control risk level still permitted under AU-C section 315?

Reply—No. AU-C section 315 addresses the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements through understanding the entity and its environment, including the entity's internal control. As the auditor obtains that understanding, the auditor may identify material weaknesses in the design of controls and, as a result, end up assessing control risk as high for some financial statement accounts and relevant assertions. Also, as discussed in section 8200.07, "Considering a Substantive Audit Strategy," after identifying and assessing the risk of material misstatement at the assertion level, the auditor may adopt a substantive audit strategy. In this circumstance, the auditor may assess control risk as high. Finally, the auditor might initially assess control risk at low level only to find out later, after testing the operating effectiveness of controls, that controls were not effective and would then reassess control risk as high.^[6]

[Issue Date: March 2008; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

^[6] [Footnote deleted, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.11 Ineffective Controls

Inquiry—If, based on his or her knowledge of the entity, an auditor believes, in advance of performing risk assessment procedures, that controls over financial reporting are nonexistent or ineffective, could the evaluation and documentation of such controls (including the walkthrough) be skipped?

Reply—No. AU-C section 315 requires the auditor to obtain an understanding of internal control relevant to the audit, and to evaluate the design of those controls and determine whether they have been implemented. In addition, AU-C section 315 requires auditors to identify and assess the risks of material misstatement at the relevant assertion level as the basis for designing and performing further audit procedures.

[Issue Date: March 2008; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.12 Use of Walkthroughs

Inquiry—AU-C section 315 requires the auditor to obtain an understanding of internal control relevant to the audit. An auditor might perform walkthroughs to confirm his or her understanding of internal control. If the auditor decides to use walkthroughs to confirm his or her understanding of internal control, how often do walkthroughs need to occur?

Reply—In accordance with AU-C section 315, the auditor is required to obtain an understanding of internal control relevant to the audit to evaluate the design of controls and to determine whether they have been implemented. To do that, performing a walkthrough would be a good practice. Accordingly, auditors might perform a walkthrough of significant accounting cycles every year. In some situations, AU-C section 315 allows the auditor to rely on audit evidence obtained in prior periods. In those situations, the auditor is required to perform audit procedures to establish the continued relevance of the audit evidence obtained in prior periods (for example, by performing a walkthrough). So, an auditor might perform walkthroughs every year in order to update his or her understanding.

[Issue Date: March 2008; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.13 Documenting Internal Control

Inquiry—Does a control have to be documented for it to be tested?

Reply—No. However, it is recommended that an entity document its controls so that the auditor can efficiently obtain an understanding of controls, assess the risks of material misstatement, and test them for operating effectiveness and reliance thereon (if the auditor chooses to test controls). If the entity does not document a control, and it is an important control, AU-C section 315 paragraph .33 requires the auditor to document the control as part of the auditor's risk assessment procedures to identify and assess the risks of material misstatement. The auditor is required to perform risk assessment procedures to identify and assess the risks of material misstatements. In addition, it may not be practical to test the operating effectiveness of controls (if the auditor chooses to do so) throughout the audit period without some level of documentation of the control by the client.

[Issue Date: March 2008; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.14 Suggesting Improvements in Internal Control

Inquiry—When performing a walkthrough of controls, may an auditor suggest improvements in internal control to the client?

Reply—Yes. A byproduct of obtaining an understanding of internal control is making suggestions for improvement to the client. That brings value to the audit process.

[Issue Date: March 2008]

.15 Identifying Significant Deficiencies

Inquiry—If the auditor decides not to test controls, does that mean there is a control deficiency that is required to be evaluated under AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*)?

Reply—No, not necessarily. It depends on the reasons the auditor decides not to test the control. The auditor's decisions about the nature, timing, and extent of further audit procedures are based on the assessment of the risks of material misstatement. Communications under AU-C section 265 are based on control deficiencies that the auditor has identified. If the auditor decides not to test a control because it is nonexistent or is not properly designed, then that would represent a control deficiency that would need to be assessed as to severity to determine whether it is a significant deficiency or material weakness. If the design of the control is appropriate, but the auditor decides not to test it for another reason (for example, because the control is redundant), then the auditor has not identified a control deficiency.

[Issue Date: March 2008; Revised, January 2010, to reflect conforming changes necessary due to the issuance of SAS No. 115; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.16 Examining Journal Entries

Inquiry—Paragraph .21 of AU-C section 330 states, in part

The auditor's substantive procedures should include audit procedures related to the financial statement closing process, such as

- agreeing or reconciling the financial statements with the underlying accounting records and
- examining material journal entries and other adjustments made during the course of preparing the financial statements.

Does the phrase *adjustments made during the course of preparing the financial statements* refer to journal entries and other adjustments prepared by the client during the process of drafting the financial statements, or does it refer to journal entries recorded during the year?

Reply—The requirement to examine material journal entries and other adjustments made during the course of preparing the financial statements in paragraph .21 of AU-C section 330 refers to those journal entries and adjustments prepared by the entity during the process of preparing its financial statements (for example, consolidating entries or elimination entries between divisions). It does not refer to the journal entries recorded by the entity in the general ledger during the year. However, paragraph .32a of AU-C section 240, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*), requires auditors to design and perform audit procedures to test the appropriateness of journal entries recorded by the entity in the general ledger during the year.

[Issue Date: March 2008; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[The next page is 8491.]

Section 8220

Sampling

.01 Application of AU-C Section 530

Inquiry—When would the auditor apply the audit sampling principles in AU-C section 530, *Audit Sampling* (AICPA, *Professional Standards*)?

Reply—Audit sampling is only one of many tools used by auditors to obtain sufficient, appropriate evidence to support an opinion regarding financial statements. AU-C section 530 outlines design, selection, and evaluation considerations to be applied by the auditor when using audit sampling. As a general rule, audit sampling can be used—

- in performing tests of controls that provide an audit trail of documentary evidence,
- in performing substantive procedures to test details of transactions and balances, and
- in dual purpose tests that test a control that provides documentary evidence of performance and whether the recorded monetary amount of transactions or balances is correct.

Sampling applies when the auditor needs to decide whether the rate of deviation from a prescribed procedure is no greater than a tolerable rate, for example in testing a matching process or an approval process. However, risk assessment procedures performed to obtain an understanding of internal control do not involve sampling. Sampling concepts also do not apply for some tests of controls. Tests of automated application controls are generally tested only once or a few times when effective (IT) general controls are present, and thus do not rely on the concepts of risk and tolerable deviation as applied in other sampling procedures. Sampling generally is not applicable to analyses of controls for determining the appropriate segregation of duties or other analyses that do not examine documentary evidence of performance. In addition, sampling may not apply to tests of certain documented controls or to analyses of the effectiveness of security and access controls. Sampling also may not apply to some tests directed toward obtaining audit evidence about the operation of the control environment or the accounting system, for example, inquiry or observation of explanation of variances from budgets when the auditor does not desire to estimate the rate of deviation from the prescribed control, or when examining the actions of those charged with governance for assessing their effectiveness.

Thus, AU-C section 530 applies when sampling techniques are used to test either the operating effectiveness of the controls or to test details of transactions or balances.

Paragraph .05 of AU-C section 530 defines *audit sampling* as

The selection and evaluation of less than 100 percent of the population of audit relevance such that the auditor expects the items selected (the sample) to be representative of the population and, thus, likely to provide a reasonable basis for conclusions about the population. In this context, *representative* means that evaluation of the sample will result in conclusions that, subject to the limitations of sampling risk, are similar to those that would be drawn if the same procedures were applied to the entire population.

A key to understanding that definition is the intent of the auditor in applying the audit procedure. As noted in paragraph .A3 of AU-C section 530, the auditor may examine fewer than 100 percent of the items comprising an account balance or class of transactions for reasons other than evaluating a characteristic of the balance or class. For example, the auditor is not performing audit sampling in the following situations:

- An auditor traces several sales transactions through a client's accounting system to gain an understanding of the manner in which transactions are processed. AU-C section 530 would not apply because the auditor's intent was to gain an understanding of the processing of these transactions by the accounting system, not to evaluate a characteristic of all sales transactions processed by the accounting system.
- The auditor might examine several large sales invoices that comprise a significant portion of the account balance and leave the remaining portion of the balance untested or test the remaining items by other means, such as the application of analytical procedures. Again, AU-C section 530 does not apply because the auditor does not intend to evaluate all items in the account balance based on the examination of the large items.

Another consideration in determining whether AU-C section 530 is applicable to circumstances in which an auditor examines fewer than 100 percent of the items comprising an account balance or class of transactions is the purpose of the test being applied. 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, AU-C section 530 applies. For example, if the auditor intends to examine selected sales invoices to draw a conclusion as to whether sales are overstated, AU-C section 530 applies—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-C section 530—the auditor's 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.

In determining whether AU-C section 530 applies to a given audit procedure, the auditor would also consider the population in which the auditor is interested. 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. The sampling concepts in AU-C section 530 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.

[Revised, May 2007; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.02 [Reserved]

.03 Adequate Size for Nonstatistical Samples

Inquiry—Is there a rule-of-thumb for determining an adequate size for nonstatistical samples for substantive audit tests?

Reply—There is no rule-of-thumb that is appropriate for all applications. AU-C section 530 imposes no requirement to use quantitative aids, such as sample size tables, to determine sample size. Nor does AU-C section 530 impose a rule regarding minimum sample size. Just as before the issuance of AU-C section 530, professional judgment is the key. Auditors often use benchmarks or starting points such as sample sizes used in prior years or in similar circumstances in other audit engagements in determining what sample size is appropriate for a given sampling application. Paragraph .A13 of AU-C section 530 lists factors that influence the auditor's professional judgment in determining sample size. Those factors include

- for tests of controls,
 - the tolerable rate of deviation of the population to be tested.
 - the expected rate of deviation of the population to be tested.
 - the desired level of assurance (complement of risk of overreliance) that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the population; the auditor may decide the desired level of assurance based on the extent to which the auditor's risk assessment takes into account relevant controls.
 - the number of sampling units in the population if the population is very small.
- for substantive tests of details,
 - the auditor's desired level of assurance (complement of risk of incorrect acceptance) that tolerable misstatement is not exceeded by actual misstatement in the population; the auditor may decide the desired level of assurance based on
 - the auditor's assessment of the risk of material misstatement.
 - the assurance obtained from other substantive procedures directed at the same assertion.
 - tolerable misstatement.
 - expected misstatement for the population.
 - stratification of the population when performed.
 - for some sampling methods, the number of sampling units in each stratum.

An auditor who applies statistical sampling uses tables or formulas to compute sample size based on these judgments. An auditor who applies nonstatistical sampling uses professional judgment to relate these factors in determining the appropriate sample size.

If the auditor considered factors such as these in determining sample size in prior years or in other engagements, there may be no reason to believe that sample sizes based on these benchmarks or starting points are inadequate. Individual firms or auditors often prefer to set their own rules regarding a benchmark or starting point for determining sample size. AU-C section 530 does not prohibit such policies. It merely alerts the auditor to factors the auditor should consider in judging the adequacy of sample size.

[Revised, May 2007; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.04 Documentation Requirements of AU-C Section 530

Inquiry—Does AU-C section 530 impose any new documentation requirements?

Reply—No, AU-C section 530 contains no new specific documentation requirements. AU-C section 230, *Audit Documentation* (AICPA, *Professional Standards*), applies to audit sampling applications just as it applies to other auditing applications. For example, AU-C section 300, *Planning an Audit* (AICPA, *Professional Standards*), requires the auditor to include in the audit documentation the audit plan, and AU-C section 230 requires the auditor to prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand (a) the nature, timing, and extent of the audit procedures performed to comply with generally accepted auditing standards and applicable legal and regulatory requirements; (b) the results of the audit procedures performed, and the audit evidence obtained; and (c) significant findings or issues arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions. Thus, with regard to audit sampling applications, the auditor's audit program might document such items as the objectives of the sampling application and the audit procedures related to those objectives. The auditor's record of the work performed might include

- the definition of the population and the sampling unit, including how the auditor considered completeness of the population.
- the definition of misstatement.
- the method of sample selection.
- a list of misstatements identified in the sample.
- an evaluation of the result of the sampling application.
- conclusions reached by the auditor.

[Revised, May 2007; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.05 Methods to Select Representative Sample

Inquiry—What are some selection methods that can be used to select a representative sample?

Reply—There is no requirement in AU-C section 530, as amended, that random sampling selection methods be used. Representative sampling methods used by auditors include

- haphazard sampling.
- systematic sampling.
- random-number sampling.

Haphazard sampling consists of selecting sampling units without any conscious bias, that is, without any special reason for including or omitting items from the sample. Haphazard sampling does not imply that units can be selected in a careless manner. Rather, a haphazard sample is selected in a manner that can be expected to be representative of the population. For example, where the physical representation of the population is a file cabinet drawer of vouchers, a haphazard sample of all vouchers processed for the year 19XX might include any of the vouchers that the auditor pulls from the drawer, regardless of each voucher's size, shape, location, or other physical features. The auditor using haphazard selection would want to be careful to avoid distorting the sample by selecting, for example, only unusual or physically small items or by omitting

items such as the first or last items in the physical representation of the population.

Systematic sampling consists of determining a uniform interval, and one item is selected throughout the population at each of the uniform intervals from the starting point.

Random-number sampling entails matching random numbers generated by a computer or selected from a random-number table with, for example, document numbers.

Another method sometimes used in practice is block sampling. Block sampling consists of selecting groups of sequential transactions (for example, all vouchers processed on several selected dates). Using block samples may be inefficient because in order for a block sample to be adequate to lead to an audit conclusion, a relatively larger number of blocks would be selected. If an auditor decides to use block sampling, the auditor may want to exercise special care to control sampling risk in designing the auditor's sample.

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[The next page is 8521.]

Section 8310

Audit Evidence: Securities

.01 [Reserved]

.02 Confirmation of Securities Held in Street Name

Inquiry—A CPA firm has been engaged to perform the initial audit of a pension plan and trust. Most of the trust assets are investments held in street name by a brokerage house. Some negotiable bearer bonds, held in a bank, are in denominations not traceable to the trust account since the bond may represent investments by more than one customer. In addition to its monthly account statements the broker will certify details and ownership of investments at the statement date and will permit examination of certain of its internal records. The bank will also certify details and ownership of investments held for the trust.

Would the fact that the securities are held in “street name” and in some cases in denominations which cannot be traced to the trust’s account preclude obtaining sufficient appropriate audit evidence on which to base an opinion on the financial statements of the pension plan and trust?

Reply—AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*), discusses audit evidence. Physical inspection and count of the securities in this case appear to be impracticable; therefore, audit evidence concerning the securities would presumably consist primarily of confirmations received from the brokerage houses and other financial institutions which have possession of the securities. Whether or not confirmations would represent sufficient appropriate audit evidence is really a matter for the auditor’s professional judgment.

[Revised, May 2007; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[The next page is 8571.]

Section 8320

Audit Evidence: Inventories

.01 Reliance on Observation of Inventories at an Interim Date

Inquiry—Although its fiscal year ends on March 31, a client has always counted its physical inventory on December 31. The March 31 ending inventory has always been calculated by the gross profit method which has proven over the past to be quite accurate. No perpetual inventory records are kept.

Can the auditor rely on an observation of inventory that takes place three months prior to the balance sheet date?

Reply—AU-C section 501, *Audit Evidence—Specific Considerations for Selected Items* (AICPA, *Professional Standards*), addresses evidence regarding inventory. Paragraph .11 of AU-C section 501 requires the auditor to attend physical inventory counting, unless impracticable, to observe the performance of management's count procedures, and to perform audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results. Paragraph .13 indicates that if attendance at physical inventory counting is impracticable, the auditor should make or observe some physical counts on an alternate date and perform audit procedures on intervening transactions.

Paragraph .A31 of AU-C section 501 further states, in part

For practical reasons, the physical inventory counting may be conducted at a date, or dates, other than the date of the financial statements. This may be done irrespective of whether management determines inventory quantities by an annual physical inventory counting or maintains a perpetual inventory system.

Normally, observing an inventory-taking on December 31 when a client has a March 31 year-end and perpetual records are used as the basis of the March 31 inventories, would present no unusual problems since tests of intervening transactions referred to in paragraph .13 of AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), usually can be readily applied. However, if the client keeps no perpetual records of inventory, the tests of the intervening transactions would, in effect, cause the auditor to create the perpetual records as a basis for the March 31 inventory.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.02 Observation of Physical Inventory on an Initial Audit

Inquiry—A company maintains large inventories of tractor parts in five different locations. The quantities of each part may be quite small, averaging six or seven pieces; but there are approximately 5000 different parts on hand, some as much as twenty years old. The company has been taking complete physical inventories at the end of each year. In the past, the parts inventories have been valued at the current catalogue prices.

A CPA has been engaged to perform the company's initial audit. What procedures may be followed in establishing the value of the parts inventory?

Reply—It would appear necessary under paragraph .11 of AU-C section 501; paragraph .A13 of AU-C section 510, *Opening Balances—Initial Audit*

Engagements, Including Reaudit Engagements (AICPA, *Professional Standards*); and paragraph .07b of AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report* (AICPA, *Professional Standards*), that the auditor observe the client's count of the parts inventory. Presumably tests would be made in each of the five locations.

Inventory pricing should be based on historical cost, rather than current selling price. While it may not be practicable to determine cost individually for the large number of parts on hand, it might be appropriate to determine the ratio of cost to catalogue price to obtain an approximation of the cost of current inventory. Also, some allowance, based on experience, should be made for obsolescence. Presumably a part will have little current value if there is a probability it will not be sold within five years. Costs of warehousing items for such a period may often approach the discounted value of the sales price.

Based upon observations and upon discussions with the client's employees, the auditor may be able to obtain some impressions as to the reliability of the earlier inventories. This would be supported by a comparison of this year's inventory with the prior year's, and by knowledge of sales and production in the current year.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.03 Cost of Inventories Acquired From Principal Stockholder

Inquiry—A corporation purchased merchandise from a stockholder who owns 99 percent of the corporation's stock and executed a chattel mortgage in favor of the stockholder. The merchandise was acquired by the stockholder prior to the formation of the corporation.

How can the CPA be sure the purchase price of this merchandise is reasonable?

Reply—The “seller's” cost can be ascertained through the examination of his cost records, invoices, etc., and comparing his total cost with the selling price to the corporation. Also, the taking of inventory can be observed and verified against physical quantities and classifications of inventory, against transfer documents and against the transferor's cost records and invoices. If the latter records are not available, the auditor can price the inventory at the current replacement cost which can be obtained by reference to recent invoices, communication with suppliers, or references to recent merchandise catalogs.

A basic consideration in this case is the fact that, upon incorporation, there is a continuance of beneficial interest in the inventory transferred and in the proceeds from its eventual disposition by virtue of the chattel mortgage and the 99 percent stock ownership. Accordingly, the transferor's cost should be carried over and continued on the books of the newly organized corporation.

.04 Reliance on Estimates of Coal Inventories by Experts

Inquiry—An electric utility maintains a large stockpile of coal. The auditors rely on the calculations of an engineering firm in their test of this inventory. The amount of coal by weight is estimated by multiplying the volume of the coal pile, calculated in cubic feet, by the estimated average density of the coal, measured in pounds per cubic foot. The calculated amount is then compared with the utility's perpetual inventory records, and, if the variance is not considered material, the perpetual inventory is accepted as the accurate amount.

Because of the uncertainties involved in this method, particularly in the estimation of the average density of the coal, the engineers are reluctant to

render an opinion on the amount of coal on hand. Other methods of calculating the amount of coal such as the “two coal-pile” theory are uneconomical.

In all cases, this inventory is a material item in the accounts of the utility. What alternative auditing procedures might be used in these circumstances?

Reply—While a slight change in density of the coal might result in a change in computed quantity of coal on hand, the effect would most likely not be material in relation to the balance sheet or statement of operations of the utility company. Perhaps, using the criteria of statistical sampling, the engineers would be willing to state that there is a X% probability that the quantity of coal is a certain amount plus or minus X% (or some other measure of variability).

.05 Dates of Observation of Inventories Which Are Kept on Perpetual Records

Inquiry—A retail dealer in tires and tubes has twenty-two stores. Each month the dealer takes inventory at two stores. The dealer’s auditor has observed the inventory taking at ten locations. To avoid the need for extra help at year end, January 31, the auditor proposes to visit the remaining locations shortly after December 31 and:

- Count the tires on hand at that time.
- Reconcile the count back to the daily report at December 31.

Do the above described procedures constitute an adequate observation of inventories?

Reply—Paragraphs .11–.15 of AU-C section 501 require the auditor to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory. Paragraph .A31 of AU-C section 501 states, in part

For practical reasons, the physical inventory counting may be conducted at a date, or dates, other than the date of the financial statements. This may be done irrespective of whether management determines inventory quantities by an annual physical inventory counting or maintains a perpetual inventory system.

Presumably the dealer has the necessary perpetual records which allow the taking of inventory at two stores each month during the year. Therefore, the proposed procedures would be acceptable and meet the requirement for inventory observation.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.06 Observation of Consignment Inventories

Inquiry—Corporation A sells supplies and equipment for manufacturing jewelry. Silver on consignment from a supplier is kept in a vault adjacent to where Corporation A keeps its silver inventory. The supplier employs an independent warehouse firm to protect the consigned silver. The bonded employee of the warehouse firm has sole access to the consignment silver and performs the duties of warehouse manager for Corporation A. The warehouse firm pays the salary of the bonded employee but is reimbursed by Corporation A. Since the possibility for substitutions between Corporation A’s silver inventories and the consignment silver exists, the auditors of Corporation A, in conducting a physical observation of Corporation A’s silver inventories, also want to conduct a physical observation of the consignment silver. Is it necessary for the auditors of Corporation A to observe the consignment silver?

Reply—AU-C section 501 addresses specific considerations by the auditor in obtaining sufficient appropriate audit evidence regarding certain aspects of inventory, including inventory owned by a third party. Paragraph .A38 of AU-C

section 501 provides that the auditor may consider it appropriate to perform other audit procedures instead of, or in addition to, confirmation with the third party. Among the steps recommended for the auditor to follow, depending on the circumstances, is to attend, or arrange for another auditor to attend, the third party's physical counting of inventory, if practicable.

Because of the relationship which Corporation A has with the warehouse and the bonded employee, and the possibility for substitutions of inventory between Corporation A and the supplier, the auditors would observe the consignment inventory and Corporation A's inventory at the same time.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[The next page is 8671.]

Section 8330

Audit Evidence: Fixed Assets

.01 Verification of Real Estate Ownership

Inquiry—What procedures may be followed in the verification of real property accounts? Is it sufficient to examine the documents involved in the purchase of the property, to examine the real estate tax bills, and to communicate with the holders of any mortgages or trusts secured by the property? Should the client be required to assume the expense of a title search by an attorney?

Reply—It is generally conceded that examination of public records which contain the history of transactions relating to realty, as well as the current status of that property, is normally the function of an attorney or title company rather than that of an auditor. Accordingly if it is feasible for the client to obtain a letter from an attorney or title company which defines the interest the company holds in the land based upon a title search, this appears to be the best evidence available as to title and encumbrances.

If this procedure is too costly, then the following other audit procedures may supply sufficient indicia of title as to enable the auditor to assume that the client does, in fact, own the land subject to named liens.

1. Compare legal description of land found in deed with that found in the title insurance policy, abstract of deed, tax receipts, etc.
2. Verify current payment of carrying expenses of land in question, such as insurance premiums, tax payments, payments to mortgagee, etc.
3. Examine any rent receipts which may show evidence of continuing ownership.
4. Visit the land in question, if this is practicable.
5. Request an attorney's letter describing any conveyances or encumbrances of real property that may have been effected during the period covered in the audit, as well as his opinion regarding present status of title.
6. Obtain statement from client as to condition of title and encumbrance.
7. Check municipal or county records for evidence of ownership.

Use of a property map in connection with undertaking these procedures would also be helpful.

.02 Examination of Assets of a Rental Company

Inquiry—A lessor is in the business of leasing autos, large trucks, tractors, and trailers. Is it necessary for the auditors to make physical observations of

the rolling stock which is scattered across the country? What other audit procedures might be employed in the verification of this equipment? Must the titles to all equipment be examined?

Reply—It is not necessary, unless some extraordinary situation or circumstances were brought to light, to examine titles to all the equipment. Random test verifications of title certificates or proper registration of vehicles should be made. The fact that the client is receiving rent for the vehicles and is currently making payments on its time-purchase contracts would also be verified in regular course. Any tax and insurance payments which the client is required to make in connection with the vehicles can be checked. Also, test confirmations of possession of vehicles with the lessee should be made. Audit responsibility would not necessarily extend to physical observation of the equipment at its numerous shifting locations.

[The next page is 8731.]

Section 8340

Audit Evidence: Confirmation Procedures

[.01] Reserved

[.02] Reserved

.03 Confirmation of Balances Due on Loans

Inquiry—A bank arranges mortgage loans whereby the borrower instructs the bank to make payments to the contractor or developer. Payment booklets, which specify the periodic amounts due, are sent twice yearly to the borrower. In addition, each borrower receives an annual statement which shows his total yearly payments as well as the various yearly charges. Many of the debtors are unable to verify the correctness of the accrued charges and are unable to check the outstanding balances of their loans because of the complex interest rates. How can these loan balances be confirmed when the debtor cannot determine the total amount of the debt?

Reply—While the debtor may not be able to calculate the balance of the loan due, there are details of the loan which he or she should know and which can be confirmed. A request that the debtor confirm the original amount of the loan and the payments he or she has made would properly serve the purpose of a confirmation. Confirmation of the interest rate might also be requested as this affects the balance of the loan and should be known by the debtor.

[.04] Reserved

[.05] Reserved

[.06] Reserved

[.07] Reserved

[.08] Reserved

.09 Insurance Claims

Inquiry—Should an auditor communicate with an insurance company, or the insurance company's attorneys, when trying to obtain sufficient appropriate audit evidence about insured claims outstanding against management?

Reply—The auditor should obtain appropriate audit evidence about claims outstanding (a) from management and (b) by communicating with the entity's external legal counsel in accordance with AU-C section 501, *Audit Evidence—Specific Considerations for Selected Items* (AICPA, *Professional Standards*). The auditor may encounter situations where neither management nor the entity's external legal counsel is able to provide sufficient information regarding outstanding claims handled by insurance companies. In those situations, the auditor may consider communicating directly with the insurance company or its attorneys appropriate.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.10 Letter of Inquiry to Management's External Legal Counsel

Inquiry—When an auditor requested management to send a letter of inquiry to management's external legal counsel, management objected because its external legal counsel would charge for answering the letter of inquiry. Management also

believed that an inquiry about legal matters was not necessary because it had not used the services of its external legal counsel in the current year for any matters concerning litigation, claims or assessments. Rather, management paid fees to its external legal counsel in connection with other matters such as corporate registrations. Do generally accepted auditing standards require that a letter of inquiry be sent to management's external legal counsel?

Reply—No. Paragraph .16 of AU-C section 501 states that

The auditor should design and perform audit procedures to identify litigation, claims, and assessments involving the entity that may give rise to a risk of material misstatement, including (Ref: par. .A39–.A45)

- a. inquiring of management and, when applicable, others within the entity, including in-house legal counsel;
- b. obtaining from management a description and evaluation of litigation, claims, and assessments that existed at the date of the financial statements being reported on and during the period from the date of the financial statements to the date the information is furnished, including an identification of those matters referred to legal counsel;
- c. reviewing minutes of meetings of those charged with governance; documents obtained from management concerning litigation, claims, and assessments; and correspondence between the entity and its external legal counsel; and
- d. reviewing legal expense accounts and invoices from external legal counsel.

Paragraph .18 of AU-C section 501 further states, in part

Unless the audit procedures required by paragraph .16 indicate that no actual or potential litigation, claims, or assessments that may give rise to a risk of material misstatement exist, the auditor should, in addition to the procedures required by other AU-C sections, seek direct communication with the entity's external legal counsel.

If information contrary to management's assertion is discovered, in addition to requesting management to send an inquiry letter to management's external legal counsel in accordance with paragraph .18 of AU-C section 501, the auditor should consider the effects of the erroneous assertion on the ability to rely on other written representations from management.

In situations where no letter of inquiry is sent to management's external legal counsel, the auditor may consider including in the written representation letter from management a specific representation that no attorney had been consulted regarding litigation, claims, and assessments.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.11 Receivables in Special Purpose Financial Statements

Inquiry—If accounts receivable and escrow balances are included in special purpose financial statements, should the accounts receivable and escrow balances be confirmed?

Reply—The generally accepted auditing standards, including confirmation, that apply to financial statements prepared in accordance with generally accepted

accounting principles apply to financial statements prepared in accordance with a special purpose framework.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[.12] **Reserved**

[.13] **Reserved**

[.14] **Reserved**

[.15] **Reserved**

.16 Retention of Returned Confirmations When a Schedule of Confirmation Results is Prepared

Inquiry—AU-C section 505, *External Confirmations* (AICPA, *Professional Standards*), addresses the auditor’s use of external confirmation procedures to obtain audit evidence, in accordance with the requirements of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), and AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*). Similarly, AU-C section 230, *Audit Documentation* (AICPA, *Professional Standards*), addresses the form, content, and extent of audit documentation. When written confirmations are received, should they be retained as part of audit documentation or is a schedule of confirmation results sufficient?

Reply—Paragraph .A4 of AU-C section 230 sets forth factors that the auditor may consider in determining the form, content, and extent of the documentation. As indicated in paragraph .03 of AU-C section 505, confirmations are typically used for accounts with higher risks of material misstatement, they often serve as significant evidence to the assertions being tested, and seasoned judgment is often needed in evaluating confirmations that identify the nature and extent of exceptions. These reasons, among others, support retaining returned confirmations even though a schedule of confirmation results is prepared.

[Revised, June 2009; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[The next page is 8751.]

Section 8345

Audit Evidence: Destruction of Documents

.01 Audit Considerations When Client Evidence and Corroborating Evidence in Support of the Financial Statements Has Been Destroyed by Fire, Flood, or Natural Disaster

Inquiry—Prior to issuance of an auditor’s report on financial statements, and either prior to or after the completion of fieldwork, the audit documentation is destroyed by a fire, flood, or natural disaster. To what extent is the auditor required to recreate the audit documentation in order to express an opinion on the financial statements?

Reply—Paragraph .05 of AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*), states, in part, that “as the basis for the auditor’s opinion, GAAS require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance ... is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level.”

If substantially all of an entity’s evidence and corroborating evidence in support of their financial statements has been destroyed and the auditor has been unable to complete audit procedures with respect to financial statement amounts and assertions,¹ the auditor should disclaim an opinion on the financial statements as the auditor is unable to form an opinion as to the fairness of presentation of the financial statements in accordance with the applicable financial reporting framework. If the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the auditor should include in the basis of modification paragraph all the reasons for that inability.

When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the auditor should amend the introductory paragraph of the auditor’s report to state that the auditor was engaged to audit the financial statements. The auditor should also amend the description of the auditor’s responsibility and the description of the scope of the audit to state only the following: “Our responsibility is to express an opinion on the financial statements based on conducting the audit in accordance with auditing standards generally accepted in the United States of America. Because of the matter(s) described in the basis for disclaimer of opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.” Paragraph .A32 of AU-C section 705, *Modifications to the Opinion in the Independent Auditor’s Report* (AICPA, *Professional Standards*), contains an illustration of an auditor’s report containing a disclaimer of opinion due to the auditor’s inability to obtain sufficient appropriate audit evidence about multiple elements of the financial statements.^[2]

¹ The auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure.

^[2] [Footnote deleted, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

In the case where the evidence and corroborating evidence is available for some, but not all, of the financial statement accounts and assertions, the auditor would explain which evidence has been destroyed (such as evidence supporting the cost of inventory, the valuation of amounts in accounts receivable, and so on).

If so engaged by an entity, the auditor may express an opinion on one or more specified elements, accounts, or items of a financial statement (such as a schedule of accounts receivable or fixed assets). If the auditor is so engaged, the guidance in AU-C section 805, *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement* (AICPA, *Professional Standards*), should be followed. The auditor should not express an opinion on specified elements, accounts, or items included in a financial statement on which he or she has disclaimed an opinion, if such reporting would be tantamount to expressing a piecemeal opinion on the financial statements. However, an auditor would be able to express an opinion on one or more specified elements, accounts, or items of a financial statement provided that matters to be reported on and the related scope of the audit were not intended to and did not encompass so many elements, accounts, or items as to constitute a major portion of the financial statements. For example, it may be appropriate for an auditor to express an opinion on an entity's schedule of accounts receivable or fixed assets even if the auditor has disclaimed an opinion on the financial statements taken as a whole. However, the report on the specified element, account, or item should be presented separately from the financial statements of the entity.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.02 Considerations When Audit Documentation Has Been Destroyed by Fire, Flood, or Natural Disaster

Inquiry—Prior to issuance of an auditor's report on financial statements, and either prior to or after the completion of fieldwork, the audit documentation is destroyed by a fire, flood, or natural disaster. To what extent is the auditor required to recreate the audit documentation in order to express an opinion on the financial statements?

Reply—Audit documentation is the principal record of auditing procedures applied, evidence obtained, and conclusions reached by the auditor in the engagement. In addition, certain Statements on Auditing Standards contain specific documentation requirements. Paragraph .02 of AU-C section 230, *Audit Documentation* (AICPA, *Professional Standards*), states that audit documentation provides (a) evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor;³ and (b) evidence that the audit was planned and performed in accordance with generally accepted auditing standards (GAAS) and applicable legal and regulatory requirements. Oral explanations cannot serve as the principal support for the work performed or the conclusions reached.

Because audit documentation is an essential element of an audit performed in accordance with generally accepted auditing standards, the auditor cannot state that he or she has performed an audit in accordance with generally accepted auditing standards without the required audit documentation. In cases where the audit documentation has been destroyed by fire, flood, or a

³ Paragraph .12 of AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*). [Footnote revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

natural disaster prior to the issuance of the auditor's report, it will be necessary for the auditor to either recreate the audit documentation in support of the audit procedures performed or re-perform the audit procedures and create new audit documentation.

In making the determination as to whether to recreate the destroyed audit documentation or to re-perform the audit procedures, the auditor may keep in mind the ultimate objective of the auditing procedures. That is, to obtain sufficient appropriate audit evidence to afford a reasonable basis for expressing an opinion on the financial statements. For example, the auditor may be able to recreate the documentation that supports certain assertions about accounts receivable by using information contained in the audit documentation with respect to sales revenue (assuming that the sales documentation was not destroyed). In addition, the auditor may be able to recreate the audit program and prepare memorandums sufficient to explain the procedures performed and the results obtained. When considering the sufficiency of such documentation, the auditor is required by paragraph .08 of AU-C section 230 to prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand (a) the nature, timing, and extent of the audit procedures performed to comply with GAAS and applicable legal and regulatory requirements; (b) the results of the audit procedures performed, and the audit evidence obtained; and (c) significant findings or issues arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions. Except for perhaps the smallest of audits, it will prove difficult for the auditor to amass sufficient audit documentation by referring to documentation for a related account or by recreating the audit documentation. Consequently, the auditor will usually have to re-perform the audit procedures and create new audit documentation.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[The next page is 8771.]

Section 8350

Audit Evidence: Audit Documentation

.01 Current Year Audit Documentation Contained in the Permanent File

Inquiry—Paragraph .06 of AU-C section 230, *Audit Documentation* (AICPA, *Professional Standards*), defines *audit documentation* as the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. AU-C section 230 is applicable to all audit documentation supporting the current year's auditor's report. Do the provisions of AU-C section 230 with respect to documentation completion and retention apply to current year audit documentation maintained in the permanent file?

Reply—Yes. AU-C section 230 applies to current year audit documentation maintained in any type of file if such documentation serves as support for the current year's audit report.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[The next page is 8801.]

Section 8700

Subsequent Events

Note: Additional Questions and Answers on subsequent events can be found in section 9070, *Subsequent Events*.

[.01] Reserved

.02 Auditor Responsibilities for Subsequent Events

Inquiry—FASB ASC 855-10-50-1 states, “An entity shall disclose the date through which subsequent events have been evaluated, as well as whether that date is the date the financial statements were issued or the date the financial statements were available to be issued.” How does the entity’s responsibility to disclose the date through which subsequent events have been evaluated affect the auditor’s responsibilities for subsequent events?

Reply—FASB ASC 855 does not change the auditor’s responsibilities under AU-C section 560, *Subsequent Events and Subsequently Discovered Facts* (AICPA, *Professional Standards*), which requires the auditor to perform subsequent event procedures from the date of the financial statements to the date of the audit report or as near as practicable thereto.¹ Because AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, *Professional Standards*), requires the auditor’s report to be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor’s opinion on the financial statements,² the auditor’s report date can never be earlier than management’s subsequent event note date. Because the auditor is concerned with events occurring through the date of the auditor’s report that may require adjustment to, or disclosure in, the financial statements, the specific management representations relating to information concerning subsequent events should be made as of the date of the auditor’s report.³ In most cases, this will result in the date that management discloses as the date through which they have evaluated subsequent events being the same date as the auditor’s report. In order to coordinate that these dates (note date, representation letter date, and auditor report date) are the same, the auditor may want to discuss these dating requirements with management in advance of beginning the audit and may also want to include, in the auditor’s written understanding with the client regarding the terms of the engagement (engagement letter), that management will not date the subsequent event note earlier than the date of their management representation letter (also the date of the auditor’s report).

[Issue Date: September 2009; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

¹ See paragraph .10 of AU-C section 560, *Subsequent Events and Subsequently Discovered Facts* (AICPA, *Professional Standards*). [Footnote revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

² See paragraph .41 of AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, *Professional Standards*). [Footnote revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

³ See paragraph .20 of AU-C section 580, *Written Representations* (AICPA, *Professional Standards*). [Footnote revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.03 Auditor's Responsibilities for Subsequent Events Relative to a Conduit Debt Obligor⁴

Inquiry—Entity A is a nonprofit conduit debt obligor with conduit debt securities that are traded in a public market. The entity has a June 30 year-end. Management of the nonprofit has scheduled its annual meeting for early August. During its annual meeting, audited financial statements will be distributed to the board of trustees, as well as to all other persons in attendance. At the same time, entity A will post a notice to its website that alerts the general public regarding the method(s) available for obtaining a copy of its audited financial statements. Entity A plans to file its audited financial statements with the Electronic Municipal Market Access system in late September, after other filing information has been prepared.

FASB ASC 855-10-25-1A states, in part

[a]n entity that meets either of the following criteria shall evaluate subsequent events through the date the financial statements are issued:

- a. It is an SEC filer.
- b. It is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).

The FASB ASC glossary defines *financial statements are issued* as follows: “Financial statements are considered issued when they are widely distributed to shareholders and other financial statement users for general use and reliance in a form and format that complies with GAAP.”

Management has asserted that the financial statements will be widely distributed as of the date of the annual meeting (and, therefore, would be considered issued) because the financial statements (in a form and format that complies with generally accepted accounting principles [GAAP]) are distributed to the board of trustees at the meeting, as well as made available to anyone else as of that date (either through their attendance at the annual meeting or through their being able to obtain a copy through the method(s) described on entity A’s website).

How does FASB ASC 855-10 affect the auditor’s responsibility and the date of the auditor’s report?

Reply—Because entity A is a conduit debt obligor with conduit debt securities that trade in a public market, management is required to evaluate subsequent events through the date the financial statements are first widely distributed (that is, issued).

The auditor, exercising professional judgment, needs to evaluate management’s assertion about the financial statement issuance date and decide whether the manner in which entity A has made its financial statements available does or does not constitute issuance for purposes of complying with GAAP and completing the auditor’s subsequent event procedures. The auditor is required, in accordance with AU-C section 560, to perform subsequent event procedures at or near the date of the auditor’s report. As discussed more fully in section 8700.02, “Auditor Responsibilities for Subsequent Events,” in most cases, this will be the same date that management discloses as the date through which they have evaluated subsequent events. In accordance with paragraph

⁴ This inquiry and response assumes an entity’s financial statements have been prepared in accordance with generally accepted accounting principles promulgated by the Financial Accounting Standards Board. The accounting and disclosures for subsequent events may be different for other accounting standard setters.

.12 of AU-C section 560, the auditor is not required to perform any audit procedures regarding the financial statements after the date of the auditor's report. If, however, a subsequently discovered fact becomes known to the auditor after the report release date, the auditor is required to perform the requirements in paragraph .15 of AU-C section 560.

[Issue Date: June 2010; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[The next page is 8901.]

Section 8800

Audits of Group Financial Statements and Work of Others

.01 Applicability of AU-C Section 600

Inquiry—Do the requirements of AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* (AICPA, *Professional Standards*), apply only when the auditor makes reference to the audit of another auditor in his or her report on the group financial statements?

Reply—No. AU-C section 600 applies to all audits of group financial statements. Certain requirements (detailed in paragraphs .50–.64 of AU-C section 600) are applicable to all components, except those for which the auditor of the group financial statements is making reference to the work of a component auditor. (See paragraph .08 of AU-C section 600.)

[Issue Date: November 2012.]

.02 Making Reference to Any or All Component Auditors

Inquiry—If the group engagement partner decides to make reference to one component auditor in the audit report on the group financial statements, is he or she required to make reference to all component auditors in that report?

Reply—No. The decision to make reference to the audit of a component auditor is made individually for each component auditor. The auditor of the group financial statements may make reference to any, all, or none of the component auditors. (See paragraphs .24 and .A52 of AU-C section 600.)

[Issue Date: November 2012.]

.03 Deciding to Act as Auditor of Group Financial Statements

Inquiry—What factors determine whether an auditor decides to act as the auditor of a group's financial statements?

Reply—The group engagement partner decides to act as the auditor of the group financial statements and report as such on the group financial statements upon evaluating whether the group engagement team will be able to obtain sufficient appropriate audit evidence through the group engagement team's work or use of the work of component auditors. Relevant factors in making this determination include, among other things, the (a) individual financial significance of the components for which the auditor of the group financial statements will be assuming responsibility, (b) extent to which significant risks of material misstatements of the group financial statements are included in the components for which the auditor of the group financial statements will be assuming responsibility, and (c) extent of the group engagement team's knowledge of the overall financial statements. (See paragraphs .15 and .A18 of AU-C section 600.)

In audits of state and local governments, additional factors to consider include (a) engagement by the primary government as the auditor of the financial reporting entity and (b) responsibility for auditing the primary government's general fund (or other primary operating fund). (See paragraph .A21 of AU-C section 600.)

[Issue Date: November 2012.]

.04 Factors to Consider Regarding Component Auditors

Inquiry—What factors might the group engagement partner consider when deciding to use the work of a component auditor and whether to make reference to the component auditor in the auditor’s report on the group financial statements?

Reply—In all group audits, the group engagement team is required to obtain an understanding of the component auditor, and the group engagement partner uses this and his or her understanding of the component when deciding to use the work of a component auditor and whether to make reference to the component auditor in the auditor’s report on the group financial statements. Factors affecting this decision include (a) differences in the financial reporting framework applied in preparing the component and group financial statements, (b) whether the audit of the component financial statements will be completed in time to meet the group reporting schedule, (c) differences in the auditing and other standards applied by the component auditor and those applied in the audit of the group financial statements, and (d) whether it is impracticable for the group engagement team to be involved in the work of the component auditor. (See paragraphs .22 and .A40 of AU-C section 600.)

[Issue Date: November 2012.]

[.05] Deleted

[Deleted, March 2013, due to the issuance of SAS No. 127, *Omnibus Statement on Auditing Standards—2013*. See section 8800.27, “Circumstances in Which Making Reference Is Inappropriate.”]

.06 Governmental Financial Statements That Include a GAAP-Basis Component

Inquiry—When a governmental university includes a nongovernmental foundation as a component unit in its financial statements, as required by the Governmental Accounting Standards Board (GASB) financial reporting framework (that is, a not-for-profit foundation that appropriately uses accounting principles generally accepted in the United States of America [GAAP] as promulgated by the Financial Accounting Standards Board [FASB]), may the auditor’s report on the university’s group financial statements make reference to the auditor of the foundation’s financial statements when the group engagement team identifies the foundation as a component?

Reply—Yes. In this situation, because the university (the primary government) is required by the GASB financial reporting framework to include the foundation as a component unit in the financial reporting entity (the group financial statements) and because GASB provides guidance on how to present component unit information that does not conform to GASB reporting standards, the financial statements of the foundation (a component) are deemed to be in accordance with the GASB financial reporting framework.

It is important to note that reference to a component auditor in these circumstances is appropriate only when the provisions established by GASB that require inclusion of the component unit in the financial statements of the primary government have been followed (see section 8800.27).

[Issue Date: November 2012; Revised: March 2013.]

[.07] Deleted

[Deleted, March 2013, due to the issuance of SAS No. 127. See section 8800.27.]

.08 Component Audit Performed in Accordance With Government Auditing Standards

Inquiry—When a component auditor conducts an audit of a component's financial statements using *Government Auditing Standards* (GAS), and the group engagement team conducts the audit of the group financial statements using generally accepted auditing standards (GAAS), may the auditor's report on the group financial statements make reference to the component auditor?

Reply—Yes. Financial audits performed under the 2011 revision of GAS incorporate AICPA Statements on Auditing Standards by reference, as well as establish additional requirements. Further, the audit reports issued to meet GAS requirements often refer separately to GAAS, as well. Therefore, the audit of the component would be deemed to have been performed in accordance with GAAS, and the audit report on the group financial statements may make reference to the component auditor. Such reference is appropriate only when the component auditor follows the requirements established by GAAS when conducting the financial audit of the component under GAS. (See paragraphs .25 and .A54 of AU-C section 600.)

[Issue Date: November 2012.]

.09 Component Audit Performed by Other Engagement Teams of the Same Firm

Inquiry—Do the requirements of AU-C section 600 apply when a CPA firm uses auditors in different offices of the firm to perform various audit procedures related to the audit of a single entity's financial statements?

Reply—If the group engagement team identifies components in the financial statements of a single entity, it is a group audit, and AU-C section 600 applies. As defined in AU-C section 600, a *component auditor* may be part of the group engagement partner's firm, a network firm of the group engagement partner's firm, or another firm. (See paragraph .11 of AU-C section 600.)

[Issue Date: November 2012.]

.10 Terms of the Group Audit Engagement

Inquiry—What matters are required to be included in the terms of the group audit engagement?

Reply—The auditor of the group financial statements is required to agree upon the terms of the group audit engagement. In addition to the matters identified in AU-C section 210, *Terms of Engagement* (AICPA, *Professional Standards*), other matters may be included in the terms of a group audit, including whether reference will be made to the audit of a component auditor in the auditor's report on the group financial statements. The terms of the engagement may also include arrangements to facilitate (a) unrestricted communication between the group engagement team and component auditors to the extent permitted by law or regulation and (b) communication to the group engagement team of important communications between (i) component auditors, those charged with governance of the component, and component management and (ii) regulatory authorities and components related to financial reporting matters. (See paragraphs .17 and .A28 of AU-C section 600.)

[Issue Date: November 2012.]

.11 Equity Method Investment Component

Inquiry—If a company has an investment accounted for using the equity method, is the equity method investment considered a component for applying AU-C section 600?

Reply—Yes. An investment accounted for under the equity method constitutes a component for purposes of AU-C section 600. As such, the requirements of AU-C section 600 apply; however, paragraphs .50–.64 of AU-C section 600 only apply when the group engagement partner assumes responsibility for the work of a component auditor. (See paragraphs .11 and .A2 of AU-C section 600.)

[Issue Date: November 2012.]

.12 Criteria for Identifying Components

Inquiry—What criteria might the group engagement team use to identify components?

Reply—A *component* is defined as “[a]n entity or business activity for which group or component management prepares financial information that is required by the applicable financial reporting framework to be included in the group financial statements.” The structure of a group and the nature of the financial information and the manner in which it is reported affect how the group engagement team identifies components. Components can be separate entities or may be identified on the basis of the group financial reporting system that may be (a) a parent, one or more subsidiaries, and so on; (b) a head office and one or more divisions or branches; or (c) both. (See paragraphs .11 and .A1 of AU-C section 600.)

In audits of state and local governments, a component may be a separate legal entity reported as a component unit or part of the governmental entity, such as a business activity, department, or program. (See paragraph .A5 of AU-C section 600.)

[Issue Date: November 2012.]

.13 Criteria for Identifying Significant Components

Inquiry—What criteria might the group engagement team use to identify significant components?

Reply—A *significant component* is a component of individual financial significance to the group or likely to include significant risks of material misstatement of the group financial statements due to its specific nature or circumstances. As the individual financial significance of a component increases relative to the group financial statements, the risks of material misstatement of the group financial statements (posed by the financial information pertaining to that component) typically increase. The group engagement team may apply a percentage to one or more chosen benchmarks to identify components that are of individual financial significance. Appropriate benchmarks might include group assets, liabilities, cash flows, revenues, expenditures, net income, or a combination of these. Components engaging in complex transactions, such as foreign currency transactions, derivatives, alternative investments, complex financing arrangements, and so on, may expose the group to a significant risk of material misstatement even though they are not otherwise of individual financial significance to the group. The group engagement team may consider such components as significant components due to these risks. (See paragraphs .11, .A6, and .A77 of AU-C section 600.)

In audits of governmental entities, appropriate quantitative benchmarks for identifying significant components might include net costs or total budget. Qualitative considerations may involve matters of heightened public sensitivity (for example, national security issues, donor-funded projects, or reporting of tax revenue).

[Issue Date: November 2012.]

.14 No Significant Components Are Identified

Inquiry—Do the requirements of AU-C section 600 apply when the group engagement team does not identify any significant components?

Reply—Yes. AU-C section 600 is applicable to audits of group financial statements, and group financial statements include financial information for more than one component, regardless of whether any component is identified as a significant component. When a group consists only of components not considered significant components, the group engagement partner can reasonably expect to obtain sufficient appropriate audit evidence (on which to base the group audit opinion) if the group engagement team will be able to (a) perform work on the financial information of some of these components and (b) use the work performed by component auditors on the financial information of other components to the extent necessary to obtain sufficient appropriate audit evidence. In addition, when no component is identified as significant, it is more likely that appropriate responses to assessed risks of material misstatement for some or all accounts or classes of transactions may be implemented at the group level without the involvement of component auditors. (See paragraphs .A19, .A65, and .A83 of AU-C section 600.)

[Issue Date: November 2012.]

.15 Restricted Access to Component Auditor Documentation

Inquiry—When a component auditor restricts the group engagement team's access to relevant documentation, will the auditor of the group financial statements be able to report on the group financial statements?

Reply—Yes. As long as the group engagement team is able to obtain sufficient appropriate audit evidence, the group engagement partner is able to report on the group financial statements. However, this is less likely as the significance of the component increases. (See paragraphs .16 and .A23 of AU-C section 600.)

[Issue Date: November 2012.]

.16 Responsibilities With Respect to Fraud in a Group Audit

Inquiry—Does AU-C section 600 change the auditor's responsibilities with respect to fraud in the audit of a group's financial statements?

Reply—No. The group engagement team is required to gain an understanding of the group and its environment and to identify and assess the risks of material misstatement of the group financial statements due to error or fraud. In addition, the group engagement team is required to design and implement appropriate responses to the assessed risks. (See paragraphs .20 and .A35 of AU-C section 600.)

[Issue Date: November 2012.]

.17 Inclusion of Component Auditor in Engagement Team Discussions

Inquiry—Is the engagement team required to include the component auditor in its discussions of the entity's susceptibility to material misstatements of the financial statements due to error or fraud?

Reply—No. Key members of the group engagement team are required to discuss the susceptibility of an entity to material misstatements of the financial statements due to error or fraud, specifically emphasizing the risks due to fraud. The group engagement partner may choose to include the component auditor in certain discussions, including those to discuss the susceptibility of

the entity to material misstatements of the financial statements. (See paragraphs .20 and .A36 of AU-C section 600.)

[Issue Date: November 2012.]

.18 Determining Component Materiality

Inquiry—If the group engagement partner decides to make reference to a component auditor in the auditor’s report on the group financial statements, does the group engagement team establish materiality for the component auditor to use in the separate audit of the component’s financial statements?

Reply—No. Reference in the group auditor’s report to the fact that part of the audit was conducted by a component auditor is intended to communicate that the group auditor is not assuming responsibility for the work of the component auditor. In that case, the component auditor is responsible for establishing materiality as part of performing the audit of the component’s financial statements.

However, if the group engagement partner assumes responsibility for the work of a component auditor, the group engagement team is required to evaluate the appropriateness of materiality at the component level. In addition, the group engagement team is required to communicate the relevant component materiality to that component auditor. The component auditor uses component materiality to evaluate whether uncorrected detected misstatements are material, individually or in the aggregate. (See paragraphs .31, .52–.53, .55, and .A73–.A74 of AU-C section 600.)

[Issue Date: November 2012.]

.19 Understanding of Component Auditor Whose Work Will Not Be Used

Inquiry—Is the group engagement team required to obtain an understanding of a component auditor for a component that is not a significant component if the group engagement team does not plan to use the work of the component auditor and plans only to perform analytical procedures at a group level?

Reply—No. It is not necessary to obtain an understanding of the auditors of those components for which the group auditor will not be using the work of the component auditor to provide audit evidence for the group audit. (See paragraphs .22, .29, and .A41 of AU-C section 600.)

[Issue Date: November 2012.]

.20 Involvement in the Work of a Component Auditor

Inquiry—When the group engagement partner decides to assume responsibility for the work of a component auditor, is the group engagement team required to be involved in the work of the component auditor?

Reply—Yes. The group engagement team is required to determine the type of work to be performed by the group engagement team (or a component auditor on behalf of the group engagement team) on the financial information of a component. The group engagement team is also required to determine the nature, timing, and extent of its involvement in the work of the component auditor. (See paragraph .51 of AU-C section 600.)

[Issue Date: November 2012.]

.21 Factors Affecting Involvement in the Work of a Component Auditor

Inquiry—What factors might affect the group engagement team’s involvement in the work of a component auditor?

Reply—Factors that may affect the group engagement team’s involvement in the work of a component auditor include (a) the significance of the component, (b) identified significant risks of material misstatement of the group financial statements, and (c) the group engagement team’s understanding of the component auditor. (See paragraph .A84 of AU-C section 600.)

[Issue Date: November 2012.]

.22 Form of Communications With Component Auditors

Inquiry—When the group engagement partner decides to assume responsibility for the work of a component auditor, are all communications between the group engagement team and component auditor required to be in writing?

Reply—No. Communication between the group engagement team and a component auditor need not necessarily be in writing. For example, the group engagement team may visit the component auditor to discuss identified significant risks or review relevant parts of the component auditor’s audit documentation. In all audits of group financial statements, however, communications between the group engagement team and component auditors about the group engagement team’s requirements should be written. (See paragraphs .49, .59–.60, and .A87 of AU-C section 600.)

[Issue Date: November 2012.]

.23 Use of Component Materiality When the Component Is Not Reported On Separately

Inquiry—Is it necessary to use a component materiality lower than group materiality when the component will not be reported on separately, and the audit of the entire group is being performed by the group engagement team as one audit?

Reply—If the component is a significant component on which the group engagement team will be performing audit procedures, the group engagement team is required to determine component materiality. (See paragraph .31 of AU-C section 600.) To reduce the risk that uncorrected and undetected misstatements in each component’s financial statements, when aggregated, exceeds the materiality for the group’s financial statements as a whole, component materiality should be less than the materiality for the group financial statements as a whole. In circumstances when appropriate responses to assessed risks of material misstatement for some or all accounts or classes of transactions may be implemented at the group level, for example when accounts receivable for the parent and subsidiaries use the same system and the consolidated accounts receivable are audited as one aggregated amount, there is no risk of aggregation error and, therefore, no need to allocate materiality to components.

[Issue Date: November 2012; Revised, February 2013.]

.24 Applicability of AU-C Section 600 When Only One Engagement Team Is Involved

Inquiry—Company X consolidates the operations of Entity A. The same group engagement team that audits Company X also audits Entity A. Because only one engagement team is involved, does AU-C section 600 apply? If so, what does AU-C section 600 require that is not already covered by other auditing standards?

Reply—AU-C section 600 applies to all audits of *group financial statements*, which are financial statements that contain more than one component. In the circumstances when the same engagement team audits all components of the

group, the considerations addressed in AU-C section 600 that relate to component auditors are not relevant. However, considerations addressed in AU-C section 600, such as understanding the components; identifying components that are significant due to individual financial significance and the significant risk of material misstatement; determining component materiality; understanding the consolidation process; and addressing the risks, including aggregation risk, of material misstatement in the group financial statements; are relevant in all group audits.

[Issue Date: February 2013.]

.25 Applicability of AU-C Section 600 When Making Reference to the Audit of an Equity Method Investee

Inquiry—When the group engagement partner decides to make reference to the audit of the component auditor of an equity investee in the auditor's report on the group financial statements, is the group auditor still required to determine component materiality for those components for which reference to component auditors will be made?

Reply—Once the group engagement partner has decided to make reference to the audit of the component auditor, paragraph .26 of AU-C section 600 requires the group engagement team to obtain sufficient appropriate audit evidence with regard to the equity investee by

- performing the procedures required by AU-C section 600, except those required by paragraphs .50–.64.
- reading the equity investee's financial statements and component auditor's report thereon to identify significant findings and issues and, when considered necessary, communicating with the component auditor in this regard.

Therefore, when the group engagement partner has decided to make reference to the audit of a component auditor, the group engagement team is not required to determine component materiality for that component.

[Issue Date: February 2013.]

.26 Procedures Required When Making Reference to the Audit of an Equity Method Investee

Inquiry—The auditor of Company A has decided to make reference to the audit of the component auditor of an equity investee in the report on Company A's financial statements. In addition to obtaining and reading the equity investee's financial statements and component auditor's report thereon, what additional procedures may be necessary in order to determine that the equity investment has been properly recorded?

Reply—In determining that the equity investment has been properly recorded, the group engagement team may conclude that additional audit evidence is needed because of, for example, significant differences in fiscal year-ends, changes in ownership, or changes in conditions affecting the use of the equity method of accounting. Examples of procedures that the group engagement team may perform include, but are not limited to, reviewing information in the group's (investor's) files that relates to the equity investee, such as investee minutes, budgets, and cash flows information, and making inquiries of investor management about the equity investee's financial results.

[Issue Date: February 2013.]

.27 Circumstances in Which Making Reference Is Inappropriate

Inquiry—Are there any circumstances in which it would be inappropriate to make reference to the audit of a component auditor of an equity investee in the auditor's report on the group financial statements?

Reply—AU-C section 600 precludes the auditor of the group financial statements from making reference to the audit of the component auditor in the following circumstances:

- When the group engagement team has serious concerns about the component auditor's professional competency or independence. (In this circumstance, the group auditor is precluded from using the work of the component auditor at all.)
- The component auditor's report on the equity investee's financial statements is restricted regarding use.
- The audit of the component was not performed in accordance with the relevant requirements of GAAS or, if applicable, the standards promulgated by the Public Company Accounting Oversight Board (PCAOB).
- The financial statements of the component (that is, the equity investee) and group are prepared in accordance with different financial reporting frameworks, unless certain conditions are met.

Determining if the Audit of the Component Was Performed in Accordance With the Relevant Requirements of GAAS

When the component auditor has performed an audit of the component financial statements in accordance with auditing standards other than GAAS or the standards promulgated by the PCAOB, the group auditor is precluded from making reference, unless the group engagement partner has determined that the component auditor has performed an audit of the financial statements of the component in accordance with the relevant requirements of GAAS. Relevant requirements of GAAS in this context are those that pertain to planning and performing the audit of the component financial statements and do not include those related to the form of the auditor's report. Audits performed in accordance with International Standards on Auditing (ISAs) promulgated by the International Auditing and Assurance Standards Board (IAASB) are more likely to meet the relevant requirements of GAAS than audits performed in accordance with auditing standards promulgated by bodies other than the IAASB. The group engagement team may provide the component auditor with AU-C appendix B, *Substantive Differences Between the International Standards on Auditing and Generally Accepted Auditing Standards* (AICPA, *Professional Standards*), that identifies substantive requirements of GAAS that are not requirements in ISAs.

The component auditor may perform additional procedures in order to meet the relevant requirements of GAAS. When the component auditor's report on the component's financial statements does not state that the audit of the component's financial statements was performed in accordance with GAAS or the standards promulgated by the PCAOB, and the group engagement partner has determined that the component auditor performed additional audit procedures in order to meet the relevant requirements of GAAS, the auditor's report on the group financial statements should clearly indicate

- a. the set of auditing standards used by the component auditor and
- b. that additional audit procedures were performed by the component auditor to meet the relevant requirements of GAAS.

Making Reference When Different Financial Reporting Frameworks Have Been Used

Conditions that, if met, permit the group auditor to make reference when the component financial statements are prepared in accordance with a different financial reporting framework than that used for the group financial statements are the following:

- The applicable financial reporting framework provides for the inclusion of component financial statements that are prepared in accordance with a different financial reporting framework, and as such, the component financial statements are deemed to be in accordance with the applicable financial reporting framework. For example, the financial reporting frameworks established by GASB and the Federal Accounting Standards Advisory Board have such provisions.
- The measurement, recognition, presentation, and disclosure criteria that are applicable to all material items in the component's financial statements under the financial reporting framework used by the component are similar to the criteria applicable to all material items in the group's financial statements under the financial reporting framework used by the group, and the group engagement team has obtained sufficient appropriate audit evidence for purposes of evaluating the appropriateness of the adjustments to convert the component's financial statements to the financial reporting framework used by the group without the need to assume responsibility for, and, thus, be involved in, the work of the component auditor.

When reference is made to a component auditor's report on financial statements prepared using a different financial reporting framework, the auditor's report on the group financial statements should disclose that the auditor of the group financial statements applied audit procedures on the conversion adjustments.

[Issue Date: February 2013.]

.28 Lack of Response From a Component Auditor

Inquiry—Paragraph .40 of AU-C section 600 requires the group engagement team to communicate to the component auditor and ask for his or her cooperation. Paragraph .41 of AU-C section 600 requires the group engagement team to ask the component auditor for certain information. If the component auditor does not respond to the group engagement team, is the auditor of the group financial statements precluded from making reference to the audit of a component auditor?

Reply—Lack of response from a component auditor to the communication and request for information from the group engagement team does not, in and of itself, preclude the group engagement partner from deciding to make reference to the audit of a component auditor. However, the group engagement team is required to obtain an understanding of the component auditor, in accordance with paragraph .22 of AU-C section 600, including

- a. whether a component auditor understands and will comply with the ethical requirements that are relevant to the group audit and, in particular, is independent.
- b. a component auditor's professional competence.
- c. whether the group engagement team will be able to obtain from a component auditor information affecting the consolidation process.
- d. whether a component auditor operates in a regulatory environment that actively oversees auditors.

Obtaining this understanding may be more difficult when the component auditor does not respond to the communication from the group engagement team. When a component auditor does not meet the independence requirements that are relevant to the group audit, or the group engagement team has serious concerns about the other matters previously listed, the group engagement team should obtain sufficient appropriate audit evidence relating to the financial information of the component without making reference to the audit of that component auditor in the auditor's report on the group financial statements or otherwise using the work of that component auditor.

[Issue Date: February 2013.]

.29 Equity Investee's Financial Statements Reviewed, and Investment Is a Significant Component

Inquiry—Company X has an equity investment in Entity A that the group engagement team has identified as a significant component. If the management of Entity A has their financial statements reviewed but refuses to allow an audit or any other work to be performed on Entity A's financial statements, does a scope limitation exist?

Reply—Yes. If Entity A is a significant component, and no auditing procedures can be performed on Entity A's financial statements, a scope limitation exists, and the effect of the group engagement team's inability to obtain sufficient appropriate audit evidence is considered in terms of AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report* (AICPA, *Professional Standards*).

[Issue Date: February 2013.]

.30 Making Reference to Review Report

Inquiry—Is it ever appropriate to make reference to another CPA's review report in an auditor's report on group financial statements?

Reply—No, it is never appropriate to make reference to the review report on the component's financial statements in the auditor's report on group financial statements. AU-C section 600 only provides for making reference to the audit of a component auditor.

[Issue Date: February 2013.]

.31 Review of Component That Is Not Significant Performed by Another Practitioner

Inquiry—Company X has an equity investment in Entity A that is not considered a significant component. A review of the financial statements of Entity A has been performed by another practitioner. Can the group engagement team use the work of the practitioner as part of the audit evidence for the audit of the group financial statements?

Reply—Paragraphs .54–.55 of AU-C section 600 discuss certain procedures to be performed on a component when the component is not a significant component. In certain circumstances, a review of a component's financial statements may be sufficient audit evidence. Therefore, a group auditor may use the work of another practitioner if the review meets the needs of the group auditor. Although the group auditor may use the review as part of the auditor's evidence for the audit of the group financial statements, the group auditor is not permitted to make reference to the practitioner's review report.

[Issue Date: February 2013.]

.32 Issuance of Component Auditor's Report

Inquiry—Company X has an investment in Entity A accounted for under the equity method of accounting. Company X is audited by one firm, and a CPA from a different firm performs audit procedures at Entity A sufficient to provide the auditor of Company X with appropriate audit evidence relative to the equity investee's financial information. Is it necessary for the auditor of Company X to obtain an auditor's report on Entity A's financial statements from the component auditor?

Reply—Although an audit report is typically obtained when an independent CPA performs work for a group auditor of a different firm, there is no requirement that such report be obtained if the group auditor assumes responsibility for the component auditor's work. When the auditor of Company X will assume responsibility for, and, thus, be involved in, the work of a component auditor, a component auditor's communication with the group engagement team may take the form of a memorandum or report of work performed. Alternatively, the auditor of Company X may decide to review the component auditor's working papers documenting the audit procedures performed. However, in order for the auditor of Company X to make reference to the audit of the component auditor, it is necessary for the component auditor to issue an auditor's report on Entity A.

[Issue Date: February 2013.]

.33 Structure of Component Auditor Engagement

Inquiry—Company X has an investment in Entity A accounted for under the equity method of accounting. Entity A is not willing to pay for an audit of its financial statements. Would an agreed-upon procedures engagement performed by an independent CPA for Entity A be sufficient to provide the auditor of Company X with appropriate audit evidence relative to the investment in the equity investee?

Reply—The auditor of Company X is responsible for determining the nature and extent of the procedures necessary to provide the auditor of Company X with sufficient appropriate audit evidence relative to the investment in the equity investee. The nature and extent of the necessary procedures are based on the significance of the component to the group. A component auditor may perform specified audit procedures relating to the likely significant risks of material misstatement of the group financial statements on behalf of the auditor of Company X. However, the structure of the engagement for the component auditor to perform the necessary procedures is not addressed by the standard.

[Issue Date: February 2013.]

.34 Subsequent Events Procedures Relating to a Component

Inquiry—Company X has an investment in Entity A that is accounted for by the equity method of accounting. Company X and Entity A are audited by different auditors. The audit of Entity A was completed before the audit of Company X began, and the auditor of Company X's financial statements has decided to make reference to the report of the auditor of Entity A. In such circumstances, who is responsible for performing auditing procedures relating to subsequent events at Entity A that may require adjustment to, or disclosure in, the group financial statements?

Reply—The auditor of the group financial statements is responsible for obtaining sufficient appropriate audit evidence that the group financial statements are free from material misstatement, regardless of whether reference is

made to the audit of a component auditor. Paragraph .39 of AU-C section 600 states that for components that are audited, the group engagement team or component auditors should perform procedures designed to identify events at those components that occur between the dates of the financial information of the components and the date of the auditor's report on the group financial statements and that may require adjustment to, or disclosure in, the group financial statements.

When the audit of the component is completed before the date of the auditor's report on the group financial statements, the group engagement team may communicate with the component auditor and ask the component auditor to perform procedures to identify subsequent events that would require adjustment to, or disclosure in, the group financial statements. Alternatively, the group engagement team may work with group management to obtain the necessary information and perform procedures themselves. Examples of procedures the group engagement team may perform include, but are not limited to, reviewing information in group management's files that relates to the component, such as component minutes, budgets, and cash flows information, and making inquiries of group management about the component's financial results.

If the group engagement team is unable to obtain sufficient appropriate audit evidence about subsequent events to make a determination about whether the group financial statements are materially misstated, then a scope limitation exists, and the effect of the group engagement team's inability to obtain sufficient appropriate audit evidence is considered in terms of AU-C section 705.

[Issue Date: February 2013.]

.35 Component and Group Have Different Year-Ends

Inquiry—Company X has a component comprising an investment in Entity A accounted for by the equity method of accounting. Entity A is audited by a component auditor. Entity A has a different year-end than Company X. The auditor of the group financial statements has decided to make reference to the audit of the component auditor. What procedures, if any, would be appropriate for the group engagement team perform as a result of the difference in year-ends?

Reply—FASB *Accounting Standards Codification* (ASC) 323-10-35-6 states that “[i]f financial statements of an investee are not sufficiently timely for an investor to apply the equity method currently, the investor ordinarily shall record its share of the earnings or losses of an investee from the most recent available financial statements. A lag in reporting shall be consistent from period to period.” When a time lag in reporting between the date of the financial statements of the group and that of the component exists, appropriate procedures performed by the group engagement team include consideration of whether the time lag is consistent with the prior period in comparative statements and, as discussed in section 8800.15, “Restricted Access to Component Auditor Documentation,” whether a significant transaction occurred during the time lag that would require adjustment to, or disclosure in, the group financial statements. The group engagement team may also perform auditing procedures on the information from the period audited by the component auditor to Company X's year-end (stub period). If the group engagement team is unable to obtain sufficient appropriate audit evidence about the stub period information, a scope limitation exists, and the effect of the group engagement team's inability to obtain sufficient appropriate audit evidence is considered in terms of AU-C section 705. If a change in stub period occurs that has a material

effect on the group's financial statements, the auditor should consider the consistency of the financial statements for the periods presented, in accordance with AU-C section 708, *Consistency of Financial Statements* (AICPA, *Professional Standards*), because of the change in reporting period.

[Issue Date: February 2013.]

.36 Investments Held in a Financial Institution Presented at Cost or Fair Value

Inquiry—Paragraph .11 of AU-C section 600 defines a component as “[a]n entity or business activity for which group or component management prepares financial information that is required by the applicable financial reporting framework to be included in the group financial statements.” Is an investment in a certificate of deposit or other types of cash investments held by a financial institution (for example, an overnight repurchase agreement) deemed a component for purposes of AU-C section 600?

Reply—No. A certificate of deposit or other cash investments held by a financial institution or bank do not constitute components.

[Issue Date: February 2013.]

.37 Employee Benefit Plan Using Investee Results to Calculate Fair Value

Inquiry—Do the investments in an employee benefit plan that rely on the investee results to calculate fair value constitute components under AU-C section 600?

Reply—No. Generally, the investments held by an employee benefit plan are required to be accounted for at fair value, with limited exceptions, and do not constitute a *component*, as defined under AU-C section 600; therefore, AU-C section 600 would not apply.

[Issue Date: February 2013.]

.38 Using Net Asset Value to Calculate Fair Value

Inquiry—Paragraphs 59–62 of FASB ASC 820-10-35 permit a reporting entity to estimate the fair value of an investment using net asset value (NAV) per share of the investment (or its equivalent) if NAV is calculated in a manner consistent with the measurement principles of FASB ASC 946, *Financial Services—Investment Companies*, as of the reporting entity's measurement date. If an entity uses the NAV of an investment as a practical expedient to estimate the fair value of that investment, is that investment considered a component under AU-C section 600?

Reply—No. Paragraph .A2 of AU-C section 600 states that an investment accounted for under the equity method constitutes a component for purposes of AU-C section 600. AU-C section 600 does not specifically identify what other, if any, types of investments may be considered components under the definition in that section.

When an entity elects to use NAV as a practical expedient, paragraph .04 of AU-C section 501, *Audit Evidence—Specific Considerations for Selected Items* (AICPA, *Professional Standards*), generally applies because it addresses situations when investments in securities are valued based on an investee's financial results, excluding investments accounted for using the equity method of accounting.

Paragraph .04 of AU-C section 501 states that when investments in securities are valued based on an investee's financial results, excluding investments accounted for using the equity method of accounting, the auditor should

obtain sufficient appropriate audit evidence in support of the investee's financial results, as follows:

- a. Obtain and read available financial statements of the investee and the accompanying audit report, if any, including determining whether the report of the other auditor is satisfactory for this purpose.
- b. If the investee's financial statements are not audited or if the audit report on such financial statements is not satisfactory to the auditor, apply or request that the investor entity arrange with the investee to have another auditor apply appropriate auditing procedures to such financial statements, considering the materiality of the investment in relation to the financial statements of the investor entity.
- c. If the carrying amount of the investment reflects factors that are not recognized in the investee's financial statements or fair values of assets that are materially different from the investee's carrying amounts, obtain sufficient appropriate audit evidence in support of such amounts.
- d. If the difference between the financial statement period of the entity and investee has or could have a material effect on the entity's financial statements, determine whether the entity's management has properly considered the lack of comparability, and determine the effect, if any, on the auditor's report.

[Issue Date: February 2013.]

.39 Disaggregation of Account Balances or Classes of Transactions

Inquiry—Company X consolidates the operations of Entity A. The same group engagement team audits Company X and the operations of Entity A; no other auditors or engagement teams are involved. Are there any requirements in AU-C section 600 to disaggregate account balances or classes of transactions for purposes of auditing the consolidated financial statements of Company X? For example, is the auditor required to disaggregate accounts receivable for purposes of confirmation procedures, or can the consolidated group of accounts be treated as one population?

Reply—AU-C section 600 does not require the auditor to disaggregate account balances or classes of transactions. The group auditor should design an audit plan that is responsive to the risks of material misstatements to the consolidated financial statements. The less similar the risks of material misstatement at the group and component level, the less appropriate it may be to perform audit procedures for some or all accounts or classes of transactions at the group level. Additionally, the more complex the group (for example, decentralized systems, fewer groupwide controls, differing jurisdictions, or diverse product lines), the less likely that testing in the aggregate will sufficiently and appropriately address the risks of material misstatement.

[Issue Date: February 2013.]

.40 Variable Interest Entities (VIEs) as a Component

Inquiry—Company X consolidates the financial information of Entity A, a variable interest entity of which Company X is the primary beneficiary. Is Entity A considered a component for purposes of AU-C section 600?

Reply—Yes. Paragraph .11 of AU-C 600 defines a component as “[a]n entity or business activity for which group or component management prepares financial information that is required by the applicable financial reporting framework to be included in the group financial statements.” Because Entity

A's financial information is required to be consolidated into Company X's financial statements, Entity A constitutes a component for purposes of AU-C section 600. As such, the requirements of AU-C section 600 apply.

[Issue Date: March 2013.]

.41 Component Using a Different Basis of Accounting Than the Group

Inquiry—A component whose financial information is required to be consolidated into group financial statements maintains its financial information on the tax basis of accounting. The group financial statements are prepared using GAAP. What is the group auditor's responsibility regarding the consolidation of the component's financial information into the group financial statements?

Reply—When a component's financial information is prepared on the tax basis of accounting, and the group financial statements are prepared using GAAP, the auditor is required by paragraph .36 of AU-C section 600 to evaluate whether the financial information of the component has been appropriately adjusted. Appropriate adjustments are adjustments that convert the tax basis of information to GAAP basis. An example of this is converting depreciation under the method used for tax purposes by the component to depreciation calculated using the method used for the group financial statements.

[Issue Date: March 2013.]

.42 Component Audit Report of Balance Sheet Only

Inquiry—Company X prepares consolidated financial statements that include the operations of entity A. The auditor for entity A has audited the balance sheet only and has disclaimed an opinion on the other financial statements. May the group auditor of Company X, who was engaged to issue an opinion on the consolidated financial statements of the group, make reference in the report on the group financial statements to the audit of the balance sheet of entity A?

Reply—No. A component auditor's report on a balance sheet only does not provide sufficient appropriate audit evidence on revenues, expenses, and cash flows of the component to enable the group engagement partner to make reference. Accordingly, the group engagement team would have to perform procedures on the financial information of entity A in order to obtain sufficient appropriate audit evidence.

[Issue Date: June 2013.]

.43 Using Another Accounting Firm to Perform Inventory Observations

Inquiry—An accounting firm outsources its year-end inventory observation procedures for an audit to another accounting firm due to location of the inventory. Is the other accounting firm considered a component auditor in accordance with AU-C section 600?

Reply—The other auditor performing inventory observation is not considered a component auditor. However, paragraph .02 of AU-C section 600 states that "an auditor may find this section, adapted as necessary in the circumstances, useful when that auditor involves other auditors in the audit of financial statements that are not group financial statements. For example, an auditor may involve another auditor to observe the inventory count or inspect fixed assets at a remote location." Paragraph .16 of AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*), requires the engagement partner to be satisfied that those performing the audit possess the appropriate competence and capabilities. In accordance with paragraph .17 of AU-C section

220, the engagement partner is responsible for the direction, supervision, and performance of the audit engagement. The requirements and application material in AU-C section 600 relating to understanding a component auditor, setting materiality, determining the type of work to be performed, and involvement in the work performed by component auditors provide relevant guidance for meeting the requirements in AU-C section 220 with regard to the other auditor.

[Issue Date: June 2013.]

[The next page is 8991.]

Section 8900

Predecessor Auditors

[.01] Reserved

.02 Communications Between Predecessor Auditors and Auditors

Inquiry—A client has decided to restate, for comparative purposes, the statement of changes in financial position reported on by the predecessor auditor to a statement of cash flows. The predecessor auditor's audit report will not be presented.

- a. Should the auditor notify the predecessor auditor as part of the auditor's procedures to prepare or evaluate restatements permitted or mandated by new accounting standards?
- b. How will the restatement affect the auditor's report?

Reply—Paragraph .12 of AU-C section 510, *Opening Balances—Initial Audit Engagements, Including Reaudit Engagements* (AICPA, *Professional Standards*), states

If the auditor becomes aware of information that leads the auditor to believe that financial statements reported on by the predecessor auditor may require revision, the auditor should request management to inform the predecessor auditor of the situation and arrange for the three parties to discuss this information and attempt to resolve the matter.

In cases where revisions result from an accounting change required or permitted by a new Financial Accounting Standards Board or AICPA pronouncement, the auditor is not required to consult with the predecessor auditor. However, the auditor may find that communication with the predecessor auditor is desirable in order to obtain any additional information or audit documentation that may be needed to prepare or evaluate the restatement. To maintain audit efficiency, such communications may be made as part of the auditor's routine request for review of selected audit documentation.

Paragraph .55 of AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, *Professional Standards*), requires that if the prior period financial statements are restated, and the predecessor auditor agrees to issue a new auditor's report on the restated financial statements of the prior period, the auditor should express an opinion only on the current period.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.03 Communications With a Predecessor Auditor Who Has Ceased Operations¹

Inquiry—AU-C section 210, *Terms of Engagement* (AICPA, *Professional Standards*), requires an auditor to attempt certain communications with the predecessor auditor prior to acceptance of an engagement. How should the

¹ AR section 400, *Communication Between Predecessor and Successor Accountants* (AICPA, *Professional Standards*), provides guidance to a successor accountant who decides to communicate with a predecessor accountant regarding acceptance of an engagement to compile or review the financial statements of a nonpublic company. In situations in which the predecessor accountant has ceased operations and the successor accountant decides to engage in such communications, the guidance in this paragraph may be useful.

auditor fulfill this responsibility when the predecessor auditor has ceased operations?

Reply—Even when the predecessor auditor has ceased operations, AU-C section 210 obligates an auditor to attempt certain communications with the predecessor auditor prior to acceptance of an engagement. The auditor should attempt the required communications, about matters that the auditor believes will assist the auditor in determining whether to accept the engagement, with the individual who had final responsibility for the audit (for example, the engagement partner). Paragraph .12 of AU-C section 210 requires the auditor to evaluate the predecessor auditor's response, or consider the implications if the predecessor auditor provides no response or a limited response, in determining whether to accept the engagement.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.04 Unavailability of the Audit Documentation of a Predecessor Auditor Who Has Ceased Operations

Inquiry—An auditor's initial audit may be facilitated by reviewing the predecessor auditor's audit documentation. What is the effect on the auditor's initial audit when the audit documentation of a predecessor auditor who has ceased operations is not available for review?

Reply—Paragraph .08 of AU-C section 510 requires the auditor to obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements, and states that the auditor should perform one or both of the following to obtain evidence regarding opening balances:

- a. Review the predecessor auditor's audit documentation
- b. Perform specific audit procedures

Paragraph .15 of AU-C section 510 requires that if the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor should express a qualified opinion or disclaim an opinion on the financial statements, as appropriate, in accordance with AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report* (AICPA, *Professional Standards*).

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.05 Significant Audit Procedures Performed by a Predecessor Auditor Who Has Ceased Operations

Inquiry—If a predecessor auditor has performed significant audit procedures, such as the observation of inventory or the confirmation of accounts receivable, and subsequently has ceased operations, to what extent may this work be used by the auditor?

Reply—Because a report on the financial statements has not been issued by the predecessor auditor and the auditor cannot complete the procedures required by AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* (AICPA, *Professional Standards*), the auditor can neither assume responsibility for the work of the predecessor auditor nor issue a report that reflects divided responsibility for the audit, as described in AU-C section 600. The auditor should perform audit procedures sufficient to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which

to base the auditor's opinion on the financial statements under audit. However, review of the predecessor auditor's audit documentation may have an effect on the nature, timing and extent of those procedures.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.06 Auditor Becomes Aware of Information During the Audit That Leads the Auditor to Believe That Financial Statements Reported On by a Predecessor Auditor Who Has Ceased Operations May Require Revision

Inquiry—Paragraph .12 of AU-C section 510 states that if the auditor becomes aware of information during the audit that leads the auditor to believe that financial statements reported on by the predecessor auditor may require revision, the auditor should request management to inform the predecessor auditor of the situation and arrange for the three parties to discuss the situation and attempt to resolve the matter. What actions may an auditor take when the auditor becomes aware of information during the audit that leads the auditor to believe that financial statements reported on by a predecessor auditor require revision when the predecessor auditor has ceased operations?

Reply—When the auditor becomes aware of information that leads the auditor to believe that the financial statements reported on by a predecessor auditor who has ceased operations may require revision, in accordance with paragraph .12 of AU-C section 510, the auditor should discuss the information with management and attempt to resolve the matter. In attempting to resolve the matter, the auditor may request that management inform the individual who had final responsibility for the audit of the financial statements reported on by the predecessor auditor (for example, the engagement partner) of the situation and arrange for that individual to discuss the information with the auditor and management. If it is determined that the financial statements require revision, the auditor may request that management disclose the information to the party responsible for winding up the affairs of the predecessor auditor. If the auditor is not satisfied with the resolution of the matter, in accordance with paragraph .13 of AU-C section 510, the auditor should evaluate (a) the implications on the current engagement and (b) whether to withdraw from the engagement or, when withdrawal is not possible under applicable law or regulation, disclaim an opinion on the financial statements. The auditor may decide to consult with legal counsel in determining an appropriate course of action.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[.07] Reserved

[.08] Reserved

[.09] Reserved

.10 Successor Accountant Becomes Aware of Information During the Performance of a Compilation or Review That Leads the Successor Accountant to Believe That Financial Statements Reported On by a Predecessor Accountant Who Has Ceased Operations May Require Revision

Inquiry—Paragraph .10 of AR section 400, *Communications Between Predecessor and Successor Accountants* (AICPA, *Professional Standards*), provides guidance to a successor accountant who, during an engagement to compile or review current-period financial statements, becomes aware of information that leads him or her to believe that financial statements reported on by a predecessor accountant may require revision. Paragraph .10 of AR section 400 states

that the successor accountant should request that his or her client communicate this information to the predecessor accountant. How may the successor accountant fulfill this responsibility when the predecessor accountant has ceased operations?

Reply—When the successor accountant becomes aware of information that leads him or her to believe that financial statements reported on by a predecessor accountant may require revision, the successor accountant should discuss the information with management. In attempting to resolve the matter, the successor accountant may request that management inform the individual who had final responsibility for the prior-period engagement (for example, the engagement partner) of the situation and arrange for that individual to discuss the information with management. If it is determined that the financial statements require revision, the successor accountant may request that management disclose the information to the party responsible for winding up the affairs of the predecessor accountant. If the successor accountant is not satisfied with the resolution of the matter, in accordance with paragraph .11 of AR section 400, the successor accountant should evaluate (a) possible implications for the current engagement and (b) whether to resign from the engagement. The successor accountant may decide to consult with legal counsel in determining an appropriate course of action.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

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TIS Section 9000

AUDITORS' REPORTS

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[The next page is 9071.]

Section 9030

Accounting Changes

[.01] Reserved

[.02] Reserved

.03 Change in Service Lives of Fixed Assets

Inquiry—A reevaluation of the lives of depreciable property resulted in an increase in the remaining lives of certain properties. The company would like to include the cumulative, net of tax, effect of this change in income. Is this in accordance with generally accepted accounting principles?

Reply—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 250, *Accounting Changes and Error Corrections*, is quite specific regarding the treatment of changes in estimated service lives of depreciable assets. Such a change is considered a change in an accounting estimate and should be recorded prospectively, that is, in the period of the change and future periods as appropriate. Therefore, the proposed accounting would not be in accordance with generally accepted accounting principles. If the change in service lives of depreciable property were accounted for as suggested, the independent auditors would have to issue a qualified or adverse opinion depending upon materiality of the item.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[.04] Reserved

[.05] Reserved

[.06] Reserved

[.07] Reserved

[.08] Reserved

[.09] Reserved

.10 Change From Generally Accepted Accounting Principles (GAAP) to a Special Purpose Framework or From a Special Purpose Framework to GAAP

Inquiry—A company that has previously issued financial statements prepared in accordance with GAAP has decided to change to the income tax basis (or vice versa). How should the change in accounting basis be accounted for and reported in the financial statements and how does the change impact the auditor's or accountant's report?

Reply—Accounting issues:

Authoritative literature does not address accounting for a change in accounting basis. FASB ASC 250 provides guidance for reporting accounting changes within the same basis. However, the situation described above is considered to be a change in accounting basis rather than an accounting change.

When only current year financial statements are presented, it is common practice to present the effect of the change in the accounting basis by showing beginning retained earnings as previously reported with an adjustment to convert to the new basis. Although not as common in practice, precedent also exists for either showing opening retained earnings on the new basis or showing the effects of the change as a cumulative-effect adjustment in the income statement.

However, if comparative financial statements are presented, the prior year(s) should be restated and presented under the basis to which the company has changed. Restatement is necessary to ensure comparability with all periods presented.

In both cases, the change in accounting basis should be disclosed in the notes to the financial statements.

—Reporting issues:

Auditing literature states that a change in accounting basis does not represent a lack of consistency and, consequently, that report modification is not required. However, the literature allows for the inclusion of an emphasis-of-matter paragraph in the auditor's report to emphasize a matter regarding the financial statements.

A summary of the relevant authoritative references follows:

Paragraph .A1 of AU-C section 708, *Consistency of Financial Statements* (AICPA, *Professional Standards*), indicates that the consistency reference in the auditor's report refers to consistent application of principles within a basis of presentation. The standards do not address the consistent use of a basis of presentation; therefore, a change in accounting basis does not require the auditor to modify the report for a lack of consistency.

Paragraph .06 of AU-C section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report* (AICPA, *Professional Standards*), indicates that an auditor should include an emphasis-of-matter paragraph in the auditor's report if the auditor considers it necessary to draw users' attention to a matter appropriately presented or disclosed in the financial statements that, in the auditor's professional judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

A sample emphasis-of-matter paragraph for an audit report on comparative financial statements in the year of change to a special purpose framework follows:

(emphasis-of-matter paragraph)

As discussed in Note A to the financial statements, in 20X4 the Company adopted a policy of preparing its financial statements on the accrual method of accounting used for federal income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles. Accordingly, the accompanying financial statements are not intended to present financial position and results of operations in accordance with accounting principles generally accepted in the United States of America. The financial statements for 20X3 have been restated to reflect the income tax basis of accounting accrual method adopted in 20X4.

Accountants performing review or compilation engagements may also consider adding an explanatory paragraph for these basis changes.

[Amended, February 1995; Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[.11] **Reserved**

[.12] **Reserved**

[The next page is 9101.]

Section 9060

Uncertainties

[.01] Reserved

[.02] Reserved

[.03] Reserved

[.04] Reserved

[.05] Reserved

.06 Possible Effect of Divorce Proceedings on Credit Rating

Inquiry—A client and his wife who are co-owners and co-managers of a business are involved in divorce proceedings. The auditor believes a divorce will adversely affect the business's credit rating. Is it necessary to include a reference in the financial statements to the divorce proceedings and their potentially adverse effects?

Reply—The auditor should not include references in his report to currently litigated divorce proceedings. The independent auditor should refrain from mentioning the client's involvements of a personal nature which might effectively disparage (or even stimulate the slander of) his business reputation or credit standing. It is possible that a divorce settlement could adversely affect the credit standing of the client, but in the absence of a final determination of the litigation or a determinative event which directly affects the financial condition of the entity under audit, the rule of informative disclosure does not compel the independent accountant to contribute in advance to a possible adverse effect on the client's credit standing.

[.07] Reserved

.08 Going Concern Problem—Financial Statements Prepared on the Income Tax Basis of Accounting

Inquiry—A client prepares its financial statements on the income tax basis of accounting. The client is experiencing financial difficulties and its ability to continue as a going concern is questionable. Since the financial statements are prepared on a special purpose framework, is the CPA's audit report required to include an emphasis-of-matter paragraph that refers to this uncertainty?

Reply—Yes. AU-C section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*), applies to all audits of financial statements, regardless of whether the financial statements are prepared in accordance with a general purpose or a special purpose framework. Therefore, when the auditor concludes that there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period, regardless of whether the financial statements are prepared in accordance with a general purpose or a special purpose framework, the auditor should include an emphasis-of-matter paragraph (following the opinion paragraph) to reflect that conclusion.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.09 Audit Report for Development Stage Enterprise

Inquiry—Is an emphasis-of-matter paragraph in the auditor's report for a going concern uncertainty always required for a development stage enterprise because there is doubt as to recovery of costs from future operations?

Reply—No. A going concern uncertainty does not automatically arise because an enterprise is in the development stage. In accordance with AU-C section 570, the auditor should consider whether the results of the procedures performed during the course of the audit identify conditions or events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. If such conditions or events are identified, the auditor should obtain information about management's plans that are intended to mitigate the adverse effects of such conditions or events, and assess whether it is likely that such plans can be effectively implemented.

If the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for one year after the balance sheet date remains after considering conditions or events and management's plans, the going concern issue should be adequately disclosed in the financial statements, and the auditor's report should include an emphasis-of-matter paragraph to reflect this conclusion.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[The next page is 9121.]

Section 9070

Subsequent Events

Note: *Additional Questions and Answers on subsequent events can be found in section 8700, Subsequent Events.*

.01 Failure to Remit Withholding Taxes in Subsequent Period

Inquiry—In the course of an examination of the financial statements, the auditor has discovered that in the period subsequent to the balance sheet date the company has not remitted to the appropriate agencies the taxes currently withheld from employees' wages. Assuming the amount is material, is it necessary that this matter be disclosed in the auditor's report?

Reply—Paragraph .02 of AU-C section 560, *Subsequent Events and Subsequently Discovered Facts* (AICPA, *Professional Standards*), states, in part

Financial statements may be affected by certain events that occur after the date of the financial statements...financial reporting frameworks ordinarily identify two types of events:

- a. Those that provide evidence of conditions that existed at the date of the financial statements
- b. Those that provide evidence of conditions that arose after the date of the financial statements

The auditor's objective is to determine whether events occurring between the date of the financial statements and the date of auditor's report that require adjustment of, or disclosure in, the financial statements have been identified and are appropriately reflected in the financial statements. Even if it is determined that the financial statements are not directly affected, it is possible that the situation indicated future serious difficulties that might require disclosures.

If the delinquent obligations are not evidence of serious financial difficulties, there usually would be no reason why obligations incurred subsequent to the balance sheet date need be reported in financial statements as of such date. In such a case, it should be expected that the delinquent payments will soon be remitted.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.02 Disclosure of Note Receivable Covering Previous Account of Bankrupt Company

Inquiry—Company A reports on a fiscal year ending January 31. Company A's accounts receivable include a material amount due from a bankrupt company. To avoid legal action, several individuals formed a new company. The new company and the individuals signed a note which would pay the accounts receivable of the bankrupt company over a three year period. The note was signed on March 1, subsequent to the balance sheet date. Should the note receivable, assumed to be collectible, be presented in the balance sheet at January 31?

Reply—AU-C section 560 and Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 855, *Subsequent Events*, deal with subsequent events. Paragraph 1 of FASB ASC 855-10-55 states, in part

Subsequent events affecting the realization of assets, such as receivables and inventories or the settlement of estimated liabilities, should be recognized in the financial statements when those events represent the culmination of conditions that existed over a relatively long period of time.

Accordingly, the accounts receivable should be reported as a note receivable at January 31, with adequate disclosure of the financial arrangements made after the balance sheet date.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.03 Discovery of Potential Liability in Subsequent Period

Inquiry—In the period subsequent to the balance sheet date, the auditors discovered that an employee of the client had used a company purchase order to obtain merchandise for his personal business. This transaction resulted in a material potential liability of the client. Negotiations with the creditor ensued and the client's attorney was successful in securing a complete release from any obligation on the part of the client.

Is it necessary to disclose this matter on the client's financial statements?

Reply—According to paragraph .02 of AU section 560, the resolution of this matter appears to constitute a subsequent event which is evidence of a condition that existed at the balance sheet date, but since no transaction in fact occurred which involved the client, it is not necessary to disclose the matter in the financial statements. However, a condition which did affect the client and which did exist at the balance sheet date is the future legal costs of settling the matter. Provisions for these costs (if they are material) should be made on the financial statements, and the reasons for incurring these costs should be disclosed.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[.04] Reserved

.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

Inquiry—An auditor completes the field work with respect to an audit of financial statements, performs all of the post-field work procedures required by the firm's quality control standards and signs the audit report but does not immediately issue the auditor's report and the related financial statements to the client. During the period that the report was signed but not issued, the client suffers a significant loss due to a natural disaster. What are the auditor's responsibilities with respect to consideration of a material subsequent event that occurs after completion of field work and after the signing of the auditor's report but before issuance of the auditor's report and the audited financial statements?

Reply—AU-C section 560 defines *subsequent events* as events occurring between the date of the financial statements and the date of the auditor's report. Paragraph .12 of AU-C section 560 states that the auditor is not required to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, if a subsequently discovered fact becomes

known to the auditor after the report release date, the auditor is required to perform certain procedures. Paragraph .02 of AU-C section 560 indicates that there are two types of events: (a) those that provide evidence of conditions that existed at the date of the financial statements, and (b) those that provide evidence of conditions that arose after the date of the financial statements.

A loss from a natural disaster occurring after year end would be considered the second type subsequent event. These events should not result in an adjustment to the financial statements. Some of these events, however, may be of such a nature that disclosure of them is required to keep the financial statements from being misleading. In addition, the auditor should always remember that the financial statements belong to the client and the client may wish to disclose the event in the notes to the financial statements even if not required to do so.

Management and the auditor should consider whether a subsequent event that provides evidence of conditions that arose after the date of the financial statements would be of such a nature that disclosure of the event is necessary in order to keep the financial statements from being misleading. Management and the auditor should also consider whether the event affects the entity's ability to continue as a going concern.

For example, if the auditee owns a major distribution center in an area that is declared a disaster area by a local, state, or federal government due to natural disaster (e.g. hurricane, earthquake, tornado), management and the auditor should assess the damage done to that asset and the impact on the entity's current and future operations and determine whether disclosure of the impact of the disaster is required to keep the financial statements from being misleading. Occasionally such an event may be so significant that disclosure can best be made by supplementing the historical financial statements with pro forma financial data giving effect to the event as if it had occurred on the date of the balance sheet. It may be desirable to present pro forma statements, usually a balance sheet only, in columnar form on the face of the historical statements.

The auditor may conclude that the event has such a material impact on the entity that it would be appropriate to include an emphasis of matter paragraph in the auditor's report directing the reader's attention to the event and its effects. As paragraph .06 of AU-C section 706, *Emphasis-of-Matter and Other-Matter Paragraphs in the Independent Auditor's Report* (AICPA, *Professional Standards*), notes, emphasis-of-matter paragraphs are included in the auditor's report if the auditor considers it necessary to draw users' attention to a matter appropriately presented or disclosed in the financial statements that, in the auditor's professional judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

If the auditor concludes that the effects of the disaster are such that substantial doubt exists as to the entity's ability to continue as a going concern for a reasonable period of time, the auditor should include an emphasis-of-matter paragraph (following the opinion paragraph) to reflect that conclusion. Paragraph .A6 of AU-C section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*), provides an example of such an emphasis-of-matter paragraph.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.06 Decline in Market Value of Assets Subsequent to the Balance Sheet Date

Inquiry—In light of overall market decline, should the decline in market value of an asset subsequent to the balance sheet date result in the adjustment of the financial statements?

Reply—FASB ASC 855-10-25-1 states that “[a]n entity shall recognize in the financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements.”

FASB ASC 855-10-25-3 states that “[a]n entity shall not recognize subsequent events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after the balance sheet date but before financial statements are issued or are available to be issued.”

FASB ASC 855-10-55-2 provides a list of examples of nonrecognized subsequent events, including changes in the fair value of assets or liabilities (financial or nonfinancial) after the balance sheet date but before financial statements are issued or are available to be issued.

[Issue Date: May 2010.]

[The next page is 9141.]

Section 9080

Audited Financial Statements

[.01] Reserved

.02 Going Concern Assumption for Venture With Limited Life

Inquiry—A corporation has recently been organized with the sole purpose of constructing a shopping center which will take several years to complete, after which the company will be liquidated. The company uses the completed contract method to recognize income and will have only one operating cycle.

Should there be an emphasis-of-matter paragraph in the auditor's report now or near the final years of operations on the assumption that after a certain fixed period it will no longer be a "going concern"?

Reply—AU-C section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*), requires that an emphasis-of-matter paragraph (following the opinion paragraph) be included in the audit report when the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains. A *reasonable period of time* is defined as "a period of time not to exceed one year beyond the date of the financial statements being audited." Therefore, when the auditor has substantial doubt that the corporation will continue as a going concern for one year from the date of the financial statements under audit, an emphasis-of-matter paragraph (following the opinion paragraph) reflecting that conclusion should be included in the audit report.

However, if the corporation has presented its financial statements on the assumption of liquidation, AU-C section 570 does not apply and therefore an emphasis-of-matter paragraph reflecting the auditor's conclusion that substantial doubt exists about the corporation's ability to continue as a going concern is not necessary.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.03 Opinion on Balance Sheet Only

Inquiry—Occasionally, a client will request from a CPA only an audited balance sheet with footnotes even though the CPA has examined and reported on all the financial statements. The usual purpose of this statement is for presentation by the client to a supplier for securing credit.

How may the CPA comply with the client's request while remaining in compliance with the reporting requirements in AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, *Professional Standards*)?

Reply—AU-C sections 200–700 apply in an audit of financial statements and are to be adapted as necessary in the circumstances when applied to audits of other historical financial information. AU-C section 805, *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement* (AICPA, *Professional Standards*), addresses special consideration in the application of those AU-C sections to an audit of a single financial statement. Examples of an auditor's report on a single financial statement can be found in illustrations 1–2 of the exhibit to AU-C section 805.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.04 Opinion on Balance Sheet With Disclaimer on Income Statement

Inquiry—A CPA firm has been engaged to perform the initial audit of a company. Since the firm did not observe the inventory taking at the beginning of the period and it is not practicable for it to satisfy itself by other means as to the beginning inventory, the firm plans to issue an opinion only on the balance sheet and disclaim an opinion on the income statement. Would this be in accordance with paragraphs .11 and .15 of AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report* (AICPA, *Professional Standards*)?

Reply—Paragraph .11 of AU-C section 705 addresses scope limitations imposed by management after the engagement has been accepted, and does not apply when the scope limitation arises from circumstances relating to the timing of the auditor's work, such as the inability to observe beginning inventory in an initial audit.

Paragraph .15 of AU-C section 705 states, in part, that “when the auditor considers it necessary to ...disclaim an opinion on the financial statements as a whole, the auditor's report should not also include an unmodified opinion with respect to the same financial reporting framework on a single financial statements...” Paragraph .A17 of AU-C section 705 addresses initial audits and states “[i]n an initial audit, it is acceptable for the auditor to express an unmodified opinion regarding financial position and disclaim an opinion regarding the results of operations and cash flows, when relevant. In this case, the auditor has not disclaimed an opinion on the financial statements as a whole.” An example of a such an auditor's report can be found in illustration 8 of the exhibit to AU-C section 705.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[.05] Reserved**.06 Reference in Financial Statements to Auditor's Report**

Inquiry—Audited financial statements often contain a note such as:

The accompanying notes are an integral part of this financial statement.
or a note sometimes reads

The accompanying notes and auditor's report are an integral part of this financial statement.

The only difference between the two notes is the inclusion of the phrase, “and auditor's report.” Is a reference to the auditor's report necessary?

Reply—Paragraph .04 of AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*), states, in part, “...an audit in accordance with GAAS is conducted on the premise that management and, when appropriate, those charged with governance, have acknowledged certain responsibilities that are fundamental to the conduct of an audit.” These responsibilities are defined as including the responsibility for the preparation and fair presentation of the financial statements. Therefore, the auditor's report cannot be an integral part of the financial statements, and it is inappropriate to include it by reference.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[.07] Reserved

[.08] Reserved

.09 Arrangement of References to Financial Statements in Auditor's Report

Inquiry—The examples of auditor's opinions in the Statements on Auditing Standards all seem to refer to the statement of financial position first, followed by the statement of results of operations, and finally the statement of cash flows. Is it necessary that the financial statements be presented in this order and the statements be referred to in the auditor's report in this order?

Reply—The order in which the financial statements are referred to in the independent auditor's report need not follow the order in which the statements are physically arranged. The illustrative standard report such as shown in the exhibit of AU-C section 700 can be used regardless of the order in which the financial statements are presented.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[.10] Reserved

[.11] Reserved

[.12] Reserved

.13 Classification of Certain Callable Obligations

Inquiry—In some situations in which there is a violation of a debt agreement that makes a long-term obligation callable, management continues to classify the obligation as long-term because it asserts that it is probable that the violation will be cured during the grace period, while the auditor does not agree with that assertion. In such a situation, does an uncertainty exist that might cause the auditor to add an other-matter paragraph (after the opinion paragraph) to his report?

Reply—No. Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 470-10-45-12 requires that long-term obligations be classified as current liabilities if they are, or will be, callable because of the debtor's violation of a provision of the debt agreement unless certain conditions are met. These conditions occur when (1) the creditor waives or loses the right to demand payment for more than one year from the balance sheet date or (2) it is probable that the violation will be cured within the grace period specified in the loan agreement.

The circumstances described above do not constitute an uncertainty as described in AU-C section 705 because they do not involve matters in which the outcome and related audit evidence are prospective (paragraph .A13 of AU-C section 705). If the auditor, on the basis of available evidence, disagrees with management's assertion, a qualified or adverse opinion because of a departure from generally accepted accounting principles should be considered.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[.14] Reserved

.15 Condensed Financial Statements of a Nonpublic Entity

Inquiry—A client prepares condensed financial statements that name the auditor and state that they have been derived from audited financial statements. The condensed statements incorporate the audited financial statements

by reference and indicate such statements and auditor's report thereon may be obtained. Is the auditor required to report on the condensed financial statements?

Reply—Paragraph .28 of AU-C section 810, *Engagements to Report on Summary Financial Statements* (AICPA, *Professional Standards*), states that if the auditor becomes aware that the entity plans to make a statement in a document that refers to the auditor and the fact that summary financial statements are derived from the financial statements audited by the auditor, the auditor should be satisfied that

- a. the reference to the auditor is made in the context of the auditor's report on the audited financial statements; and
- b. the statement does not give the impression that the auditor has reported on the summary financial statements.

If these conditions are met, the auditor need not do anything further. If these conditions are not met, the auditor should request management to change the statement or delete the reference to the auditor's report. Alternatively, the entity may engage the auditor to report on the summary financial statements.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[The next page is 9161.]

Section 9100

Signing and Dating Reports

.01 Use of Successor Firm Name in Signing Registration Statement

Inquiry—A CPA firm has been requested to provide an opinion on the consolidated financial statements of a client covering a five-year period. During this five-year period, the CPA firm has undergone several changes in its organization and its name:

1. Opinions for the first two years were issued by John Doe & Co.
2. In the third year, the accounting practice merged with another firm and the opinions for years three and four were signed by Doe, Roe & Co. Primary responsibility for the client was retained by the partners of John Doe & Co.
3. This partnership was later dissolved and the opinion in year five was signed by John Doe & Co., who, under the dissolution agreement, retained the working papers for this client.

Since it is impracticable to obtain the consent of each partner of the dissolved partnership, may the opinion on the five-year statements be issued by John Doe & Co.?

Reply—This situation is discussed in paragraph .A46 of AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, *Professional Standards*). Since the partners of John Doe & Co., as it presently exists, retained primary responsibility for the publicly held company in question during the merger period, and since the firm is a successor in interest to the engagement and has retained all working papers for this client, it appears that, after consideration of these circumstances, the statements of consolidated income for the five-year period may be released solely in the name of John Doe & Co.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.02 Reporting on Companies With Different Fiscal Years

Inquiry—A CPA has a client whose fiscal year ends on June 30. A parent company of this client now wishes to go public and must file consolidated financial statements with the SEC. The parent company, however, observes a fiscal year ending on December 31.

The CPA has been asked by the parent to provide financial statements with an auditor's opinion for the year ending December 31, 20X3. To do this, the auditor needs to assemble figures for the period January 1, 20X3, to June 30, 20X3, from the financial statements for the year ended June 30, 20X3, and figures for the period July 1, 20X3, to December 31, 20X3, from the financial statements for the year ended June 30, 20X4.

The CPA has been having difficulty in segregating the financial information into these six-month periods because of the condition of the accounting records. Furthermore, the inventories were not observed nor were the receivables confirmed at the December 31 dates.

Under these conditions, should the CPA express his opinion for the year ended June 30, 20X3, and disclaim an opinion for the six months ended December 31, 20X3?

Reply—In order for an auditor to express an opinion on financial statements for prior periods, it is generally not necessary to observe all audit procedures required for the most recent financial statements. Paragraphs .A9–.A11 of AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report* (AICPA, *Professional Standards*), indicate that an inability to perform a specific procedure, such as observation of inventories, does not constitute a limitation on the scope of an audit if the auditor is able to obtain sufficient appropriate audit evidence by performing alternative procedures.

Generally, if the client's records are reasonably well kept and the auditor has satisfied himself as to year-end financial statements, review of ratios of sales to cost of sales and determination that accruals have been properly recognized at the interim date will enable an auditor to satisfy himself that the financial statements at an intervening interim date are fairly presented. On the other hand, if no perpetual inventory records are kept and if the client has not prepared inventories as of the interim date, it may not be practicable to reconstruct such inventory, and a disclaimer of opinion should be expressed on the reconstructed statements. In such circumstances, it would appear necessary that the auditor indicate in a basis for disclaimer paragraph that, due to the fact that he was not engaged to make an audit of financial statements as of such date until June 30, 20X4, he was not in a position to observe the amount of inventory at such date and is unable to satisfy himself thereto by the application of other auditing procedures. If this be the case, the SEC would probably be willing to accept combined income statements based on statements of the subsidiary company as of a date six months different than the parent and to accept unconsolidated balance sheets, with the balance sheet of the subsidiary being presented as of its appropriate year-end. The absence of correspondence with debtors and creditors would probably not cause similar problems.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[.03] Reserved

[.04] Reserved

.05 Signing of Independent Auditor's Report

Inquiry—Should the independent auditor's report be manually signed?

Reply—Paragraph .39 of AU-C section 700 states that the auditor's report should include the manual or printed signature of the auditor's firm.

Although AU-C section 700 does not require a manual signature, Department of Labor and Securities and Exchange Commission regulations require manual signatures in certain circumstances.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.06 The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report

Inquiry—AU-C section 580, *Written Representations* (AICPA, *Professional Standards*), establishes a requirement that the auditor request written representations from management as part of an audit of financial statements performed in accordance with generally accepted auditing standards. Additionally, paragraph .41 of AU-C section 700 states that the auditor's report should be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion. Among other things, sufficient appropriate audit evidence includes evidence that the audit

documentation has been reviewed, and that the entity's financial statements, including the related notes, have been prepared and that management has asserted that it has taken responsibility for them. Is the auditor required to have the signed management representation in hand as of the date of the auditor's report?

Reply—Paragraph .A27 of AU-C section 580 addresses this issue and states that occasionally, circumstances may prevent management from signing the representation letter and returning it to the auditor on the date of the auditor's report. In those circumstances, the auditor may accept management's oral confirmation, on or before the date of the auditor's report, that management has reviewed the final representation letter and will sign the representation letter without exception as of the date of the auditor's report thereby providing sufficient appropriate audit evidence for the auditor to date the report. However, possession of the signed management representation letter prior to releasing the auditor's report is necessary because paragraph .21 of AU-C section 580 requires that the representations be in the form of a written letter from management. Furthermore, when there are delays in releasing the report, a fact may become known to the auditor that, had it been known to the auditor at the date of the auditor's report, might affect the auditor's report and result in the need for updated representations. AU-C section 560, *Subsequent Events and Subsequently Discovered Facts* (AICPA, *Professional Standards*), addresses the auditor's responsibilities in such circumstances.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.07 Naming the City and State Where the Auditor Practices

Inquiry—Paragraph .40 of AU-C section 700 states that the auditor's report should "name the city and state where the auditor practices." May the auditor comply with this requirement by issuing his or her report on the firm's letterhead that contains the city and state where the auditor practices?

Reply—Yes. The city and state where the auditor practices is not required to be placed under the auditor's signature and may be named in the firm's letterhead on which the report is issued.

[Issue Date: February 2013.]

.08 Audit Firm With Multiple Offices on Their Company Letterhead and Effect on Report

Inquiry—According to paragraph .40 of AU-C section 700, the auditor's report should name the city and state where the auditor practices. If an auditor's letterhead denotes multiple office locations, has this requirement been met by issuing the report on the firm's letterhead?

Reply—No. If the firm's letterhead includes multiple office locations, it will not be clear which location is the issuing office, and, therefore, the auditor would need to indicate the city and state where the auditor practices in the auditor's report.

[Issue Date: June 2013.]

[The next page is 9181.]

Section 9110

Special Reports

.01 Determination of Sales Price Based on Auditor's Report

Inquiry—A CPA has been designated by a contract of sales to prepare a statement of “net current assets” and a statement of net income of the selling firm. Both are elements in the determination of the sales price.

A disagreement has arisen between the seller and the buyer as to the pricing of the inventory which represents the major portion of the “net current assets.” The seller relies on a formula represented as “heretofore agreed” The buyer demands a formula “based upon good accounting practice.”

The CPA believes he may have to submit two inventory values to comply with the contract provisions—one to describe the “net current assets” which will use the formula set forth in the contract, and a second using the normal pricing methods of prior years. There is a major variation between the two. The formula in the contract was not represented as being based on good accounting methods but was developed by management after the date of their latest audit.

Can the CPA express an unmodified opinion on each of the two statements if different price bases are used provided full disclosure is made?

Reply—This is a special report situation and these are special circumstances in which the auditor may have a certain reporting latitude he might not otherwise have. Since seller and buyer were both parties to the contract, the CPA was designated by the contract to prepare specified statements, and the contract apparently describes a special formula to be used in pricing inventories, the CPA would ordinarily perform strictly according to the terms of the engagement and report on one set of statements as being fairly presented or correctly presented in accordance with the specified contractual formula.

However, since the CPA is aware of the basic disagreement between seller and buyer, he might be much more helpful towards ultimately resolving the issue if he were to prepare statements on both bases.

The auditor may properly report on the two statements prepared in accordance with different inventory pricing bases, full disclosure, of course, being assumed. A more significant question, under the circumstances, is whether he has (or can obtain) consent from both parties modifying the terms of the engagement to allow preparation of the statements on a dual basis.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[.02] Reserved

.03 Audit of Sales for Percentage-of-Sales Lease Agreements

Inquiry—Tenants' lease agreements with a large shopping center provide for a minimum annual rental plus a percentage rent for sales in excess of a certain dollar amount. In accordance with the leases, the shopping center has engaged the services of a CPA to verify that sales exceeding the specified minimum base are being reported. If the CPA is satisfied that the internal control of a tenant is good, may he or she rely on copies of sales tax returns filed with the state as sufficient evidence for his examination? Is any further verification necessary if a tenant submits a written confirmation of its annual sales from its CPA?

Reply—The degree of reliance which the auditor can place on the work of a tenant's CPA will depend upon many considerations such as those described in AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* (AICPA, *Professional Standards*). Comparison of the sales figure reported to the client with the figure reported on the tenant's sales tax return would not in itself be sufficient verification, and additional procedures will be necessary.

An audit program suitable for determining the annual sales of the tenants will have to be highly flexible. Flexibility is required so as to enable the field auditors involved to adjust the audit procedures employed from store to store, as dictated by changes in types of merchandise sold, selling policies employed, sufficiency of records maintained, adequacy of internal control, etc. Accordingly, the depth of the examination will vary to some extent with almost every tenant audited.

Procedures might include examining weekly cash reports submitted by store managers and comparing these reports with general ledger entries, bank statements, and state and federal tax returns, and test checking consecutively numbered sales invoices.

Perhaps the most important documents to play a role in such an examination of the tenants' sales will be the lease agreements which provide the very basis for such examination and which may well contain restrictions on the number and type of records and reports that each tenant will be required to make available.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[.04] **Reserved**

[.05] **Reserved**

[.06] **Reserved**

.07 Statement of Cash Receipts and Disbursements

Inquiry—What is the appropriate language for audit, review, and compilation reports on a statement of cash receipts and disbursements?

Reply—Report language will vary depending on the level of service performed. A statement of cash receipts and disbursements is a financial statement prepared in accordance with a special purpose framework (see paragraph .07 of AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* [AICPA, *Professional Standards*]), also referred to as an other comprehensive basis of accounting (see paragraph .04 of AR section 60, *Framework for Performing and Reporting on Compilation and Review Engagements* [AICPA, *Professional Standards*]). It is a pure cash-basis financial statement that summarizes cash activity of the entity, including the individual sources and uses of cash, and may be the only financial statement prepared for the period.

Audit reports on this financial statement should contain an emphasis-of-matter paragraph that states the cash receipts and disbursements basis of accounting is being used and that it represents a basis of accounting other than accounting principles generally accepted in the United States of America (see paragraph .19 of AU-C section 800). This extra paragraph is not required for full-disclosure compilation and review reports.

Illustrations of audit, review, and compilation reports on statements of cash receipts and disbursements follow:

A) *Audit*

We have audited the accompanying financial statements of ABC Partnership, which comprise the statement of assets and liabilities arising from cash transactions as of December 31, 20X1, and the related statement of revenue collected and expenses paid for the year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with the cash basis of accounting described in Note X; this includes determining that the cash basis of accounting is an acceptable basis for the preparation of the financial statements in the circumstances. Management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

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 from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the partnership's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the partnership's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets and liabilities arising from cash transactions of ABC Partnership as of December 31, 20X1, and its revenue collected and expenses paid during the year then ended in accordance with the cash basis of accounting described in Note X.

Basis of Accounting

We draw attention to Note X of the financial statements, which describes the basis of accounting. The financial statements are prepared on the cash basis of accounting, which is a basis of accounting other than accounting

principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

B) Review

I (We) have reviewed the accompanying statements of cash receipts and disbursements of XYZ Company for the years ended December 31, 20X2, and 20X1. A review included primarily applying analytical procedures to management (owners') financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion. Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with cash receipts and disbursements basis of accounting described in Note X and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

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 receipts and disbursements basis of accounting described in Note X.

C) Compilation With Full Disclosure

I (We) have compiled the accompanying statements of cash receipts and disbursements of XYZ Company for the years ended December 31, 20X2, and 20X1. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with the cash receipts and disbursements basis of accounting described in Note X.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with the cash receipts and disbursements basis of accounting described in Note X and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

D) Compilation With Substantially All Disclosures Omitted Including Disclosure of the Basis of Accounting Used

I (We) have compiled the accompanying statements of cash receipts and disbursements of XYZ Company for the years ended December 31, 20X2, and 20X1. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any

assurance about whether the financial statements are in accordance with the cash receipts and disbursements basis of accounting.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with the cash receipts and disbursements basis of accounting and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

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

[Amended, February 1995; Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature; Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.08 Statutory Basis Financial Statements Differ From GAAP

Inquiry—Financial statements filed with a state regulatory agency are prepared on a statutory basis which differs from generally accepted accounting principles (GAAP). How should the accountant report on the financial statements if he or she knows they will be distributed to third parties other than the regulatory agency?

Reply—Paragraph .21 of AU-C section 800 addresses this situation and indicates that the auditor should express a qualified or adverse opinion regarding the application of GAAP and, in a separate paragraph, express an opinion about whether the financial statements are presented in accordance with the prescribed basis of accounting mandated by the state regulatory agency. In accordance with paragraph .16 of AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report* (AICPA, *Professional Standards*), the auditor's report would include a basis for modification paragraph that provides an explanation in full of the differences between GAAP and the state mandated policies, or alternatively, a brief description of the differences with a reference to a footnote identifying these differences in detail.

The exhibit of AU-C section 800 includes an illustration of an auditor's report on a complete set of financial statements prepared in accordance with a regulatory basis of accounting when the financial statements together with the auditor's report are intended for general use.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[.09] Reserved

[.10] Reserved

[.11] Reserved

[.12] Reserved

.13 Report Distribution Restriction Related to Financial Statements Prepared on a Basis of Accounting Prescribed in an Agreement

Inquiry—An auditor was asked to report on special purpose financial statements of a corporation prepared in accordance with contractual basis of accounting. Certain assets, such as receivables, inventories, and other properties, have been valued on a basis specified in the agreement (fair market value). Is the auditor required to issue a report containing a paragraph that restricts the distribution of the report?

Reply—Yes. Paragraph .20 of AU-C section 800 indicates that in such circumstances, the auditor's report on special purpose financial statements should include an other-matter paragraph, under an appropriate heading, that restricts the use of the auditor's report when the special purpose financial statements are prepared in accordance with

- a. a contractual basis of accounting,
- b. a regulatory basis of accounting, or
- c. an other basis of accounting when required pursuant to paragraph .06a–b of AU-C section 905, *Alert That Restricts the Use of the Auditor's Written Communication* (AICPA, *Professional Standards*).

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.14 Liquidation Basis Financial Statements

Inquiry—The stockholders of a corporation adopted a plan of complete liquidation. The liquidation will occur over a period of three years. What constitutes the basic financial statements following the adoption of the plan, and on what basis should those statements be presented?

Reply—Interpretation No. 1, “Reporting on Financial Statements Prepared on a Liquidation Basis of Accounting,” of AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, *Professional Standards*, AU-C sec. 9700 par. .01–.05), states that a liquidation basis of accounting may be considered GAAP for entities in liquidation or for which liquidation appears imminent.

The financial statements of entities adopting a plan of liquidation may be presented with financial statements of a prior period that were prepared on a going concern assumption. The basic financial statements following the adoption of a plan of liquidation consist of a statement of net assets in liquidation, and the related statement of changes in net assets in liquidation.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.15 Reporting on Medicaid/Medicare Cost Reports

Inquiry—Third-party payors may require health care entities to prepare and submit “cost reports” as a condition of participation in a payor's program. The most common examples are Medicare and Medicaid. Sometimes, a specific payor (such as a state Medicaid program) will require health care entities to obtain an audit of their financial statements and further, will require some form

of independent auditor association with or “certification” of cost reports submitted by the health care entity. No standards exist that define or specify what is meant by “certification” of a cost report. A financial statement audit conducted in accordance with generally accepted auditing standards (GAAS) does not include rendering an opinion or any form of assurance on the entity’s compliance with laws and regulations, nor does it provide any assurance on an entity’s cost report. Consequently, auditors have expressed concern that providing such certification might erroneously imply that they are providing assurance on the entity’s cost report or on its compliance with cost report rules or regulations. When an auditor has been engaged to perform an audit of a health care entity’s basic financial statements, what form of report should the auditor issue to comply with the certification requirement?

Reply—The auditor could enter into a separate engagement to examine the cost report under AT section 601, *Compliance Attestation* (AICPA, *Professional Standards*). However, typically states do not require such extensive services and therefore, health care entities may be reluctant to engage the auditor to perform such an examination. If a health care entity includes their cost report as supplementary information to their audited basic financial statements, an auditor may report on the cost report as supplementary information in accordance with AU-C section 720, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*).^[1] AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*), addresses those situations where the auditor is engaged to report on whether certain cost report amounts or statistics are fairly stated, in all material respects, in relation to those basic financial statements as a whole. The following is an illustration of an other matter paragraph that the auditor may include in the auditor’s report on the audited financial statements or a separate report that the auditor can issue on certain data within a cost report:

Our audit was made for the purpose of forming an opinion on the financial statements as a whole. The financial and statistical data on pages x–x, designated with the tickmark “#”² that are excerpted from ABC Health System’s [identify title of cost report, such as “Annual Report of Hospitals and Hospital Health Care Complexes”]³ for the year ended December 31, 200X, identified by Declaration Control Number xxxxxxx and prepared as of [insert date that cost report was submitted]⁴ are presented for purposes of additional analysis and are not a required part of the financial statements. The financial and statistical data, designated with the tickmark “#,” is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing

[1] [Footnote deleted, December 2010, to reflect conforming changes necessary due to the issuance of SAS Nos. 118–120.]

² It should be clear from the description in the auditor’s report and/or the specific page numbers referenced as to which data is, and which data is not, covered by the “in relation to” opinion.

³ This wording presumes that the supplementary information is comprised of specific pages or schedules excerpted from the cost report. If the entire cost report is included as supplementary information, this sentence might be reworded to read “Certain supplementary financial and statistical data designated with the tickmark “#” in ABC Health System’s [identify title of cost report, such as “Annual Report of Hospitals and Hospital Health Care Complexes”] for the year ended December 31, 200X.”

⁴ A provider’s as-filed cost report may subsequently be revised; therefore, the auditor’s report should clearly identify the specific version of the cost report to which the “in relation to” report applies, such as by identifying specific control numbers and/or date of preparation/filing. Doing so will eliminate any future misunderstanding as to the version of the cost report/cost report excerpts covered by the “in relation to” opinion.

procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is stated fairly in all material respects in relation to ABC Health System's financial statements taken as a whole.

The financial and statistical data, designated with the tickmark "#," has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is stated fairly in all material respects in relation to ABC Health System's basic financial statements taken as a whole. Those auditing procedures applied in the audit of the financial statements were not intended to determine compliance with, and therefore would not detect compliance with or deviations from, the applicable instructions furnished by the [*identify related regulators, such as "XYZ State Department of Health"*] relating to the preparation of the cost report or the reporting requirements contained in the [*identify related regulations, such as "XYZ State Medicaid Accounting and Reporting Manual"*].⁵ None of the other information included in the accompanying schedules excerpted from [*identify source*] has been subjected to the auditing procedures applied in our audit of the basic financial statements referred to above and, accordingly, we express no opinion or any other form of assurance thereon.⁶

This report is intended solely for the information and use of Management and the Board of Directors of ABC Health System and the [*identify requesting organization, such as "XYZ State Department of Health"*] and is not intended to be and should not be used by anyone other than these specified parties.⁷

Because this is a restricted-use report, the auditor should consider the guidance in paragraphs .A5–.A6 of AU-C section 905 before deciding whether to combine this report with the auditor's report on the basic financial statements.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature; Revised, December 2010, to reflect conforming changes necessary due to the issuance of SAS Nos. 118–120; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

⁵ An auditor engaged to perform a financial statement audit in accordance with auditing standards generally accepted in the United States of America would not be in a position to express an opinion, or provide any form of assurance, regarding compliance with cost report preparation instructions or rules and regulations covering reimbursement as promulgated by the government program. [Footnote revised, December 2010, to reflect conforming changes necessary due to the issuance of SAS Nos. 118–120.]

⁶ A disclaimer should be included as to any other data included in the supplementary information.

⁷ Restrictive use language should be included in the report. Paragraph .06 of AU-C section 905, *Alert as to the Intended Use of the Auditor's Written Communication* (AICPA, *Professional Standards*), states that the auditor should include an alert that restricts the use of an auditor's written communication when the subject matter of the auditor's written communication is based on (a) measurement or disclosure criteria that are determined by the auditor to be suitable only for a limited number of users who can be presumed to have an adequate understanding of the criteria, (b) measurement or disclosure criteria that are available only to the specified parties, or (c) matters identified by the auditor during the course of the audit engagement when the identification of such matters is not the primary objective of the audit engagement (commonly referred to as a by-product report). [Footnote revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.16 Example Reports on Federal Deposit Insurance Corporation Loss Sharing Purchase and Assumption Transactions

Inquiry—The Federal Deposit Insurance Corporation’s (FDIC’s) Resolutions Handbook (Handbook) states that a loss sharing *transaction* is a purchase and assumption (P&A) transaction that the FDIC commonly uses as a resolution tool for handling failed institutions with more than \$500 million in assets. A P&A is a resolution transaction in which a healthy institution purchases some or all of the assets of a failed bank or thrift and assumes some or all of the liabilities, including all insured deposits. The Handbook also states that a loss sharing P&A uses the basic P&A structure, except for the provision regarding transferred assets. Instead of selling some or all of the assets to the acquirer at a discounted price, the FDIC agrees to share in future loss experienced by the acquirer on a fixed pool of assets.

How may an independent auditor respond to the requirement in the Handbook for P&A agreements that “[w]ithin 90 days after each calendar year end, the acquiring bank must furnish the FDIC a report signed by its independent public accountants containing specified statements⁸ relative to the accuracy of any computations made regarding shared loss assets”?

Reply—When the FDIC requirement applies to an engagement covering an FDIC loss sharing P&A transaction, the auditor may respond to the requirement by issuing a report in accordance with the requirements of AU-C section 806, *Reporting on Compliance With Aspects of Contractual Agreements or Regulatory Requirements in Connection With Audited Financial Statements* (AICPA, *Professional Standards*). The following are illustrations of auditor reports for three possible outcomes for which the independent auditor might report:

Example A—Independent Auditor’s Report on Compliance With Contractual Provisions

Independent Auditor’s Report

[To the Board of Directors of ABC Bank]

We have audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of *ABC Bank* (the “Bank”) as of *[insert date—e.g. December 31, 20XY]*, and the related statements of income, changes in stockholder’s equity, and cash flows for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated *[insert date]*.

In connection with our audit, nothing came to our attention that caused us to believe that the Bank failed to comply with the computational provisions of Exhibit 4.15A Single Family Shared-Loss Agreement, Article II section 2.1(b), *[[and] Exhibit 4.15B, Commercial Shared-Loss Agreement, Article II section 2.1(a)]*⁹ of the Purchase and Assumption agreement between the Bank and the Federal Deposit Insurance Corporation dated *[insert date]*, insofar as they relate to accounting matters. However, our audit was not directed primarily toward obtaining knowledge of such noncompliance. Accordingly, had we performed additional procedures, other matters may

⁸ The term *specified statements* is not defined in the Federal Deposit Insurance Corporation’s (FDIC’s) Resolutions Handbook. The practitioner is advised to read the terms of the loss share agreement and confirm that the audit requirement in that agreement provides for the receipt of a report expressing negative assurance.

⁹ Applicable depending on the nature of the agreement between the acquiring bank and the FDIC.

have come to our attention regarding the Bank's noncompliance with the above-referenced provisions, insofar as they relate to accounting matters.

This report is intended solely for the information and use of the Bank and the Federal Deposit Insurance Corporation and is not intended to be and should not be used by anyone other than these specified parties.

[Signature]

[Auditor's city and state]

[Date of the auditor's report]

Example B—Independent Auditor's Report on Compliance With Contractual Provisions: Assuming Amended Computations Are Attached

Independent Auditor's Report

[To the Board of Directors of ABC Bank]

We have audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of *ABC Bank* (the "Bank"), which comprise the balance sheet as of [insert date—e.g. December 31, 20XY], and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated [insert date].

In connection with our audit, after giving effect to the attached corrected computations, nothing came to our attention that caused us to believe that the Bank failed to comply with the computational provisions of Exhibit 4.15A Single Family Shared-Loss Agreement, Article II section 2.1(b), [[and] Exhibit 4.15B, Commercial Shared-Loss Agreement, Article II section 2.1(a)]¹⁰ of the Purchase and Assumption agreement between the Bank and the Federal Deposit Insurance Corporation dated [insert date], insofar as they relate to accounting matters. However, our audit was not directed primarily toward obtaining knowledge of such noncompliance. Accordingly, had we performed additional procedures, other matters may have come to our attention regarding the Bank's noncompliance with the above-referenced provisions, insofar as they relate to accounting matters.

This report is intended solely for the information and use of the Bank and the Federal Deposit Insurance Corporation and is not intended to be and should not be used by anyone other than these specified parties.

[Signature]

[Auditor's city and state]

[Date of the auditor's report]

Example C—Independent Auditor's Report on Compliance With Contractual Provisions: Noncompliance

Independent Auditor's Report

[To the Board of Directors of ABC Bank]

We have audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of *ABC Bank* (the "Bank"), which comprise the balance sheet as of [insert date—e.g. December 31, 20XY], and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the

¹⁰ Applicable depending on the nature of the agreement between the acquiring bank and the FDIC.

financial statements, and have issued our report thereon dated [*insert date*].

In connection with our audit, we noted that the Bank did not comply with [*state computational provision not met*] Our audit was not directed primarily toward obtaining knowledge as to whether the Bank failed to comply with the computational provisions of Exhibit 4.15A Single Family Shared-Loss Agreement, Article II section 2.1(b), [[and] Exhibit 4.15B, Commercial Shared-Loss Agreement, Article II section 2.1(a)]¹¹ of the Purchase and Assumption agreement between the Bank and the Federal Deposit Insurance Corporation dated [*insert date*], insofar as they relate to accounting matters. Accordingly, had we performed additional procedures, other matters may have come to our attention regarding the Bank's noncompliance with the above-referenced provisions, insofar as they relate to accounting matters.

This report is intended solely for the information and use of the Bank and the Federal Deposit Insurance Corporation and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

[Issue Date: February 2010; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.17 Application of Financial Accounting Standards Board (FASB) *Accounting Standards Codification 740-10* (previously, *FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes*) to Other Comprehensive Basis of Accounting Financial Statements—Recognition and Measurement Provisions

Inquiry—Does an auditor need to consider the recognition and measurement provisions of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 740-10 (previously, *FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes*) when auditing financial statements prepared in accordance with a special purpose framework?

Reply—Ordinarily, the recognition and measurement provisions of FASB ASC 740-10 (previously, *FASB Interpretation No. 48*) would not apply to special purpose financial statements because a liability for an uncertain tax position would not be reported on an entity's income tax return, nor would it be based on cash receipts or disbursements. However, FASB ASC 740-10 may apply in order for an entity's financial statements to comply with the financial reporting provisions of a governmental regulatory agency to whose jurisdiction the entity is subject. If the recognition and measurement provisions do apply and the financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP, then the auditor should consider whether the financial statements (including the accompanying notes) include all informative disclosures that are appropriate for the basis of accounting used.

[Issue Date: June 2010; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

¹¹ Applicable depending on the nature of the agreement between the acquiring bank and the FDIC.

.18 Small Business Lending Fund Auditor Certification Guidance

Inquiry—Enacted into law on September 27, 2010, as part of the Small Business Jobs Act of 2010, the Small Business Lending Fund (SBLF) encourages lending to small businesses by providing capital to community banks with under \$10 billion in assets. The United States Department of the Treasury will make SBLF funding available by purchasing senior preferred stock or equivalents in institutions that apply, and are approved, to participate in the SBLF. Generally speaking, the dividend rate paid by institutions on SBLF funding decreases as the institution's *qualified small business lending*, as defined by the Treasury Department, increases.

Under the terms of the SBLF, a participating community bank is required to calculate and report the amount of its qualified small business lending in a supplemental report. In addition to requiring the institution's management to certify to the Treasury Department that the information provided in each supplemental report is accurate, the institution is also required to receive and submit within 90 days of the end of each fiscal year following the investment date a certification from its external auditors that the processes and controls used to generate the supplemental reports are satisfactory.

How may an independent auditor respond to this requirement?

Reply—An independent auditor may satisfy this requirement by issuing a report in accordance with the requirements of AU-C section 806. This assurance, relative to the supplemental reports, may be provided in a separate report or in one or more paragraphs of the auditor's report accompanying the audited financial statements. Such assurance should not be provided unless the auditor has audited the financial statements and subjected the supplemental reports to audit procedures applied in the audit of the financial statements. Professional judgment needs to be applied by the auditor in determining the nature, timing, and extent of those audit procedures. In addition, when the auditor has expressed an adverse opinion or disclaimed an opinion on the financial statements, the auditor should issue a report on compliance only when instances of noncompliance are identified. When the auditor has identified one or more items of noncompliance, the report on compliance should describe such noncompliance.

The following is an illustration of a report that an auditor may use when, as a result of the auditor's audit procedures, nothing has come to the auditor's attention to indicate that the bank failed to comply with the terms of the SBLF:

Independent Auditor's Report

[To the Board of Directors of Institution Name]

[Address]

[City, State]

We have audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of [Institution Name] (the "Bank"), which comprise the balance sheet as of [Date], and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated [Date].

In connection with our audit, nothing came to our attention that caused us to believe that the Bank failed to comply with the Small Business Lending Fund Securities Purchase Agreement (the Agreement) between the Bank and the United States Department of the Treasury (Treasury) dated [Date], insofar as the Agreement relates to accounting matters provided on the Bank's Supplemental Reports filed with Treasury during the year ended

[Date] under sections 1.3(j) and 3.1(d) of the Agreement, including that nothing came to our attention that caused us to believe that the Bank's Supplemental Reports did not set forth a complete and accurate statement of loans held by the Bank in each of the categories described therein for the time period(s) specified therein. However, our audit was not directed primarily toward obtaining knowledge of such noncompliance. Accordingly, had we performed additional procedures, other matters may have come to our attention regarding the Bank's compliance with the above-referenced provisions, insofar as they relate to accounting matter

This report is intended solely for the information and use of the Bank and Treasury and is not intended to be and should not be used by anyone other than these specified parties.

[Signature]

[Date]

[Issue Date: October 2011; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.19 Lender Comfort Letters

Inquiry—No-documentation or low-documentation loans remain popular options within the lending community, especially in lending to the self-employed. The information a prospective borrower is asked to furnish in connection with such loans is limited; however, lenders or brokers still attempt to assess a borrower's creditworthiness and verify the accuracy of information provided to them by the borrower.

Examples of requested information include

- confirmation of a client's self-employed status.
- verification of income from self-employment.
- profitability of a client's business.
- the impact on a client's business if money is withdrawn to fund the down payment on a real estate purchase.

How may an accountant respond to a request from a client, lender, or loan broker to confirm client information in connection with a pending loan application?

Reply—When presented with such requests, the accountant should consider the guidance in Interpretation No. 2, "Responding to Requests for Reports on Matters Relating to Solvency," of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*, AT sec. 9101 par. .23–.33). Paragraph .27 of Interpretation No. 2 states that a practitioner is precluded from giving any form of assurance on matters relating to solvency or any financial presentation of matters relating to solvency. Paragraph .25 of Interpretation No. 2 defines matters relating to solvency as whether an entity (a) is not insolvent at the time the debt is incurred or would not be rendered insolvent thereby, (b) does not have unreasonably small capital, or (c) has the ability to pay its debts as they mature.

In response to a request to confirm client information in connection with a pending loan application, an accountant may provide a client with various-professional services that may be useful with a financing. Those services include

- an audit, a review, or a compilation of personal financial statements.
- an examination, a review, or a compilation of pro forma personal financial information.
- an examination or a compilation of prospective personal financial statements.
- an agreed-upon procedures report, as long as the agreed-upon procedures do not provide any assurance on matters related to solvency.

Additionally, a broker or lender may be satisfied with a copy of the client's income tax return and a letter from the accountant, including an acknowledgment that the income tax return was prepared by the accountant. Obtaining client consent before providing any confidential information to a third party is required under professional ethics standards, the Gramm-Leach-Bliley Act, the Internal Revenue Code, and federal and state privacy statutes and regulations. The following is a sample letter that may be used in this situation:

Date

ABC Company

Address

City, State Zip

Dear Mr. _____:

I am writing to you at the request of Mr. & Mrs. _____.

The purpose of this letter is to confirm to you that I prepared the 20XX federal income tax return of Mr. & Mrs. _____ and delivered this return to them for filing with the IRS. At their request, I have attached a copy of the tax return and related schedules provided to them for filing.

This return was prepared from information furnished to me by Mr. & Mrs. _____. This information was neither audited nor verified by me, and I make no representation nor do I provide any assurance regarding the accuracy of this information or the sufficiency of this tax return for your credit decision-making purposes.

I prepared Mr. & Mrs. _____ tax return in accordance with the applicable IRS rules and regulations solely for filing with the IRS. As a result, the tax return does not represent any assessment on my part regarding creditworthiness and does not include any statement of their financial position or income and expense for the year 20XX, in accordance with accounting principles generally accepted in the United States of America, and should not be construed to do so.

As you know, a credit decision should be based on a lender's exercise of due diligence in obtaining and considering multiple factors and information. Any use by you of Mr. & Mrs. _____ 20XX federal income tax return and this letter is solely a matter of your responsibility and judgment. This letter is not intended to establish a client relationship with you nor is it intended to establish any obligation on my part to provide any future information to you with regard to Mr. & Mrs. _____.

Sincerely,

_____ (Firm Name)

cc: Mr. & Mrs. _____ (Client)

[Issue Date: July 2012.]

.20 Effective Date of AU-C Section 905 in a Compliance Audit

Inquiry—AU-C section 905 is “effective for the auditor’s written communications related to audits of financial statements for periods ending on or after December 15, 2012. For all other engagements conducted in accordance with GAAS, this section is effective for the auditor’s written communications issued on or after December 15, 2012.”

Which effective date applies in a compliance audit performed pursuant to AU-C section 935, *Compliance Audits* (AICPA, *Professional Standards*), and Office of Management and Budget Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations* (Circular A-133), in which the financial statements of an entity are for a period prior to December 15, 2012 (for example, as of and for the year ended September 30, 2012), but the opinion on compliance and reporting on internal control over compliance (the Circular A-133 report) relating to that same period is issued after December 15, 2012 (for example, the Circular A-133 report is issued on January 15, 2013)?

Reply—Some auditors view the compliance audit performed pursuant to AU-C section 935 and Circular A-133 as related to the audit of the financial statements because Circular A-133 also requires a financial statement audit. Other auditors view the compliance audit as being unrelated to the financial statement audit. Generally, both views may be reasonable. Therefore, the effective date used depends on the auditor’s professional judgment of the circumstances. If, in the auditor’s professional judgment, the compliance audit relates to the audit of the financial statements, AU-C section 905 would not apply and the auditor would use the restricted use alert language required by AU section 532, *Restricting the Use of an Auditor’s Report*, in the Circular A-133 report. However, if, in the auditor’s professional judgment, the compliance audit is unrelated to the audit of the financial statements, AU-C section 905 applies and the auditor’s Circular A-133 report would use the intended use alert language required by paragraph .11 of AU-C section 905.

It should be noted that a Circular A-133 report for periods ending on or after December 15, 2012, should implement the intended use alert language required by paragraph .11 of AU-C section 905.

Finally, with regard to the reporting issued to satisfy the requirements of *Government Auditing Standards* on internal control over financial reporting, and compliance and other matters, which is also required in a Circular A-133 compliance audit, such reporting is related to the audit of the financial statements. Therefore, the auditor would continue to use the restricted use alert language required by AU section 532 when reporting on periods prior to December 15, 2012.

[Issue Date: December 2012.]

.21 Reporting on Current-Value Financial Statements That Supplement Historical-Cost Financial Statements in Presentations of Real Estate Entities

Inquiry—A real estate entity presents current-value financial statements¹² to supplement historical-cost financial statements. May an auditor accept an engagement to report on current-value financial statements that supplement historical-cost financial statements and, if so, how should the auditor report?

¹² Generally accepted accounting principles require the use of current-value accounting for financial statements of certain types of entities (for example, investment companies, employee benefit plans, personal financial statements, and mutual and common trust funds). This interpretation does not apply to reports on current-value financial statements of such entities.

Reply—An auditor may accept an engagement to report on current-value financial statements that supplement historical-cost financial statements of a real estate entity only if the auditor believes the following two conditions exist:

- The measurement and disclosure criteria used to prepare the current-value financial statements are reasonable.
- Competent persons using the measurement and disclosure criteria would ordinarily obtain materially similar measurements or disclosures.

If these conditions are satisfied, an auditor may report on such current-value financial statements in a manner similar to that discussed in paragraph .22 of AU-C section 800. However, because the current-value financial statements only supplement the historical-cost financial statements and are not presented as a stand-alone presentation, it is not necessary to restrict the use of the auditor's report on the presentation as required by that paragraph.

The following is an example of a report an auditor might issue when reporting on current-value financial statements that supplement historical-cost financial statements of a real estate entity.

Independent Auditor's Report

[Appropriate Addressee]

Report on the Financial Statements¹³

We have audited the accompanying historical-cost financial statements of X Company, which comprise the historical-cost balance sheets as of December 31, 20X3, and 20X2, and the related historical-cost statements of income, shareholders' equity, and cash flows for the years then ended, and the related notes to the historical-cost financial statements. We also have audited the supplemental current-value financial statements of X Company, which comprise the current-value balance sheets as of December 31, 20X3, and 20X2, and the related supplemental current-value statements of income and shareholders' equity for the years then ended, and the related notes to the current-value financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of the historical-cost financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of historical-cost financial statements that are free from material misstatement, whether due to fraud or error.

Management is responsible for the preparation and fair presentation of the supplemental current-value financial statements in accordance with the basis of accounting described in Note 1; this includes determining that the basis of accounting described in Note 1 is an acceptable basis for the preparation of the supplemental current-value financial statements in the circumstances. Management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of supplemental current-value financial statements that are free from material misstatement, whether due to fraud or error.

¹³ The subtitle "Report on the Financial Statements" is unnecessary in circumstances when the second subtitle, "Report on Other Legal and Regulatory Requirements," is not applicable.

Auditor's Responsibility

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 from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.¹⁴ Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

Opinion on the Historical-Cost Financial Statements

In our opinion, the historical-cost financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X3, and 20X2, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Opinion on the Supplemental Current-Value Financial Statements

In our opinion, the supplemental current-value financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X3, and 20X2, and the results of its operations for the years then ended in accordance with the basis of accounting described in Note 1.

Basis of Accounting for the Supplemental Current-Value Financial Statements

As described in Note 1, the supplemental current-value financial statements have been prepared by management to present relevant financial information that is not provided by the historical-cost financial statements and are not intended to be a presentation in conformity with accounting principles generally accepted in the United States of America. In addition, the supplemental current-value financial statements do not purport to present the net realizable, liquidation, or market value of X Company as a whole. Furthermore, amounts ultimately realized by X Company from the disposal of properties may vary significantly from the current values

¹⁴ In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances." In addition, the next sentence, "Accordingly, we express no such opinion," would not be included.

presented. Our opinion on the supplemental current-value financial statements is not modified with respect to this matter.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Signature]

[Date]

In accordance with paragraph .17 of AU-C section 800, the auditor should also consider the adequacy of disclosures relating to the current-value financial statements. Adequate disclosures describe the accounting policies applied and such matters as the basis of presentation, nature of the reporting entity's properties, status of construction-in-process, valuation bases used for each classification of assets and liabilities, and sources of valuation, in a sufficiently clear and comprehensive manner that enables a knowledgeable reader to understand the current-value financial statements.

[Issue Date: March 2013.]

.22 Use of Restricted Alert Language When Financial Statements Are Audited in Accordance With GAAS and Government Auditing Standards

Inquiry—Paragraph .11 of AU-C section 905,¹⁵ states that the restricted alert language required by paragraph .07 of AU-C section 905 should not be used when

- a. the engagement is performed in accordance with *Government Auditing Standards*, and
- b. the auditor's written communication (commonly referred to as a by-product report) pursuant to that engagement is issued in accordance with
 - i. AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*);
 - ii. AU-C section 806; or
 - iii. AU-C section 935.

Assume an entity's financial statements are audited in accordance with both GAAS and *Government Auditing Standards*. If the auditor issues a compliance report in accordance with AU-C section 806 but that report is not required to be issued in accordance with *Government Auditing Standards* and the report does not refer to *Government Auditing Standards*, is the auditor prohibited from using the restricted alert language required by paragraph .07 of AU-C section 905?

Reply—No, use of the restricted alert language is not prohibited. An auditor may include a restricted alert paragraph using the language required by paragraph .07 in AU-C section 905 as long as the compliance report is not required to be issued in accordance with *Government Auditing Standards* and the report does not refer to *Government Auditing Standards*.

For example, a not-for-profit organization is required to have a financial statement audit conducted in accordance with GAAS and *Government Auditing Standards* because the organization receives federal funds. In addition to the reports required by *Government Auditing Standards*, the auditor of the not-for-profit organization is requested to provide a compliance report in accordance

¹⁵ All referenced AU-C sections can be found in AICPA *Professional Standards*.

with AU-C section 806 to the organization's financial institution about whether the auditor identified any instances of noncompliance with the covenants of a loan agreement. Because this compliance report is not required to be issued in accordance with *Government Auditing Standards* and the report would be issued only in accordance with GAAS and would not refer to *Government Auditing Standards*, the auditor may use the restricted alert language required by paragraph .07 of AU-C section 905.

[Issue Date: March 2013.]

.23 Modification of Compliance Report When Financial Statements Are Audited in Accordance With GAAS

Inquiry—The exhibit, “Illustrations of Reports on Compliance With Aspects of Contractual Agreements or Regulatory Requirements in Connection With Audited Financial Statements,” in AU-C section 806 provides illustrative reports on compliance based on a financial statement audit conducted in accordance with auditing standards generally accepted in the United States of America. Based on the facts in section 9110.22, “Use of Restricted Alert Language When Financial Statements Are Audited in Accordance With GAAS and Government Auditing Standards,” does the auditor need to modify this language to indicate that the financial statement audit was also conducted in accordance with *Government Auditing Standards*?

Reply—No. In the example in section 9110.22, the auditor's compliance report about whether the auditor identified any instances of noncompliance with the covenants of a loan agreement would be issued only in accordance with GAAS and would not be issued in accordance with *Government Auditing Standards*. Therefore, the illustrative language would not need to be modified and could refer only to the audit being conducted in accordance with auditing standards generally accepted in the United States of America.

[Issue Date: March 2013.]

[The next page is 9201.]

Section 9120

Reliance on Others

[.01] Reserved

.02 Responsibility for Audit of Dividend Fund Managed by Agent

Inquiry—A mutual fund employs a management company to act as its dividend disbursing agent and transfer agent. Dividend checks to the individual shareholders of the mutual fund are drawn from a “dividend disbursing agency fund.” This account, however, does not appear as an asset or liability on the books of either the mutual fund or the management company.

Is it the responsibility of the mutual fund’s auditors or the management company’s auditors to audit the dividend disbursing agency fund?

Reply—Since it is one of the primary responsibilities of the management company for the mutual fund, to draw and pay individual dividend checks to the fund’s shareholders, it would be appropriate for, if not incumbent upon, the management company’s auditors, in connection with their audit, to see that this function is being properly discharged, even though the account from which these checks are disbursed does not appear as an asset or liability on the books of either the fund or the management company.

[.03] Reserved

.04 Reliance on State Grain Inspectors for Inventory Measurements

Inquiry—A grain company operates several storage elevators. The company maintains perpetual inventory records for all facilities—both at the elevators and the home office. State grain inspectors measure the stored grain and in effect perform the same audit functions as the CPA firm. Past experience has been that the differences between the measurements of the state inspectors, the CPA firm, and the perpetual inventory records are immaterial. The state inspectors are qualified with years of experience. Can the CPA firm accept the findings of the state inspectors as adequate inventory observation in accordance with generally accepted auditing standards?

Reply—Paragraph .A29 of AU-C section 501, *Audit Evidence—Specific Considerations for Selected Items* (AICPA, *Professional Standards*), can be applied to this situation. The CPA firm could use the measurements and calculations of the state grain inspectors but not as a complete substitute for its own independent inventory observation.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[.05] Reserved

.06 Use of Other Auditors’ Work When They Are Not Independent

Inquiry—AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* (AICPA, *Professional Standards*), provides guidance when component auditors are involved in an audit of group financial statements. How does the lack of independence of the component auditors affect the use of their work and reports by the group engagement team?

Reply—In these circumstances, the work and reports of the component auditors cannot be used in accordance with AU-C section 600. The responsibility for the audit report on the financial statements rests solely with the group engagement partner.

Therefore, judgments about assessments of inherent and control risk, the materiality of misstatements, the sufficiency of tests performed, the evaluation of significant accounting estimates, and other matters affecting the auditor's report should always be those of the group engagement team.

The group engagement team, however, may use professional judgment in evaluating the work of the component auditors who are lacking in independence in the way an auditor would consider the work performed by internal auditors.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.07 Reference to Other Auditors in Accompanying Information Report

Inquiry—An audit report is based in part on the report of component auditors. If the group engagement partner makes reference to component auditors' audit in the audit report, is the report on accompanying information, which includes data audited by component auditors, required to include a reference to component auditors' audit?

Reply—Yes. If a portion of the financial statements was audited by component auditors and the group engagement partner's report refers to the component auditors, the group engagement partner's report on the accompanying information, which includes data audited by component auditors, also should refer to component auditors' audit.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[.08] Reserved

[The next page is 9221.]

Section 9130

Limited Scope Engagements

[.01] Reserved

.02 Auditor's Report if Inventories Not Observed

Inquiry—An auditor has been asked to perform an audit for an entity on a limited scope basis. The entity is required by regulation to have an audit performed, and a disclaimer of opinion is acceptable to the regulator. The engagement does not include any independent verification of the inventory. The auditor will not be present at any physical inventory taking and the pricing and clerical accuracy of the inventory will not be tested. The inventory is material in relation to the other accounts on the client's financial statements.

May the auditor accept the engagement on a limited scope basis? What type of opinion can the auditor give under these circumstances?

Reply—A disclaimer of opinion is appropriate when the scope limitation precludes inventory observation and any other audit tests of the inventories. Paragraph .07 of AU-C section 210, *Terms of Engagement* (AICPA, *Professional Standards*), specifies that if management or those charged with governance impose a limitation on the scope of the auditor's work in the terms of the proposed audit engagement, such that the auditor believes the limitation will result in disclaiming an opinion on the financial statements as a whole, the auditor is not permitted to accept such a limited engagement as an audit engagement. However, if the entity is required by regulation to have an audit, and a disclaimer of opinion is acceptable to the regulator, the auditor is permitted, but not required, to accept the engagement.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[.03] Reserved

[.04] Reserved

[.05] Reserved

[.06] Reserved

.07 Inadequate Internal Control and Financial Records

Inquiry—How should the auditor report that he or she has been unable, because of inadequate internal control and financial records, to obtain sufficient appropriate audit evidence that all transactions were recorded?

Reply—AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report* (AICPA, *Professional Standards*), addresses the auditor's inability to obtain sufficient appropriate audit evidence (also referred to as a limitation on the scope of an audit). In accordance with paragraphs .08 and .10 of AU-C section 705, the inability of the auditor to obtain sufficient appropriate audit evidence results in one of the following modifications to the opinion in the auditor's report:

- a. A qualified opinion when the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

- b. A disclaimer of opinion when the auditor concludes that auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

A disclaimer of opinion in this situation would be appropriate under AU-C section 705 if the effects of the inadequacy of internal control and the accounting records are sufficiently pervasive. Otherwise, a qualified opinion may be appropriate.

Paragraph .20 of AU-C section 705 requires that when a modification to the auditor's opinion results from an inability to obtain sufficient appropriate audit evidence, the auditor should include in the basis of modification paragraph the reasons for that inability.

[Revised, May 2007; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[.08] **Reserved**

[.09] **Reserved**

.10 Effect of Generally Accepted Accounting Principles (GAAP) Departures on Limited Scope Engagements

Inquiry—The auditor of a company is unable to observe physical inventory at year end due to a restriction imposed by the client. Because the inventory is material, the auditor plans to issue a disclaimer of opinion on the financial statements in accordance with paragraph .10 of AU-C section 705.

The auditor also discovers significant mathematical errors in the client's last-in, first-out provision in the prior year. The auditor advises the client to report the error as a prior period adjustment in accordance with Financial Accounting Standards Board *Accounting Standards Codification* 250, *Accounting Changes and Error Corrections*. If the client refuses to do so, the auditor is now faced with a GAAP departure and a disclaimer of opinion—both related to the company's inventory.

How would the GAAP departure affect the auditor's disclaimer of opinion?

Reply—Assuming the auditor decided not to withdraw from the engagement, the requirement in paragraph .22 of AU-C section 705 should be followed. That paragraph requires the auditor, even if the auditor has expressed an adverse opinion or disclaimed an opinion on the financial statements, to "... describe in the basis of modification paragraph any other matters of which the auditor is aware and that would have required a modification to the opinion and the effects thereof."

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[The next page is 9241.]

Section 9150

Compilation and Review Engagements

[.01] Reserved

[.02] Reserved

[.03] Reserved

.04 Financial Statements Marked As “Unaudited”

Inquiry—Is it required that each page of compiled or reviewed financial statements of nonissuers be marked “unaudited”?

Reply—No. Neither AR section 80, *Compilation of Financial Statements* (AICPA, *Professional Standards*), nor AR section 90, *Review of Financial Statements* (AICPA, *Professional Standards*), requires that each page of compiled or reviewed financial statements of a nonissuer be marked as “unaudited.” However, nothing precludes the preparer from labeling the financial statements as “unaudited.”

Each page of the financial statements compiled by the accountant should include a reference such as “See accountant’s compilation report” or “See independent accountant’s compilation report” (paragraph .18 of AR section 80). Each page of the financial statements reviewed by the accountant should include a reference such as “See independent accountant’s review report” (paragraph .29 of AR section 90).

[Amended, February 1995; Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature; Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

[.05] Reserved

[.06] Reserved

[.07] Reserved

.08 Supplementary Information

Inquiry—Are supporting schedules of balance sheet or income statement accounts considered supplementary information? If so, what are the reporting requirements in a review or compilation engagement?

Reply—Paragraph .53 of AR section 80 and paragraph .60 of AR section 90 state that 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 or she is taking with respect to such information. Financial and nonfinancial information (other than the financial statements and the accountant’s report thereon) that is included in a document containing compiled or reviewed financial statements and the accountant’s report thereon is considered to be supplementary information.

If the information does not accompany the basic financial statements, it is not supplementary information and, therefore, the accountant does not have a reporting obligation.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature; Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

.09 Application of AR Section 300 to Certain Companies Required to File With Regulatory Bodies

Inquiry—Some nonissuers, as defined in paragraph .04 of AR section 60, *Framework for Performing and Reporting on Compilation and Review Engagements* (AICPA, *Professional Standards*), such as privately owned brokers or dealers in securities, may be required to include unaudited financial statements in a form prescribed by a regulatory body concerned with the sale or trading of securities, such as the National Association of Securities Dealers or the New York Stock Exchange. Does the first sentence of paragraph .02 of AR section 300, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms* (AICPA, *Professional Standards*), preclude an accountant from using the alternative form of report illustrated in AR section 300 in those circumstances?

Reply—No. Paragraph .02 of AR section 300 excludes from the definition of a prescribed form those forms “. . . concerned with the sale or trading of securities.” In that context, “securities” refers to those issued or to be issued by the entity submitting the prescribed form. Accordingly, an accountant is not precluded in the circumstances described in this question from using the alternative form of compilation report illustrated in AR section 300 if the entity is not submitting the prescribed form in connection with the actual or contemplated sale or trading of its own securities.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature; Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

.10 Review of Financial Statements Included in a Prescribed Form

Inquiry—Can an accountant perform a review of financial statements included in a prescribed form that are presented on a basis other than accounting principles generally accepted in the United States of America?

Reply—A review can be performed on the financial statements included in a prescribed form prepared in accordance with any financial reporting framework, but AR section 90 reporting standards would apply, not those in AR section 300.

Accordingly, where the prescribed form or related instructions call for the departures from the applicable financial reporting framework, a review report in accordance with the reporting requirements of AR section 90 would be appropriate provided that, as required by paragraphs .34–.36 of AR section 90, the review report discloses the departures from the applicable financial reporting framework, including the departures called for by the prescribed form or related instructions.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature; Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

[.11] Reserved

[.12] Reserved

[.13] Reserved

[.14] Reserved

[.15] Reserved

.16 Reference to Accountant's Report in Notes to Financial Statements

Inquiry—Paragraph .18 of AR section 80 and paragraph .29 of AR section 90 require that each page of the financial statements compiled or reviewed by the accountant include a reference such as “See accountant’s compilation report,” “See independent accountant’s compilation report,” or “See independent accountant’s review report.”

Does this requirement extend to the related notes to the financial statements?

Reply—Yes, the related notes to financial statements are an integral part of the basic financial statements.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature; Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

[.17] Reserved**.18 Bank Engaged an Accountant to Compile a Financial Statement of Another Entity**

Inquiry—A bank has engaged an accountant to compile a balance sheet for another entity. The bank has possession of the books and records of the entity. Can the accountant issue a compilation report under such circumstances?

Reply—Yes, there is nothing in the Statements on Standards for Accounting and Review Services (SSARSS) that precludes the CPA firm from issuing a compilation report under such circumstances assuming that the accountant is able to adhere to the requirements of AR section 80, including obtaining knowledge about the entity.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature; Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

[.19] Reserved**.20 Reissuance When Not Independent**

Inquiry—An accountant performed a review in the prior year and a compilation in the current year. The accountant was independent in the prior year but his or her independence was impaired in the current year. May the accountant reissue his or her review report on the prior year financial statements?

Reply—Yes. Paragraph .08 of AR section 200, *Reporting on Comparative Financial Statements* (AICPA, *Professional Standards*), states, in part, “A continuing accountant who performs a lower level of service with respect to the financial statements of the current period should either (a) include as a separate paragraph of his or her report a description of the responsibility assumed for the financial statements of the prior period . . . or (b) reissue his or her report on the financial statements of the prior period.” The separate paragraph referred to in preceding item (a) includes a statement that the accountant has not performed any procedures in connection with the prior period review engagement after the date of his or her review report as reflected in the illustrative example in exhibit A, “Illustrative Compilation Reports on Comparative Financial Statements,” of AR section 200.

[Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

[.21] Reserved

[.22] Reserved

[.23] Reserved

.24 Issuing a Compilation Report on Financial Statements That Omit Substantially All Disclosures After Issuing a Report on the Same Financial Statements That Include Substantially All Disclosures

Inquiry—May an accountant accept an engagement to compile financial statements that omit substantially all disclosures, if he or she previously issued an audit, review, or compilation report on financial statements with substantially all disclosures for the same reporting period?

Reply—Yes. The financial statements that omit substantially all disclosures are separate and distinct from the financial statements that include substantially all disclosures. Paragraph .20 of AR section 80 states that an accountant may compile financial statements that omit substantially all disclosures provided the omission of the disclosure is not, to the accountant's knowledge, undertaken with the intention of misleading those who might reasonably be expected to use the financial statements.

If the accountant believes that the entity's intent is to mislead users, the accountant should not accept the engagement.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature; Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

.25 Determining Whether Financial Statements Have Been Prepared by the Accountant

Inquiry—Paragraph .01 of AR section 80 states that the accountant is required to comply with the provisions of that section whenever he or she submits financial statements to a client or to third parties. Submission of financial statements is defined in paragraph .04 of AR section 60 as presenting to management financial statements that the accountant has prepared. If an accountant's work effort results in or contributes to the existence of financial statements, what should an accountant consider in determining whether he or she prepared those financial statements?

Reply—Due to computer technology, it is often unclear whether existing financial statements have been "prepared" by an accountant or by management. In considering whether an accountant is deemed to have prepared financial statements, an accountant needs to apply professional judgment to all the facts and circumstances. Some factors that an accountant may consider include the following:

1. *The process used to create the financial statements.* If an accountant takes a client's trial balance and puts the accounts into a format that would represent a financial statement, then an accountant has probably prepared the financial statements. The less an accountant has to do with creating the statements, the less likely an accountant would be deemed to have prepared the statements.
2. *Whether the client engaged the accountant to prepare financial statements or reasonably expected that as part of the professional services engagement the accountant would prepare financial statements.* An accountant may determine that he or she prepared financial statements even when not so engaged if, as part of an accounting or bookkeeping services engagement, in the accountant's professional

judgment, the client reasonably expected that the existing financial statements were prepared as a product of that engagement.

3. *The extent of work effort that an accountant contributed to the existence of the financial statements.* For example, if an accountant is intricately involved in adjusting the general ledger and other accounts that are, in turn, presented in a financial statement format, the more likely an accountant may be viewed as preparing the financial statements. On the other hand, if an accountant is not very involved in the accounting process, the less likely that an accountant would be deemed to have prepared the financial statements.
4. *Where the underlying accounting information resides.* If all the accounting data resides on the accountant's computer, it is more likely that the accountant is deemed to have prepared the financial statements. However, based on the facts and circumstances of the situation, an accountant may conclude that he or she prepared financial statements through the use of accounting or bookkeeping software utilized by the client.

Considerations such as who printed the financial statements or the location at which an accountant's services were performed (for example, at the client's location or the accountant's location) are generally not factors in determining whether the accountant has prepared financial statements.

The previously mentioned factors are not meant to be all-inclusive nor are they meant to be used as a program or checklist for determining whether the accountant has prepared financial statements. They address certain general areas that may be factors in the exercise of professional judgment. The accountant may consider other factors in the exercise of professional judgment.

[Issue Date: December 2008; Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

.26 The Accountant's Responsibilities for Subsequent Events in Compilation and Review Engagements

Inquiry—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 855-10-50-1 states, "An entity shall disclose the date through which subsequent events have been evaluated, as well as whether that date is the date the financial statements were issued or the date the financial statements were available to be issued." How does the entity's responsibility to disclose the date through which subsequent events have been evaluated affect the accountant's responsibilities for subsequent events in a compilation or review engagement?

Reply—FASB ASC 855, *Subsequent Events*, does not change the accountant's responsibilities under AR section 80 with respect to compilation engagements or AR section 90 with respect to review engagement. AR section 90 states that an accountant performing a review engagement should consider inquiring of members of management who have responsibility for financial and accounting matters concerning events subsequent to the date of the financial statements that could have a material effect on the financial statements.¹ In a compilation engagement, the accountant does not have any responsibility with respect to subsequent events unless evidence or information comes to the accountant's attention that a subsequent event that has a material effect on the financial statements has occurred. When such evidence or information comes

¹ See paragraph .19 of AR section 90, *Review of Financial Statements* (AICPA, *Professional Standards*).

to an accountant's attention during a compilation or review engagement, the accountant should request that management consider the possible effects on the financial statements, including the adequacy of any related disclosure.² If the accountant determines that a subsequent event is not appropriately accounted for in the financial statements or disclosed in the notes, he or she should follow the guidance in paragraphs .27–.29 of AR section 80 or paragraphs .34–.36 of AR section 90 regarding departures from the applicable financial reporting framework with respect to compilations or reviews, respectively.³

Because the accountant's compilation or review report should be dated as of the completion of the compilation or review procedures,⁴ the date of the accountant's compilation or review report can never be earlier than management's subsequent event note date.

In a review engagement, because the accountant is concerned with events occurring through the date of the review report that may require adjustment to, or disclosure in, the financial statements, the specific management representations relating to information concerning subsequent events should be made as of the date of the accountant's review report.⁵

In most cases, the date that management discloses as the date through which they have evaluated subsequent events (in the notes to the financial statements and, in a review engagement, in the management representation letter) will be the same date as the accountant's compilation or review report. In order to coordinate that these dates (the note date, the representation letter date [in a review engagement], and the accountant's compilation or review report date) are the same, the accountant may want to discuss these dating requirements with management in advance of beginning the compilation or review engagement. The accountant also may want to include, in the accountant's understanding with the client regarding the services to be performed (engagement letter), that management will not date the subsequent event note earlier than the date of management's representations (in a review engagement) and the date of the accountant's compilation or review report.

[Issue Date: December 2009; Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

.27 The Accountant's Reporting Responsibility With Respect to Subsequent Discovery of Facts Existing at the Date of the Report

Inquiry—Paragraphs .47–.52 of AR section 80 and paragraphs .54–.59 of AR section 90 provide requirements and guidance when the accountant becomes aware that facts may have existed at the date of the accountant's compilation or review report (or the date of submission of compiled financial statements not intended for third party use in which the accountant does not report), respectively, that might have caused him or her to believe that information supplied by the entity was incorrect, incomplete, or otherwise unsatisfactory had the accountant then been aware of such facts.

Paragraph .49(a) of AR section 80 and paragraph .56(a) of AR section 90 state that when the accountant has concluded that action should be taken to prevent further use of the accountant's report or the financial statements, and

² See paragraph .44 of AR section 80, *Compilation of Financial Statements* (AICPA, *Professional Standards*), and paragraph .51 of AR section 90.

³ See paragraph .45 of AR section 80 and paragraph .52 of AR section 90.

⁴ See paragraph .17 of AR section 80 and paragraph .28 of AR section 90.

⁵ See paragraph .24 of AR section 90.

the effect on the accountant's report or the financial statements of the subsequently discovered information can promptly be determined,

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

What does the term *where applicable* refer to in paragraph .49(a) of AR section 80 and paragraph .56(a) of AR section 90?

Reply—The use of the term *where applicable* refers to a situation in which the accountant has not reported on compiled financial statements not intended for third party use. In the case of a review or a compilation in which the accountant has issued a report, then a revised accountant's report should be issued and the reason for the financial statement's revision usually should be described in the accountant's revised report as well as in a note to the revised financial statements.

[Issue Date: May 2010; Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

.28 Compilation Engagement When the Accountant Is Performing Management Functions

Inquiry—Is it permissible for an accountant to compile financial statements for an entity with respect to which the accountant also performs management functions?

Reply—Yes. However, the accountant should consult Interpretation No. 101-3, "Performance of Nonattest Services," under Rule 101, *Independence* (AICPA, *Professional Standards*, ET sec. 101 par. .05), regarding the independence rules. Interpretation No. 101-3 states that members "should not perform management functions or make management decisions for the attest client." If independence is impaired, the accountant would need to disclose this fact in the compilation report, in accordance with paragraph .21 of AR section 80.

[Issue Date: September 2011.]

.29 Effects on Compilation and Review Engagements When Management Does Not Assess Whether the Reporting Entity Is the Primary Beneficiary of a Variable Interest Entity and Instructs the Accountant to Not Perform the Assessment

Inquiry—FASB ASC 810-10-25-38A requires a reporting entity with a variable interest in a variable interest entity (VIE) to assess whether the reporting entity has a controlling financial interest in the VIE and, thus, is the VIE's primary beneficiary. If management of the enterprise with a variable interest in a VIE does not perform the required assessment and instructs the accountant engaged to compile or review the reporting entity's financial statements to not perform the assessment, is the accountant required to withdraw from the compilation engagement because of management's refusal to provide information or to withdraw from the review engagement because of a scope limitation?

Reply—No. Because management is required to perform the assessment in accordance with accounting principles generally accepted in the United States of America (GAAP), the failure to perform such an assessment and management's instructions to the accountant to not perform the assessment are a

departure from GAAP, not a refusal to provide information or a scope limitation. In accordance with paragraph .27 of AR section 80 or paragraph .34 of AR section 90, as applicable, the accountant should consider whether modification of the standard report is adequate to disclose the departure.

If the accountant concludes that modification of the standard report is appropriate, the accountant may modify the accountant's compilation or review report as follows (assuming there are no other known departures from GAAP):

Accountant's Compilation Report

[Appropriate Addressee]

I (we) have compiled the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States.

Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements. During our compilation, I (we) did become aware of a departure from accounting principles generally accepted in the United States of America that is described in the following paragraph.

Accounting principles generally accepted in the United States of America require management to assess whether the company has a controlling interest in any entities in which the company has a variable interest in order to determine if those entities should be consolidated. Management has not performed the required assessment and therefore, if there are variable interest entities for which the company is the primary beneficiary, has not consolidated those entities. Although the effects on the financial statements of the failure to perform the required assessment have not been determined, many elements in the financial statements would have been materially affected had management determined that the company is the primary beneficiary of any variable interest entities.

[Signature of accounting firm or accountant, as appropriate]

[Accountant's city and state]

[Date of the accountant's report]

Independent Accountant's Review Report

[Appropriate Addressee]

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. A review includes primarily applying analytical procedures to management's (owners') financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management (owners) is (are) responsible for the presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (our) responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.

Based on my (our) review, with the exception of the matter(s) 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 accounting principles generally accepted in the United States.

Accounting principles generally accepted in the United States of America require management to assess whether the company has a controlling interest in any entities in which the company has a variable interest in order to determine if those entities should be consolidated. Management has not performed the required assessment and therefore, if there are variable interest entities for which the company is the primary beneficiary, has not consolidated those entities. Although the effects on the financial statements of the failure to perform the required assessment have not been determined, many elements in the financial statements would have been materially affected had management determined that the company is the primary beneficiary of any variable interest entities.

[Signature of accounting firm or accountant, as appropriate]

[Accountant's city and state]

[Date of the accountant's report]

If the accountant believes that modification of the standard report is not adequate to indicate the deficiencies in the financial statements, in accordance with paragraph .29 of AR section 80 or paragraph .36 of AR section 90, as applicable, the accountant should withdraw from the compilation or review engagement and provide no further services with respect to those financial statements. The accountant may wish to consult with his or her legal counsel in those circumstances.

[Issue Date: April 2012.]

.30 Disclosure of Independence Impairment in the Accountant's Compilation Report on Comparative Financial Statements When the Accountant's Independence Is Impaired in Only One Period

Inquiry—Paragraph .21 of AR section 80 states that when issuing a report with respect to a compilation of financial statements for an entity with respect to which the accountant is not independent, the accountant's report should be modified. How may an accountant modify the accountant's compilation report on comparative financial statements for an entity with respect to which the accountant was not independent as of and for the earlier period ended, but such impairment was subsequently cured?

Reply—The accountant may indicate the independence impairment as of and for the earlier period ended that was subsequently cured by including language such as the following as the final paragraph of the accountant's compilation report: "As of and for the year ended December 31, 20X1, I was not independent with respect to XYZ Company."

The accountant is not precluded from disclosing a description about the reason(s) that the accountant's independence is impaired, as noted in paragraph .21 of AR section 80.

Although the accountant is not required to disclose that his or her independence impairment was subsequently cured, the accountant may elect to make such a disclosure. An illustration of the accountant's compilation report if the accountant elects to make such a disclosure is as follows: "As of and for the year ended December 31, 20X1, I was not independent with respect to XYZ Company. I am currently independent with respect to XYZ Company."

As noted previously, the accountant is not precluded from disclosing a description about the reason(s) for the impairment and how the impairment was subsequently cured.

[Issue Date: May 2012.]

.31 Break-Even Financial Statements

Inquiry—An accountant is engaged to compile financial statements with inventory recorded so that the financial statements reflect no profit or loss (break-even financial statements). How would this affect the accountant's compilation report?

Reply—Break-even financial statements are not in accordance with GAAP. Accordingly, in accordance with paragraph .27 of AR section 80, the accountant should consider whether modification of the standard report is adequate to disclose the departure. If the accountant concludes that modification of the standard report is appropriate, in accordance with paragraph .28 of AR section 80, the accountant should disclose the departure in a separate paragraph of the report, including disclosure of the effects of the departure on the financial statements if such effects have been determined by management or are known as a result of the accountant's procedures.

[Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

.32 Modification to the Accountant's Compilation or Review Report When a Client Adopts a Private Company Council Accounting Alternative

Inquiry—A private company client has adopted one or more of the Private Company Council (PCC) accounting alternatives in the current year and disclosed the change in accounting principle, which is material to the financial statements. Is the accountant required to add an emphasis-of-matter (EOM)

paragraph to the compilation or review report for this change in accounting principle?

Reply—No, there is no requirement in the SSARs for an accountant to add an EOM paragraph to a compilation or review report for any reason. The SSARs include EOM guidance in paragraphs .25–.26 of AR section 80 and paragraph .33 of AR section 90. Though there is no requirement for an accountant to add an EOM paragraph to a compilation or review report, the SSARs do not preclude the accountant from voluntarily including an EOM paragraph regarding the change in accounting principle. In accordance with paragraph .26 of AR section 80, the accountant should not include an EOM paragraph in a compilation report on financial statements that omit substantially all disclosures unless the matter is disclosed in the financial statements.

[Issue Date: March 2014.]

.33 Compilation or Review Report in Which Management Refuses to Include Disclosure Related to Adoption of a PCC Accounting Alternative

Inquiry—When management has adopted one or more of the PCC accounting alternatives but does not disclose this change in accounting principle, which is material to the financial statements, how should the accountant's compilation or review report be modified?

Reply—If the accountant has determined that the change in accounting principle has a material effect on the financial statements and management refuses to disclose this change in the financial statements, the accountant is required to address the known departure from GAAP by

- modifying the compilation report (assuming management has not elected to omit substantially all disclosures) in accordance with paragraphs .27–.29 of AR section 80, or
- modifying the review report in accordance with paragraphs .34–.36 of AR section 90.

[Issue Date: March 2014.]

.34 Modification to the Accountant's Compilation or Review Report When a Client Adopts a Private Company Council Accounting Alternative That Results in a Change to a Previously Issued Report

Inquiry—A private company client has adopted the guidance in FASB Accounting Standards Update (ASU) No. 2014-07, *Consolidation (Topic 810): Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements*, in the current year. In the prior year, the private company elected not to consolidate a material VIE and, therefore, the accountant's compilation or review report noted a departure from GAAP. The private company is now presenting comparative financial statements and this accounting change (which should be applied retrospectively) no longer requires the material VIE to be consolidated. Accordingly, the prior year compilation or review report on those statements would no longer need to refer to a departure from GAAP. Is the accountant required to add an explanatory paragraph to the compilation or review report in the current period?

Reply—Yes. Paragraph .14 of AR section 200 states that when the accountant's report on the financial statements of the prior period contains a changed reference to a departure from the applicable financial reporting framework (in

this case, GAAP), the report should include an explanatory paragraph indicating

- a. the date of the accountant's previous report,
- b. the circumstances or events that caused the reference to be changed, and,
- c. when applicable, that the financial statements of the prior period have been changed.

According to paragraph .15 of AR section 200, a changed reference to a departure from GAAP includes the removal of a prior reference or the inclusion of a new reference.

Following is an illustration of an explanatory paragraph to be added to an accountant's compilation report when a private company has elected to adopt ASU No. 2014-07 for a VIE when there is a common control leasing arrangement and the VIE was material in 2013 and 2012:

In our report dated March 1, 2013, with respect to the 2012 financial statements, we referred to a departure from accounting principles generally accepted in the United States of America because ABC Company excluded a variable interest entity from the accompanying financial statement that should have been consolidated. As described in Note X, in March 2014 the Financial Accounting Standards Board issued Accounting Standards Update No. 2014-07, *Consolidation (Topic 810): Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements*, which makes changes to the FASB guidance and no longer requires nonpublic companies to apply variable interest entity guidance to certain common control leasing arrangements. This guidance required retrospective application.

Following is an illustration of an explanatory paragraph to be added to an accountant's review report when a private company has elected to adopt ASU No. 2014-07 for a VIE when there is a common control leasing arrangement and the change was material in 2013 and 2012:

In our report dated March 1, 2013, with respect to the 2012 financial statements, we referred to a departure from accounting principles generally accepted in the United States of America because ABC Company excluded a variable interest entity from the accompanying financial statement that should have been consolidated. As described in Note X, in March 2014 the Financial Accounting Standards Board issued Accounting Standards Update No. 2014-07, *Consolidation (Topic 810): Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements*, which makes changes to the FASB guidance and no longer requires nonpublic companies to apply variable interest entity guidance to certain common control leasing arrangements. This guidance required retrospective application. Accordingly, our statement on the 2012 financial statements presented herein, which states that we are not aware of any material modifications that should be made to the accompanying financial statements, is different from that expressed in our previous report.

[Issue Date: April 2014.]

[The next page is 9261.]

Section 9160

Other Reporting Issues

[.01] Reserved

[.02] Reserved

.03 Dates on Cover for Financial Statements

Inquiry—Paragraph .57 of AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, *Professional Standards*), specifies that an auditor's report disclose that prior year financial statements presented for comparative purposes are unaudited. Is it appropriate to include the dates of both the current year and prior year financial statements on the cover of the financial statements?

Reply—Both years may be included on the cover if the financial statements for the prior year are referred to as unaudited.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[.04] Reserved

[.05] Reserved

[.06] Reserved

.07 Financial Statements Cover Period Longer Than Twelve Months

Inquiry—Is it acceptable for an auditor to express an opinion on financial statements covering a period longer than 12 months?

Reply—It is acceptable provided the title of the financial statements is descriptive of the period covered and the auditor's report clearly indicates the period covered by the financial statements.

.08 Title of Auditors' Report

Inquiry—Does the auditor's report require a title?

Reply—Paragraph .23 of AU-C section 700 states "The auditor's report should have a title that includes the word *independent* to clearly indicate that it is the report of an independent auditor." Paragraph .16 of AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report* (AICPA, *Professional Standards*), states, in part, "When the auditor is not independent but is required by law or regulation to report on the financial statements, the auditor should disclaim an opinion and specifically state that the auditor is not independent." Therefore, if the auditor is not independent, the auditor's report should not have a title that includes the word *independent*.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[.09] Reserved

.10 Distinction Between Internal and General Use of Financial Statements

Inquiry—Are financial statements differentiated between internal and general use in the professional reporting literature?

Reply—Internal use by management and general use of financial statements are no longer differentiated for historical financial statements. However, the distinction between general and internal use is made for financial forecasts and projections.

[.11] **Reserved**

[.12] **Reserved**

[.13] **Reserved**

.14 Part of Audit Performed by Another Independent Auditor Who Has Ceased Operations

Inquiry—If an auditor who has ceased operations audited the financial statements of one or more components included in an entity's group financial statements, may the group engagement partner make reference in the auditor's report on the group financial statements to the audit of that auditor or assume responsibility for that auditor's work in accordance with AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* (AICPA, *Professional Standards*)?

Reply—The group engagement partner may make reference to the audit of a component auditor, or assume responsibility for that auditor's work, only if the component auditor has issued an audit report and the group engagement team has completed the procedures required by AU-C section 600 regarding the component auditor prior to the time that the other auditor ceased operations. The procedures described in AU-C section 600 cannot be appropriately performed after the other auditor has ceased operations. In situations in which the group engagement team cannot use the work of the component auditor in accordance with AU-C section 600, the group engagement team should perform audit procedures sufficient to afford a reasonable basis for an opinion on the financial statements under audit. However, review of the component auditor's working papers may have an effect on the nature, timing, and extent of those procedures.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

[.15] **Reserved**

[.16] **Reserved**

[.17] **Reserved**

[.18] **Reserved**

[.19] **Reserved**

[.20] **Reserved**

.21 Fiscal Years for Tax and Financial Reporting Purposes Differ

Inquiry—Can an entity have different fiscal years for tax and reporting purposes?

Reply—There is no requirement in the accounting literature for the tax and the financial reporting year-end to be the same. However, having different fiscal years complicates further any interperiod tax allocation the entity may have.

[.22] Reserved

[.23] Reserved

.24 Required Presentation of the Statement of Stockholders' Equity

Inquiry—Is the statement of stockholders' equity required when financial position and results of operations are presented?

Reply—Disclosure of changes in capital accounts and retained earnings is required. According to Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 505-10-50-2, "if both financial position and results of operations are presented, disclosure of changes in the separate accounts comprising stockholders' equity (in addition to retained earnings) . . . is required to make the financial statements sufficiently informative. Disclosure of such changes may take the form of separate statements or may be made in the basic financial statements or notes thereto."

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.25 Use of Singular v. Plural Terminology for Accountants and Auditors

Inquiry—In reporting on audited, reviewed, or compiled financial statements, should accountants use singular or plural terminology when referring to themselves?

Reply—Use of plural or singular terminology is not addressed in the professional standards. Illustrative auditors' reports in Statements on Auditing Standards use plural terminology, while the accountants' reports in Statements on Standards for Accounting and Review Services use both singular and plural.

In practice, sole practitioners often use singular terms; firms that have one partner with professional staff use both singular and plural; and firms that have more than one partner most often use plural. However, the use of singular or plural references to the accountant or auditor is purely discretionary. For ease of report preparation, firms should be consistent in their use of singular or plural in all reports.

.26 Compilation and Review—Comparative Financial Statements

Inquiry—A nonissuer's financial statements for the year ended December 31, 20X1, were compiled by a predecessor accountant. Management had elected to omit substantially all of the disclosures and the statement of cash flows required by generally accepted accounting principles (GAAP).

A successor auditor is engaged to audit the 20X2 financial statements, and the client has asked the auditor to include the 20X1 compiled financial statements for comparative purposes with the 20X2 financial statements.

Is the successor auditor permitted to do this?

Reply—No. Paragraph .05 of AR section 200, *Reporting on Comparative Financial Statements* (AICPA, *Professional Standards*), states that compiled financial statements that omit substantially all of the disclosures required by

an applicable financial reporting framework are not comparable to financial statements that include such disclosures.

The 20X1 financial statements would need to be revised to include the statement of cash flows and all disclosures required by GAAP. Either the predecessor or the successor accountant would then need to at least compile the full disclosure financial statements for 20X1.

[Revised, December 2010, to reflect conforming changes necessary due to the issuance of SSARS No. 19.]

.27 Providing Opinion on a Schedule of Expenditures of Federal Awards in Relation to an Entity's Financial Statements as a Whole When the Schedule of Expenditures of Federal Awards Is on a Different Basis of Accounting Than the Financial Statements

Inquiry—An entity subject to Office of Management and Budget Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations* (Circular A-133), prepares its Schedule of Expenditures of Federal Awards (SEFA) on the cash basis of accounting while preparing its basic financial statements in accordance with GAAP. Paragraph .05a of AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*), requires the auditor to determine that the supplementary information was derived from, and relates directly to, the underlying accounting and other records used to prepare the financial statements. If the SEFA is prepared on a different basis of accounting than that of the financial statements, but the SEFA can be reconciled to the underlying accounting and other records used in preparing the financial statements or to the financial statements themselves, may the auditor provide an opinion on whether the SEFA is presented fairly, in all material respects, in relation to the entity's financial statements as a whole?

Reply—As discussed in chapter 7 of the AICPA Audit Guide Government Auditing Standards and *Circular A-133 Audits*, Circular A-133 requires the auditor to determine and provide an opinion on whether the SEFA is presented fairly in all material respects in relation to the financial statements as a whole (often referred to as providing an in-relation-to opinion). Further, Circular A-133 does not specifically prescribe the basis of accounting to be used by the entity to prepare the SEFA. Therefore, some SEFAs may be presented on a basis of accounting that differs from that used to prepare the financial statements. Nevertheless, the entity is required to disclose the basis of accounting and the significant accounting policies used in preparing the SEFA.

As noted in paragraph 7.03 of the guide, the auditee should be able to reconcile amounts presented in the financial statements to related amounts in the SEFA. Further, paragraph .07d of AU-C section 725 would require the auditor to compare and reconcile the SEFA to the underlying accounting and other records used in preparing the financial statements or to the financial statements themselves.

Therefore, as long as the cash basis SEFA can be reconciled back to the underlying accounting and other records used in preparing the financial statements or to the financial statements themselves, the conditions set forth in paragraph .05a of AU-C section 725 are considered met, and, as long as the other conditions and requirements of AU-C section 725 are met, the auditor may provide an in-relation-to opinion on the SEFA.

[Issue Date: June 2011; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.28 Combining a Going Concern Emphasis-of-Matter Paragraph With Another Emphasis-of-Matter Paragraph

Inquiry—In certain circumstances, generally accepted auditing standards (GAAS) requires the auditor to include an emphasis-of-matter paragraph in the auditor’s report.¹ For example, paragraph .15 of AU-C section 570, *The Auditor’s Consideration of An Entity’s Ability to Continue as a Going Concern* (AICPA, *Professional Standards*), states that if, after considering identified conditions or events and management’s plans, the auditor concludes that substantial doubt about the entity’s ability to continue as a going concern for a reasonable period of time remains, the auditor should include an emphasis-of-matter paragraph in the auditor’s report to reflect that conclusion.

In addition to certain paragraphs in GAAS that require the auditor to include an emphasis-of-matter paragraph in the auditor’s report, an emphasis-of-matter paragraph may also be included in the auditor’s report, at the auditor’s discretion, to draw users’ attention to a matter appropriately presented or disclosed in the financial statements that, in the auditor’s professional judgment, is of such importance that it is fundamental to users’ understanding of the financial statements, in accordance with paragraph .06 of AU-C section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor’s Report* (AICPA, *Professional Standards*).

May an auditor combine a going concern emphasis-of-matter paragraph with another emphasis-of-matter paragraph, such as an emphasis-of-matter paragraph highlighting the significance of related-party transactions?

Reply—AU-C section 706 does not preclude the auditor from combining matters in an emphasis-of-matter paragraph that are either required to be included in the auditor’s report or included at the auditor’s discretion, recognizing that the requirements in paragraph .07 of AU-C section 706 should be followed for each matter identified. Whether the auditor decides to combine more than one matter in the same paragraph is a matter of professional judgment. However, it may be prudent to emphasize each matter separately in separate paragraphs to make it clear that you have more than one matter of emphasis in your report.

Regardless whether the matters are combined or separated, the auditor should (a) include the emphasis-of-matter paragraph(s) immediately after the opinion paragraph, (b) use the heading “Emphasis of Matter” or other appropriate heading, (c) include in the paragraph(s) a clear reference to the matters being emphasized and to where relevant disclosures that fully describe the matters can be found in the financial statements, and (d) indicate that the auditor’s opinion is not modified with respect to the matters emphasized.

With regard to (b) preceding, another heading may be used if it adequately describes the nature of the matter being disclosed or communicated. When more than one matter is being emphasized, it may be appropriate to be more descriptive in the use of the headings.

[Issue Date: May 2012; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

¹ Exhibit B, “List of AU-C Sections Containing Requirements for Emphasis-of-Matter Paragraphs” of AU-C section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor’s Report* (AICPA, *Professional Standards*).

.29 Modification to the Auditor's Report When a Client Adopts a PCC Accounting Alternative

Inquiry—A private company audit client has adopted one or more of the PCC accounting alternatives in the current year and disclosed the change in accounting principle, which is material to the financial statements. Is the auditor required to add an emphasis-of-matter (EOM) paragraph to the auditor's report for this change in accounting principle?

Reply—Yes. According to paragraphs .07–.12 of AU-C section 708, *Consistency of Financial Statements* (AICPA, *Professional Standards*), if an entity has adopted a change in accounting principle and that change has a material effect on the financial statements, the auditor should include, in the auditor's report, an EOM paragraph in the period of the change and in subsequent periods until the new accounting principle is applied in all periods presented. If the change in accounting principle is accounted for by retrospective application to the financial statements of all prior periods presented, the EOM paragraph is needed only in the period of such change.

The auditor's EOM paragraph should describe the change in accounting principle and provide a reference to the entity's note disclosure. Following is an illustration of this paragraph when a private company has elected to adopt a change in accounting for goodwill in its December 31, 2014 financial statements (and that change is material and has been disclosed in the financial statements):

Change in Accounting Principle

As discussed in Note X to the financial statements, the Company has elected to change its method of accounting for goodwill in 2014. Our opinion is not modified with respect to this matter.

[Issue Date: March 2014.]

.30 Modification to the Auditor's Report When a Client Adopts a PCC Accounting Alternative That Results in a Change to a Previously Issued Report

Inquiry—A private company client has adopted the guidance in FASB Accounting Standards Update (ASU) No. 2014-07, *Consolidation (Topic 810): Applying Variable Interest Entities (VIE) Guidance to Common Control Leasing Arrangements*, in the current year. In the prior year, the private company elected not to consolidate a material variable interest entity (VIE) and, therefore, the auditor's report was modified in order to note a material departure from GAAP. The private company is now presenting comparative financial statements, and this accounting change (which is required to be applied retrospectively) no longer requires the material VIE to be consolidated. Accordingly, the prior year auditor's report on those statements would no longer need to be modified. Is the auditor required to add an EOM paragraph to the current year's report?

Reply—Yes. According to paragraph .53 of AU-C section 700 when reporting on prior period financial statements in connection with an audit of the current period, the auditor should disclose the following matters in an EOM paragraph in accordance with AU-C section 706 if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed:

1. The date of the auditor's previous report
2. The type of opinion previously expressed

3. The substantive reasons for the different opinion
4. That the auditor's opinion on the amended financial statements is different from the auditor's previous opinion

Following is an illustration of an EOM paragraph when a private company has elected to adopt ASU No. 2014-07 for a VIE when there is a common control leasing arrangement and that VIE was material in 2013 and 2012:

Emphasis of Matter—Variable Interest Entity

In our report dated March 1, 2013, we expressed an opinion that the 2012 financial statements did not fairly present the financial position, results of operations, and cash flows of ABC Company in accordance with accounting principles generally accepted in the United States of America because ABC Company excluded a variable interest entity from the accompanying financial statement that, in our opinion, should have been consolidated. As described in Note X, in March 2014 the Financial Accounting Standards Board issued Accounting Standards Update No. 2014-07, *Consolidation (Topic 810): Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements*, which makes changes to the FASB guidance and no longer requires nonpublic companies to apply variable interest entity guidance to certain common control leasing arrangements. This guidance required retrospective application. Accordingly, our present opinion on the 2012 financial statements, as presented herein, is different from that expressed in our previous report.

[Issue Date: April 2014.]

[The next page is 9281.]

Section 9170

Supplementary Information

.01 Consolidating Information Presented on the Face of the Financial Statements

Inquiry—An entity wants to present consolidating information in order to present the separate financial statements of the components of the consolidated group. Does the auditor's reporting responsibility change depending on whether the consolidating information is presented on the face of the financial statements in separate columns or whether the consolidating information is shown outside the basic consolidated financial statements?

Reply—An entity may present consolidating information either on the face of the statements or outside the basic financial statements.

When the auditor is engaged to express an opinion only on the consolidated financial statements, and consolidating information is included on the face of the financial statements, such consolidating information would be considered supplementary information, the same as if the information was presented outside the basic financial statements, as long as such information is clearly differentiated from the financial statements because of its nature and how it is presented. 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 outside the basic financial statements, the consolidating information might be titled "Consolidating Balance Sheets, December 31, 20X1." If the other information is clearly differentiated from the basic financial statements, such information may be identified as *unaudited* or as *not covered by the auditor's report*.

When the consolidated financial statements include consolidating information that has not been separately audited, and the auditor is engaged to report on the consolidating information in relation to the basic consolidated financial statements as a whole, the auditor's report on the consolidating information might read as follows:

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The consolidating information is presented for purposes of additional analysis rather than to present the financial position, results of operations, and cash flows of the individual companies and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from, and relates directly to, the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures, in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

When the auditor is engaged to express an opinion on both the consolidated financial statements and the separate financial statements of the components presented in consolidating financial statements, the auditor's reporting responsibilities with respect to the separate financial statements are the same as his or her responsibilities with respect to the consolidated financial statements. In such cases, the consolidating financial statements and accompanying notes should include all the disclosures that would be necessary for presentation in accordance with generally accepted accounting principles of separate financial statements of each component.

[Issue Date: September 2011; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.02 Supplementary Information That Accompanies Interim Financial Information

Inquiry—When performing an interim review in accordance with AU-C section 930, *Interim Financial Information* (AICPA, *Professional Standards*), is the auditor required to report on supplementary information when a client presents supplementary information along with interim financial statements?

Reply—No; however, nothing precludes the auditor from reporting on the supplementary information. If the auditor decides to report on the supplementary information, the auditor may disclaim on the supplementary information or issue a report based on the limited procedures performed as part of the interim review. An example of a report based on the limited procedures applied in the review follows:

Our review was made primarily for the purpose of obtaining a basis for reporting whether we are aware of any material modifications that should be made to the interim financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America through performing limited procedures. The accompanying supplementary information is presented for purposes of additional analysis and is not a required part of the interim financial statements. The supplementary information has been subjected to the limited procedures applied in the review of the interim financial statements, and we did not become aware of any material modifications that should be made to such information.

[Issue Date: October 2012; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

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TIS Section 9500

ATTESTATION ENGAGEMENTS

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-

[The next page is 9521.]

Section 9510

Attestation Reports

.01 Testing Prospective Financial Information as Part of Performing Auditing Procedures

Inquiry—Generally accepted accounting principles require that certain accounts be carried at or adjusted to fair value. Many fair value models are based on the present value of future cash flows or earnings. In making those fair value calculations, management may seek the auditor’s assistance in developing what may be considered either a full or partial financial forecast. In testing an entity’s fair value calculation, an auditor might test management’s assumptions including, for example future cash flows for the next five years. Similarly, the auditor may make an independent estimate of fair value, for example, by using a cash flow model developed and prepared by the auditor.

Does the auditor’s assistance in developing or preparing prospective cash flows require the auditor to examine or compile such information in accordance with Statements on Standards for Attest Engagements (SSAEs)?

Reply—No. Paragraph .01 of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*), states that the attest standards apply when a practitioner is “engaged to issue or does issue an examination...” Accordingly, the auditor would not be required to follow the SSAEs unless the auditor has also been engaged to examine, compile, assemble or apply agreed upon procedures to prospective financial information or the auditor issues an examination, compilation, assembly or agreed upon report on prospective financial information.

.02 Availability of Criteria for a Fee

Inquiry—A practitioner may perform an attestation engagement only if he or she has reason to believe that the subject matter is capable of evaluation against criteria that are suitable and available to users. Paragraph .33 of AT section 101 states in part that criteria should be available to users in one or more of a number of ways, including available publicly. Paragraph .34 of AT section 101 goes on to say “If criteria are only available to specified parties, the practitioner’s report should be restricted to those parties who have access to the criteria as described in paragraphs .78 and .80 [of AT section 101].” If criteria is only available for a fee, is it considered available publicly for the purpose of paragraphs .33–.34 of AT section 101?

Reply—Yes, as long as the criteria is available to any person in the normal course of business, it is considered available publicly. This would include certain industry associations and other organizations that make criteria available free of charge to their members but charge a fee to nonmembers.

.03 Reporting on New York State Medicaid Cost Reports*

On June 27, 2006, the New York State Department of Health (“DOH”) issued a prescribed “Opinion of Independent Accountant” (the “Cost Report Opinion”) that is required to be utilized by CPAs reporting on audits and attestation engagements associated with a nursing home’s filing of its Annual Report of Residential Health Care Facility (RHCF-4). The purpose of this

* This Technical Question and Answer (TIS) has not been updated to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 122–126. This TIS will be updated in a subsequent update of AICPA *Technical Practice Aids*.

Technical Practice Aid (“TPA”) is to provide clarity to CPAs performing these engagements. This TPA also may be useful to a CPA performing audits and attestation engagements for the purpose of reporting on an Annual Institutional Cost Report of Hospitals and Hospital Healthcare Complexes and other cost reports filed with the New York State Department of Health or other New York State agencies.

The Cost Report Opinion as prescribed by the DOH references certain data in the facility’s RHCF-4 cost report (the “supplemental data”). The Cost Report Opinion includes three separate opinions:

1. An opinion on the facility’s financial statements (displayed as schedules within the cost report) based on an audit conducted in accordance with generally accepted auditing standards.
2. An opinion as to whether the supplemental data is stated fairly in all material respects in relation to the financial statements as a whole.
3. An opinion under the attestation standards (the “attestation opinion”) on the supplemental data’s conformity with the DOH cost report instructions.

The required format of the Cost Report Opinion, as prescribed by the DOH, is attached as Exhibit A. The AICPA staff understands that all DOH Cost Reports, including the Annual Institutional Cost Report of Hospitals and Hospital Healthcare Complexes, within New York State will include similar language.

The Cost Report Opinion contains certain terminology that differs from the language found in AICPA professional standards and therefore may be unclear to practitioners. AICPA staff held conversations with the DOH for the purpose of better understanding their views about these wording differences and their expectations about the procedures a CPA would perform to issue the Cost Report Opinion. The following responses are those of AICPA staff based on their understanding of the requirements and expectations of the DOH.

Four issues are addressed in this Technical Practice Aid:

1. The CPA’s consideration of materiality in completing the attestation engagement.
2. The meaning of the term “certification” in the Cost Report Opinion, and its impact on the CPA’s procedures.
3. The Independence Standards that the CPA is expected to adhere to in the performance of the engagement.
4. Dating the CPA’s report.

Inquiry—The attestation opinion contained in the Cost Report Opinion reads as follows:

In our opinion, the above supplemental data are in all material respects in conformity with the applicable instructions relating to the preparation of the RHCF-4 as furnished by the New York State Department of Health for the year ended Month XX, 20XX.

With respect to the attestation opinion’s phrase, “in all material respects,” may a CPA utilize materiality applied at the financial statement level to plan the scope of the attestation procedures, or in the evaluation of misstatements, if any, that are identified through the attestation procedures?

Reply—No. The AICPA staff understands that the DOH believes that the use of materiality applied at the financial statement level would not be appropriate for planning or performing attestation procedures related to cost report instructions, or for evaluating any misstatements identified related to conformity with cost report instructions. Rather, the AICPA staff's understanding is that materiality should be determined and applied at the individual schedule level. Accordingly, the DOH expects the CPA to perform procedures on line items, columns, and totals in the specific schedules covered by the CPA's attestation opinion to be able to opine that the financial and statistical data presented on each schedule has been prepared in conformity, in all material respects as determined at the individual schedule level, with the applicable instructions. As a result, the CPA ordinarily will perform procedures beyond those performed in the audit of the financial statements with respect to certain amounts included in the supplemental data. These additional procedures result from the application of a lower materiality level for procedures performed on information included in the individual schedules as compared to the materiality level applied in the financial statement audit.

The CPA may consider attestation risk and materiality in applying his or her professional judgment in determining the nature, timing and extent of attestation procedures for testing the financial and statistical data. The CPA's risk assessment should give consideration to the effects of whether amounts in a particular schedule are either understated or overstated. The quantity of attestation evidence needed is affected by the risk of misstatement (items presenting greater risk likely will require evaluation of attestation evidence beyond that deemed necessary for purposes of the financial statement audit) and by the quality of such attestation evidence. In determining the nature, timing and extent of attest procedures to perform, the CPA may give consideration to:

1. His or her assessment of the facility's policies and procedures related to the preparation of the cost report in accordance with the applicable instructions and,
2. Deficiencies related to internal control over the preparation of the cost report (which may differ from internal control over financial reporting evaluated for purposes of the financial statement audit).

In addition to the above considerations, the CPA may focus his or her testing on those amounts, line items, or schedules that impact the facility's reimbursement or rate setting most significantly.

The purpose of testing the supplemental data is to obtain sufficient appropriate attestation evidence to provide a reasonable basis for the CPA's opinion on whether the financial and statistical data in the schedules is in conformity, in all material respects as determined at the individual schedule level, with the applicable instructions. The CPA will have performed audit procedures directed toward evaluating certain amounts included in the supplemental data in connection with the audit of the facility's financial statements. The CPA may consider the results of those procedures in determining the nature, timing and extent of additional work necessary because of a lower materiality level for individual schedules compared to the materiality level for the financial statements.

The CPA ordinarily would select individual amounts from the supplemental data to examine based on the risk of misstatement or departure from the cost report instructions or by applying sampling. A combination of both selection techniques as described below may be necessary to provide the CPA with sufficient appropriate attestation evidence relative to the supplemental data.

The CPA may select amounts to test based on the risk of material misstatement associated with the reimbursement or rate-setting impact of a particular amount, line item, or schedule. For example, the costs associated with non-moveable equipment may have a greater impact on rate setting when compared with major moveable equipment. Accordingly, the CPA may determine that it is necessary to obtain more attestation evidence related to costs for non-moveable equipment. Factors influencing the CPA's assessment of risk might include the facility's history of misstatements in the cost report, the complexity associated with the preparation of a schedule and the effectiveness of management's internal control over the preparation of the applicable cost report schedules.

The CPA may select amounts to test utilizing sampling. The CPA uses his or her professional judgment to determine when it may be appropriate to use sampling and the sample size.

The CPA's procedures ordinarily will include agreeing individual supplemental data amounts, as appropriate, to related audit documentation or the audited financial statements, or to the general ledger, sub-ledgers, or client analyses prepared in support of the cost report schedules. In addition, the CPA's procedures ordinarily will include substantive procedures applied to selected supplemental data amounts, which are designed to identify material misstatements at the individual schedule level. Substantive procedures include tests of details and substantive analytical procedures. For example, the CPA might select supplemental data amounts and compare them to vendor's invoices or analytically compare the relationship of amounts and current year expectations.

As a result of procedures performed, the CPA may identify departures from the cost report instructions. In that case, the CPA would need to re-consider his or her initial risk assessment and determine whether additional procedures need to be performed. If departures from the cost report instructions are not corrected by facility management, the CPA would consider whether such departures result in the CPA opining that there is a material departure from the cost report instructions.

Inquiry—The Cost Report Opinion includes the following paragraph:

The undersigned hereby certifies this opinion and that I/we have disclosed any and all material facts known to me/us, disclosure of which is necessary to make this opinion, the basic financial statements and the supplemental data not misleading. The undersigned hereby further certifies that I/we will disclose any material fact discovered by me/us subsequent to this certification which existed at the time of this certification and was not disclosed in the basic financial statements or the supplemental data, the disclosure of which is necessary to make the basic financial statements or the supplemental data not misleading and will disclose any material misstatement in said financial statements or supplemental data.

Given that the terms "certifies" and "certification" are not defined in AICPA professional standards, should the CPA perform additional procedures beyond those contemplated by Statements on Auditing Standards (SASs) and Statements on Standards for Attestation Engagements (SSAEs) in order to provide a "certification"? Additionally, since the financial statements and supplemental schedules are the responsibility of management, what is the CPA's responsibility with respect to information discovered subsequent to the certification's report date?

Reply—New York State Public Health Law Section 2808-b states in part "All financial statements or financial information...shall be certified in their entirety by an independent public accountant..." Although the phrase "certifies

this opinion” does not appear in AICPA professional standards, there is nothing in the concept of a certification that would be in conflict with or contrary to those standards. The CPA may consider the phrase “certifies this opinion” to be the equivalent of rendering or expressing an opinion. However, it is the responsibility of the CPA to determine, and take any and all steps that are necessary and proper, in order to be able to appropriately sign the Cost Report Opinion.

Public Health Law 2808-b further states that “Subsequent to such certification (the CPA should disclose) any material fact discovered by him which existed at the time of such certification ...which is necessary to make the financial statements or financial information not misleading” If the CPA becomes aware of information, which relates to the audited financial statements or supplemental schedules previously reported on by him or her, but which was not known to the CPA at the date of the Cost Report Opinion, and such subsequently discovered information is deemed to be necessary to make the basic financial statements not misleading, the CPA should ensure that such subsequently discovered information is communicated to the DOH. AU section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor’s Report*, provides that the CPA should request the client to communicate such information to the DOH. However, the CPA retains the responsibility to ensure that such information is communicated to the DOH—whether by the client or the CPA. In fulfilling this responsibility, if the client refuses to make such communication the CPA should notify the DOH of the information and that the Cost Report Opinion should no longer be relied upon.

Inquiry—The Cost Report Opinion is titled “Opinion of Independent Accountant” and includes the following paragraph:

During the period of this professional engagement, at the time of expressing this opinion, and during the period covered by the financial statements I/we did not have nor were committed to acquire, any direct financial interest or material indirect financial interest in the ownership or operation of the facility and I/we were not connected in any way with the ownership, financing or operation of the facility as a director, officer or employee, or in any capacity other than as an independent certified public accountant or independent public accountant.

What independence requirements are expected to be followed in conducting the engagements contemplated by the Cost Report Opinion?

Reply—The CPA should follow Independence Standards as issued by the AICPA and that are codified in the AICPA *Code of Professional Conduct* as well as any independence standards issued by the N.Y. Board of Accountancy.

Inquiry—The engagements underlying the Cost Report Opinion may have different dates for completion of field work. For example, the audits of the financial statements and the supplemental data in relation to the basic financial statements taken as a whole may have been completed (and the CPA’s opinions thereon rendered) before the CPA completes the work related to the attestation opinion. In those situations, may the Cost Report Opinion be dual-dated?

Reply—Yes. Although dual-dating is not required, the Cost Report Opinion may be dual dated for the attestation opinion as follows:

[Date], except for our examination of the conformity of specified data with the instructions for the year ended December 31, 20XX, as to which the date is [Date].

Exhibit

FORM RHCF-4 DOH 490 (06/07/06)

PLEASE COMPLETE ALL OF THE FOLLOWING INFORMATION

NAME OF FACILITY_____
OPERATING CERTIFICATE NUMBER_____
NAME OF ADMINISTRATOR_____
NAME OF CONTROLLER OR CHIEF FISCAL OFFICEROpinion of Independent Accountant

We have audited the balance sheet of _____ as of December 31, 2004 and the related statements of operations, changes in net assets or equity and cash flows for the year then ended included as Exhibits A through E (the basic financial statements), except for lines 041, 042 and 043 of Exhibit E of Part IV of the accompanying Annual Report of Residential Health Care Facility (RHCF-4) identified by Declaration Control Number _____. These financial statements are the responsibility of the facility 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 aforementioned financial statements present fairly, in all material respects, the financial position of _____ as of December 31, 2004 and the results of its operations, changes in net assets or equity and its 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 whole. The following supplemental data, which are the responsibility of the facility management, are presented for the purpose of additional analysis and are not required as part of the basic financial statements identified by Declaration Control Number _____.

PART I—STATISTICAL DATA

Bed Capacity—Patient Days, Line 017

PART II—CROSSWALK

Schedule 7, Column 0161

Schedules 8 through 11, except for Schedule 8C, Lines 010 through 035

PART IV—UNIFORM REPORT

Exhibit H, except Columns 0034–0044, Lines 054–057, 060–069 and 090
Exhibit I
Schedule 4, except Columns 0114–0122, Lines 054–057, 060–069 and 090
Schedule 6

The above supplemental data have been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, are stated fairly in all material respects when considered in conjunction with the basic financial statements included as Exhibits A through E of the RHCF-4, taken as a whole.

Our procedures were not intended to determine compliance with, and therefore would not necessarily disclose deviations from, reporting requirements contained in the New York State Residential Health Care Facility Accounting and Reporting Manual.

The other information included on Parts I, II, III and IV of the Annual Report of Residential Health Care Facility (RHCF-4) identified by Declaration Control Number _____, (not detailed in the preceding paragraphs), was not audited by us and, accordingly, we express no opinion thereon.

We have examined the above supplemental data for the year ended December 31, 2004. [Facility name] _____ management is responsible for the preparation of the supplemental data in conformity with the applicable instructions relating to the preparation of the RHCF-4 as furnished by the New York State Department of Health for the year ended December 31, 2004. Our responsibility is to express an opinion on the supplemental data's conformity with those instructions based upon our examination.

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 supplemental data's conformity with the applicable instructions 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 above supplemental data are in all material respects in conformity with the applicable instructions relating to the preparation of the RHCF-4 as furnished by the New York State Department of Health for the year ended December 31, 2004.

This RHCF-4 report, including this accountant's opinion, is intended solely for the information and use of the management and ownership of the facility and the officers and agencies of the State of New York, and is not intended to be and should not be used by anyone other than these specified parties.

The undersigned hereby certifies this opinion and that I/we have disclosed any and all material facts known to me/us, disclosure of which is necessary to make this opinion, the basic financial statements and the supplemental data not misleading. The undersigned hereby further certifies that I/we will disclose any material fact discovered by me/us subsequent to this certification which existed at the time of this certification and was not disclosed in the basic financial statements or the supplemental data, the disclosure of which is necessary to make the basic financial statements or the supplemental data not misleading and will disclose any material misstatement in said financial statements or supplemental data.

During the period of this professional engagement, at the time of expressing this opinion, and during the period covered by the financial statements I/we did not have nor were committed to acquire, any direct financial interest or

material indirect financial interest in the ownership or operation of the facility and I/we were not connected in any way with the ownership, financing or operation of the facility as a director, officer or employee, or in any capacity other than as an independent certified public accountant or independent public accountant.

Signature of Accounting Firm

Name of Accounting Firm

By: _____
Signature of CPA Partner-in-Charge

Name of CPA

CPA License Number

Date of CPA Signature

Address

City/State/ZIP

Telephone

DOH 490

[Revised, December 2010, to reflect conforming changes necessary due to the issuance of SAS Nos. 118–120.]

[The next page is 9541.]

Section 9520

Statement on Standards for Attestation Engagements No. 16, Reporting on Controls at a Service Organization

[.01] Reserved

[.02] Reserved

[.03] Reserved

.04 Definition of *Service Organization and User Entity*

Inquiry—Statement on Standards for Attestation Engagements (SSAE) No. 16,¹ *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801),¹ uses the terms *service organization* and *user entity*. What do these terms mean?

Reply—AT section 801 defines a *service organization* as an organization or segment of an organization that provides services to user entities, which are likely to be relevant to user entities' internal control over financial reporting (ICFR). A service organization performs a function or task for the user entities that results in data or other information that the user entities incorporate in their financial statements. Some examples of service organizations are custodians for investment companies, mortgage servicers that service loans for others, and claims processors that process medical claims for self-insured entities. AT section 801 defines a *user entity* as an entity that uses a service organization.

[Issue Date: June 2011; Revised, November 2011.]

[.05] Reserved

[.06] Reserved

.07 Types of Reports Under AT Section 801

Inquiry—Are there type 1 and type 2 reports under AT section 801?

Reply—Yes, AT section 801 enables practitioners to provide two types of service auditor's reports. In both reports the service organization must prepare a description of its system that includes, among other things, the nature of the service provided, how the service is performed, and the service organization's controls and related control objectives as they relate to the service provided. In a type 1 report, the service auditor expresses an opinion on whether the description is fairly presented (that is, does it describe what actually exists) and whether the controls included in the description are suitability designed.

¹ For service auditors' reports for periods ending on or after June 15, 2011, Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801), supersedes the guidance for service auditors that previously was contained in Statement on Auditing Standards (SAS) No. 70, *Service Organizations*, as amended (now superseded). For audits of financial statements for periods ending on or after December 15, 2012, AU-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization* (AICPA, *Professional Standards*), supersedes the guidance for user auditors that previously was contained in SAS No. 70, as amended (now superseded). [Footnote added, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

Controls that are suitably designed are able to achieve the related control objectives if they operate effectively. In a type 2 report, the service auditor's report contains the same opinions that are included in a type 1 report and also includes an opinion on whether the controls were operating effectively. Controls that operate effectively do achieve the control objectives they were intended to achieve. Both reports are examination reports, which means the practitioner obtains a high level of assurance.

[Issue Date: June 2011; Revised, November 2011.]

.08 Changes Introduced by AT Section 801

Inquiry—Does the implementation of AT section 801 result in significant changes to a service auditor's engagement?

Reply—The following are the three major changes introduced by AT section 801:

1. Management of the service organization is required to provide the service auditor with a written assertion about the fairness of the presentation of management's description of the service organization's system, the suitability of the design of the controls included in the description and, in a type 2 engagement, the operating effectiveness of those controls. That assertion is either attached to or included in the service organization's description of its system.
2. In a type 2 engagement, the description of the service organization's system and the service auditor's opinion on the description covers a period (the same period as the period covered by the service auditor's tests of the operating effectiveness of controls). In Statement on Auditing Standards (SAS) No. 70, *Service Organizations*, as amended (now superseded), the description of the service organization's system in a type 2 report was as of a specified date, rather than for a period.
3. The service auditor is required to identify, in the description of tests of controls, any tests of controls performed by the internal audit function (other than those performed in a direct assistance capacity) and the service auditor's procedures with respect to that work. Tests of controls are procedures designed to evaluate the operating effectiveness of controls in achieving the control objectives stated in management's description of the service organization's system.

The following are other differences introduced by AT section 801:

- Suitable criteria are used by management to measure and present the subject matter and by the service auditor to evaluate the subject matter. Paragraphs .14–.16 of AT section 801 provide suitable criteria for the fairness of the presentation of a service organization's description of its system and the suitability of the design and operating effectiveness of its controls. Criteria are the standards or benchmarks used to measure and present the subject matter and against which the service auditor evaluates the subject matter.
- The service auditor's examination report contains the report elements identified in paragraph .85 of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*). Paragraphs .52–.53 of AT section 801 tailor these report elements to a service auditor's engagement.
- The service auditor may not use evidence obtained in prior engagements about the satisfactory operation of controls in prior periods to provide a basis for a reduction in testing in the current period, even if it is supplemented with evidence obtained during the current period.

- AT section 801 specifically states that it is not applicable when the service auditor is reporting on controls at a service organization relevant to subject matter other than user entities' ICFR (such as controls related to regulatory compliance or privacy).

[Issue Date: June 2011; Revised, November 2011; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.09 Implementation Guidance for Reporting on Controls at a Service Organization Under AT Section 801

Inquiry—Has the AICPA Guide *Service Organizations: Applying SAS No. 70, as Amended* (commonly known as the SAS 70 guide)² been rewritten to reflect AT section 801?

Reply—Yes. AICPA Guide *Service Organizations: Applying SAS No. 70, as Amended* was rewritten to reflect the requirements and guidance in AT section 801 and is available as AICPA Guide *Service Organizations, Applying SSAE No. 16, Reporting on Controls at a Service Organization (SOC 1)* (SOC 1³ guide).

[Issue Date: June 2011; Revised, November 2011.]

.10 Illustrative Assertion for Management of Service Organization in an SSAE No. 16 Engagement

Inquiry—Where can I find an illustrative management assertion for an SSAE No. 16 engagement?

Reply—Exhibit A, “Illustrative Assertions by Management of a Service Organization,” of AT section 801 contains illustrative management assertions for type 1 and type 2 engagements. In addition, appendix B, “Illustrative Service Auditor’s Reports,” of the SOC 1 guide contains illustrative type 2 reports that include management assertions.

[Issue Date: June 2011; Revised, November 2011.]

.11 Illustrative Assertion for Management of Subservice Organization in an SSAE No. 16 Engagement

Inquiry—AT section 801 requires management of a subservice organization to provide a written assertion when the inclusive method is used. AT section 801 contains illustrative management assertions for management of a service organization. Is an illustrative assertion for management of a subservice organization available?

Reply—Yes. Example 2 of appendix B of the SOC 1 guide contains an illustrative assertion for an inclusive engagement.

[Issue Date: June 2011; Revised, November 2011.]

² Prior to the issuance of SSAE No. 16, the guidance for service auditors reporting on controls at a service organization and for user auditors auditing the financial statements of a user entity was contained in SAS No. 70, as amended (now superseded). For that reason, reports on controls at a service organization were frequently referred to as “SAS 70 reports,” and the related AICPA Guide *Service Organizations, Applying SAS No. 70, as Amended* was referred to as the “SAS 70 guide.” [Footnote renumbered and revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

³ The AICPA has introduced the service organization controls (SOC) series of reports, which are further explained in section 9530.02, “Service Organization Controls Reports.” Engagements performed under AT section 801 are designated as SOC 1 engagements. AICPA Guide *Service Organizations, Applying SSAE No. 16, Reporting on Controls at a Service Organization (SOC 1)* is referred to as the SOC 1 guide. [Footnote renumbered, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.12 Another CPA Firm Acts as the Accounting Department for Your Client—Auditor Responsibility

Inquiry—An auditor is in the process of planning an audit for a client and determines that significant accounting and financial reporting processes and controls are performed by an outside CPA firm. What is the auditor's responsibility with respect to the functions performed by the other CPA firm?

Reply—Paragraph .01 of AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), addresses the auditor's responsibility to identify and assess the risks of material misstatements in the financial statements through understanding the entity and its environment, including the entity's internal control. Paragraph .13 of AU-C section 315 states that the auditor should obtain an understanding of internal control relevant to the audit. Therefore, the auditor's responsibility is the same regardless of whether the client designs and operates its own accounting processes and controls or whether those processes and controls are outsourced to a third party.

Assuming that the other CPA firm has not undergone a type 1 or type 2 service auditor's examination and, therefore, cannot provide user entities with such a report, the auditor may obtain the necessary understanding by visiting the other CPA firm's office where the information is processed to understand how the processes and controls have been designed and whether those controls have been implemented.

If the auditor intends to rely on any of the controls performed by the other CPA firm, then those controls would need to be tested to determine if they are operating effectively, just as they would if the controls had been implemented by the client.

[Issue Date: November 2011; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.13 Placement of Management's Assertion in an SSAE No. 16 Engagement

Inquiry—Does AT section 801 require that management's assertion accompany the service organization's description of its system?

Reply—Yes. Paragraph .09c(vii) of AT section 801 states that one of the conditions for engagement acceptance or continuance is that management provide a written assertion that will be included in or attached to management's description of the service organization's system.

[Issue Date: November 2011.]

.14 Type 2 Reports That Cover Less Than a Six-Month Period

Inquiry—Does AT section 801 require that a type 2 report cover a minimum period?

Reply—AT section 801 discourages the service auditor from performing a type 2 engagement that covers a period of less than six months. Paragraph .A42 of AT section 801 indicates that a type 2 report that covers a period that is less than six months is unlikely to be useful to user entities and their auditors. However, there are certain limited circumstances, such as the following, in which a type 2 report covering less than six months may be considered:

- The service auditor was engaged close to the date by which the report on controls is to be issued, precluding the service auditor from testing the operating effectiveness of controls for a six month period.
- The service organization or a particular system or application has been in operation for less than six months.

- Significant changes have been made to the controls, and it is not practicable either to wait six months before issuing a report or to issue a report covering the system both before and after the changes.

[Issue Date: November 2011; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.15 Information About Relevant IT Control Objectives and Related Controls in Description of Service Organization’s System

Inquiry—Does AT section 801 require that management’s description of the service organization’s system include a description of the service organization’s IT control objectives and related controls? If so, does the SOC 1 guide address which IT control objectives and controls would usually be relevant to a user entity’s ICFR?

Reply—The definition of *service organization’s system* in paragraph .07 of AT section 801 indicates that the description of the service organization’s system includes the policies and procedures designed, implemented, and documented by management of the service organization to provide user entities with the services covered by the service auditor’s report. Paragraph .A11 of AT section 801 further clarifies that sentence: “The policies and procedures referred to in the definition of service organization’s system refer to the guidelines and activities for providing transaction processing and other services to user entities and include the infrastructure, software, people, and data that support the policies and procedures.” Paragraph 3.65 of the SOC 1 guide indicates that if the control objectives in a service organization’s description of its system only address application controls, and the proper functioning of general computer controls is necessary for the application controls to operate effectively, the service organization would be expected to include the relevant general computer controls in its description of the system as they relate to the specified control objectives. Appendix D, “Illustrative Control Objectives for Various Types of Service Organizations,” of the SOC 1 guide includes illustrative control objectives related to general computer controls.

[Issue Date: November 2011.]

.16 Identification of Risks in the Description of the Service Organization’s System

Inquiry—Does the service organization’s description of its system need to identify the risks that could prevent the service organization’s controls relevant to user entities’ ICFR from achieving the related control objectives?

Reply—AT section 801 does not require that management identify, in its description of the service organization’s system, the risks related to each control objective included in the description. However, the service auditor would probably expect management to be able to discuss its consideration of risks in designing the controls to achieve the related control objectives.

[Issue Date: November 2011.]

.17 Information About the Risk Assessment Process to Be Included in the Description

Inquiry—Paragraph .14 of AT section 801 indicates that management’s description of a service organization’s system should include aspects of the service organization’s risk assessment process. What information should be included in describing the risk assessment process?

Reply—The content of the description of the risk assessment process will vary depending on the complexity of the service organization’s process. Paragraph .A18 of AT section 801 indicates that management may have a formal or informal process for identifying relevant risks. A formal process may include estimating the significance of identified risks, assessing the likelihood of their occurrence, and deciding about actions to address them. In those circumstances, nothing precludes management from including the details of its process in the description. However, because control objectives relate to the risks that controls seek to mitigate, paragraph .A18 of AT section 801 indicates that thoughtful identification by management of the control objectives when designing, implementing, and documenting the service organization’s system may itself comprise an informal process for identifying relevant risks.

[Issue Date: November 2011.]

.18 Purpose of SSAE No. 16 Reports

Inquiry—Will entities now become “SSAE 16 certified”?

Reply—No. A popular misconception about SAS No. 70, as amended (now superseded), was that a service organization became “certified” as SAS No. 70 compliant after undergoing a type 1 or type 2 service auditor’s engagement. No such certification existed under SAS No. 70, as amended (now superseded), nor does it exist under AT section 801. An SSAE No. 16 report (as was the case for a SAS No. 70 report) is primarily an auditor-to-auditor communication, the purpose of which is to provide user auditors with information about controls at a service organization that are relevant to the user entities’ ICFR.

[Issue Date: November 2011; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.19 Providing a Service Organization With a Bridge Letter

Inquiry—May a service auditor provide a service organization with a *bridge letter* under AT section 801 (a letter from a service auditor stating that nothing has changed since the last type 1 or type 2 report)?

Reply—No. AT section 801 does not address such letters or reports. A service organization may choose to issue a letter that describes updates or changes in its controls since the previous type 1 or type 2 report. However, there are no provisions in AT section 801 for service auditors to report on such a letter. Service auditors and user auditors are cautioned against providing assurance on or inferring assurance from such letters, respectively.

[Issue Date: November 2011; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.20 Format of Type 1 and Type 2 SSAE No. 16 Reports

Inquiry—Other than the addition of management’s assertion and changes to the auditor’s report, is the format of the SSAE No. 16 report package the same as it was under SAS No. 70, as amended (now superseded)?

Reply—Except for the addition of management’s assertion, AT section 801 has the same report package as it did under SAS No. 70, as amended (now superseded). That package consists of the following components:

- Section 1: The service auditor’s report, that is, the letter from the service auditor
- Section 2: Management of the service organization’s written assertion
- Section 3: Management’s description of the service organization’s system

- Section 4: The service auditor's description of tests of the operating effectiveness of controls and results of those tests (type 2 reports only)
- Section 5: Optional other information provided by management of the service organization

[Issue Date: November 2011; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.21 Understanding Internal Control in Audit of a Service Organization's Financial Statements When Also Reporting on Service Organization's Controls Under AT Section 801

Inquiry—If an auditor performs an SSAE No. 16 engagement for a service organization and also audits that service organization's financial statements, when auditing the service organization's financial statements, does the auditor still need to obtain a sufficient understanding of the service organization and its environment, including its internal control, sufficient to assess the risk of material misstatement and design audit procedures?

Reply—Yes. In an SSAE No. 16 engagement, the service auditor focuses on controls at the service organization that are relevant to the *user entities'* ICFR, rather than controls at the service organization that are relevant to the *service organization's* ICFR. Some of the controls included in the service organization's description of its system may be relevant to the service organization's ICFR, but because controls evaluated and tested for the purposes of an SSAE No. 16 engagement are not necessarily controls that affect the service organization's financial reporting, the auditor of the service organization's financial statements would still need to obtain an understanding of the service organization's internal control for the purpose of the audit.

[Issue Date: November 2011.]

.22 Determining Control Objectives and Controls in an SSAE No. 16 Engagement

Inquiry—Does AT section 801 define or suggest specific control objectives for service organizations that provide services that are likely to be relevant to user entities' ICFR or does the service organization define its own control objectives and controls?

Reply—AT section 801 does not define or suggest specific control objectives for service organizations that provide services that are likely to be relevant to user entities' ICFR. In an SSAE No. 16 engagement, the service auditor evaluates whether the service organization's controls were suitably designed or operating effectively by determining whether the control objectives specified by management of the service organization were achieved. AT section 801 requires that the control objectives be reasonable in the circumstances. Although most service organizations that provide similar services will have similar control objectives, in order for control objectives to be reasonable in the circumstances, they should reflect features of the particular service organization, such as the nature of the services provided, the industry in which the user entity operates, and the needs of the user entities. Accordingly, in SSAE No. 16 engagements, not all service organizations will have the same control objectives. However, certain control objectives are typical for certain types of service organizations. To assist service auditors, appendix D of the SOC 1 guide contains illustrative control objectives for various types of service organizations, including application service providers, claims processors, credit card payment processors, investment managers, payroll processors, and transfer agents. The appendix also includes illustrative general control objectives that may be applicable to any service organization.

[Issue Date: November 2011; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.23 Reporting Under International Standard on Assurance Engagements 3402, Assurance Reports on Controls at a Service Organization

Inquiry—AT section 801 is based on International Standard on Assurance Engagements (ISAE) 3402, *Assurance Reports on Controls at a Service Organization*, issued by the International Auditing and Assurance Standards Board (IAASB). May a U.S. CPA perform and report on a service auditor's engagement under ISAE 3402?

Reply—Unless they also meet the international requirements, a U.S. CPA could not issue a stand-alone ISAE 3402 report. However, a U.S. CPA could issue a report indicating the examination was performed in accordance with AICPA and IAASB standards, assuming that the requirements of both standards have been met.

[Issue Date: November 2011.]

.24 Engagements Performed Under AICPA and IAASB Standards

Inquiry—Under what circumstances would a service organization request that the service auditor report under both AICPA and IAASB standards?

Reply—Engagements performed under AT section 801 and ISAE 3402 are very similar. (Exhibit B, “Comparison of Requirements of Section 801, *Reporting on Controls at a Service Organization*, With Requirements of International Standard on Assurance Engagements 3402, *Assurance Reports on Controls at a Service Organization*,” of AT section 801 identifies differences between AT section 801 and ISAE 3402.) For service organizations with international operations or international clients, there may be a benefit to obtaining a report indicating that the examination was performed in accordance with AICPA and IAASB standards. An engagement that is performed in accordance with both sets of standards would not be expected to involve a substantially different examination scope or approach than an individual SSAE No. 16 engagement would.

[Issue Date: November 2011.]

.25 Applying AT Section 801 Internationally

Inquiry—If a service organization in the United States provides services to a user entity in Europe, may the practitioner perform the examination under AT section 801 or should it be performed under ISAE 3402?

Reply—The applicability of AT section 801 is not limited to user entities located in the United States. Accordingly, a user entity in Europe could be a recipient of an SSAE No. 16 report.

[Issue Date: November 2011.]

.26 Reporting on Controls at a Service Organization Relevant to Subject Matter Other Than User Entities' ICFR

Inquiry—May AT section 801 be used for reporting on a service organization's controls relevant to subject matter other than user entities' ICFR?

Reply—No. AT section 801 does not apply to examinations of controls over subject matter other than user entities' ICFR. In the past, some CPAs used SAS No. 70, as amended (now superseded) to report on controls at a service organization relevant to subject matter other than user entities' ICFR. However, SAS No. 70, as amended (now superseded) was never intended for such reporting, and neither is AT section 801. Paragraph .A2 of AT section 801

clarifies this point, and paragraph .02a of AT section 801 indicates that AT section 801 may be helpful to practitioners in developing and performing such engagements under AT section 101. AT section 101 provides a framework that enables practitioners to develop engagements and report on subject matter other than financial statements. For example, an entity may be required by law or regulation to maintain the privacy of the information it collects from its customers. Such information may be passed on to a service organization that performs certain tasks for the user entity. Even though certain controls over the privacy of the information are implemented by the service organization, management of the user entity is not relieved of its responsibility for effective internal control over the privacy of the information it processes for the user entity. In this situation, management of the service organization may engage a CPA to report on the effectiveness of its controls over privacy that are relevant to the user entities, and it may provide that report to the user entities and other specified parties identified in the report. Such an examination would be performed under AT section 101, not AT section 801. The increasing use of *cloud computing* companies (that provide user entities with on-demand network access to a shared pool of computing resources, such as networks, servers, storage, applications, and services) has created an increasing demand for CPAs to report on a cloud computing service organization's controls relevant to subject matter other than user entities' ICFR.

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[The next page is 9561.]

Section 9530

Service Organization Controls Reports

.01 Reporting on Controls at a Service Organization Relevant to Subject Matter Other Than User Entities' Internal Control Over Financial Reporting

Inquiry—Is authoritative guidance available for reporting under AT section 101, *Attest Engagements* (AICPA, *Professional Standards*), on a service organization's controls relevant to subject matter other than user entities' internal control over financial reporting (ICFR)?

Reply—Yes. The AICPA Guide *Reporting on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy* (SOC 2) (SOC 2 guide) is designed to assist practitioners in reporting under AT section 101 on an examination of controls at a service organization relevant to the security, availability, or processing integrity of a system or the confidentiality, or privacy of the information processed by the system.

[Issue Date: November 2011.]

.02 Service Organization Controls Reports

Inquiry—What does the acronym “SOC” stand for?

Reply—The acronym SOC stands for service organization controls, as in “service organization controls reports.” The AICPA introduced this term to make practitioners aware of the various professional standards and guides available to them for examining and reporting on controls at a service organization relevant to user entities and to help practitioners select the appropriate standard or guide for a particular engagement. The following are the designations for the three engagements included in the SOC report series and the source of the guidance for performing and reporting on them:

- SOC 1: Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801), and AICPA Guide *Service Organizations: Applying SSAE No. 16, Reporting on Controls at a Service Organization* (SOC 1)
- SOC 2: AICPA Guide *Reporting on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy* (SOC 2) and AT section 101
- SOC 3: TSP section 100, *Trust Services Principles, Criteria, and Illustrations for Security, Availability, Processing Integrity, Confidentiality, and Privacy*, and AT section 101

[Issue Date: November 2011.]

.03 Authority of SOC 1 and SOC 2 Guides

Inquiry—What is the authority of the SOC 1 and SOC 2 guides?

Reply—The SOC 1 and SOC 2 guides have been cleared by the AICPA's Auditing Standards Board. AT section 50, *SSAE Hierarchy* (AICPA, *Professional Standards*), classifies attestation guidance included in an AICPA guide as an interpretive publication and indicates that a practitioner should be aware of and consider interpretive publications applicable to his or her examination. If a practitioner does not apply the attestation guidance included in an applicable interpretive publication, the practitioner should be prepared to

explain how he or she complied with the SSAE provisions addressed by such attestation guidance.

[Issue Date: November 2011.]

.04 SOC 3 Engagements

Inquiry—What is a SOC 3 engagement?

Reply—A SOC 3 engagement is similar to a SOC 2 engagement in that the practitioner reports on whether an entity (any entity, not necessarily a service organization) has maintained effective controls over its system with respect to security, availability, processing integrity, confidentiality, or privacy. Like a SOC 2 engagement, a SOC 3 engagement uses the criteria in TSP section 100. Unlike a SOC 2 engagement, a SOC 3 report (1) does not contain a description of the practitioner's tests of controls and results of those tests and (2) is a general-use report rather than a restricted use report. (The term *general use* refers to reports for which use is not restricted to specified parties.)

[Issue Date: November 2011.]

.05 Types of Reports for SOC 2 Engagements

Inquiry—Are there type 1 and type 2 reports for SOC 2 engagements?

Reply—Yes. In a SOC 2 engagement, like a SOC 1 engagement, the practitioner has the option of providing either a *type 1* or a *type 2 report*. In both reports, management of the service organization prepares a description of its system. In a type 1 report, the service auditor expresses an opinion on whether the description is fairly presented (that is, does it describe what actually exists) and whether the controls included in the description are suitably designed. Controls that are suitably designed *are able* to achieve the related control objectives or criteria if they operate effectively. In a type 2 report, the service auditor's report contains the same opinions that are included in a type 1 report, and also includes an opinion on whether the controls were operating effectively. Controls that operate effectively *do* achieve the control objectives or criteria they were intended to achieve. Both SOC 1 and SOC 2 reports are examination reports, which means the practitioner obtains a high level of assurance.

[Issue Date: November 2011.]

.06 Minimum Period of Coverage for SOC 2 Reports

Inquiry—Does the SOC 2 guide require that a type 2 report cover a minimum period?

Reply—The SOC 2 guide does not prescribe a minimum period of coverage for a SOC 2 report, however, paragraph 2.09 of the SOC 2 guide states that one of the relevant factors to consider when determining whether to accept or continue a SOC 2 engagement is the period covered by the report. The guide presents an example of a service organization that wishes to engage a service auditor to perform a type 2 engagement for a period of less than two months. The guide states that in those circumstances, the service auditor should consider whether a report covering that period will be useful to users of the report, particularly if many of the controls related to the applicable trust services criteria are performed on a monthly or quarterly basis. A practitioner would use professional judgment in determining whether the report covers a sufficient period.

[Issue Date: November 2011.]

.07 Placement of Management's Assertion in a SOC 2 Report

Inquiry—In a SOC 2 engagement, does management's assertion need to accompany the service organization's description of its system?

Reply—Paragraph 2.13b of the SOC 2 guide states, in part, that a service auditor ordinarily should accept or continue an engagement to report on controls at a service organization only if management of the service organization acknowledges and accepts responsibility for “providing a written assertion that will be attached to management's description of the service organization's system and provided to users.” The recommendation in the SOC 2 guide is that the assertion be attached to the description rather than included in the description to avoid the impression that the practitioner is reporting on the assertion rather than on the subject matter.

[Issue Date: November 2011.]

.08 Illustrative Assertion for Management of a Service Organization in a SOC 2 Engagement

Inquiry—Where can I find an illustrative management assertion for a SOC 2 engagement?

Reply—Appendix C, “Illustrative Management Assertions and Related Service Auditor's Reports on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, and Privacy,” and appendix D, “Illustrative Type 2 Service Organization Controls Report,” of the SOC 2 guide contain illustrative assertions by management of a service organization for type 2 SOC 2 engagements.

[Issue Date: November 2011.]

.09 Illustrative Assertion for Management of a Subservice Organization in a SOC 2 Engagement

Inquiry—The SOC 2 guide contains illustrative management assertions for management of a service organization. Is an illustrative assertion for management of a subservice organization available in the SOC 2 guide?

Reply—No. However, the illustrative assertions in appendix C or appendix D of the SOC 2 guide can be used to construct the subservice organization's assertion. Paragraphs 2.13–.15 of the SOC 2 guide address the requirement for an assertion by management of a subservice organization when the inclusive method is used.

[Issue Date: November 2011.]

.10 Management of a Subservice Organization Refuses to Provide a Written Assertion in a SOC 1 or SOC 2 Engagement

Inquiry—When using the inclusive method, if management of a subservice organization will not provide a written assertion, what should the service auditor do?

Reply—Paragraph .A8 of AT section 801 indicates that the subservice organization's refusal to provide the service auditor with a written assertion precludes the service auditor from using the inclusive method. However, the service auditor may instead use the carve-out method. Paragraph 2.15 of the SOC 2 guide contains similar guidance for SOC 2 engagements.

[Issue Date: November 2011.]

.11 Determining Whether Management of a Service Organization Has a Reasonable Basis for Its Assertion (SOC 1 and SOC 2 Engagements)

Inquiry—Paragraph .09c(ii) of AT section 801 states that one of the requirements for a service auditor to accept or continue a type 1 or type 2 engagement is that management acknowledge and accept responsibility for having a reasonable basis for its assertion. Paragraph .A17 of AT section 801 indicates that the service auditor’s report on controls is not a substitute for the service organization’s own processes to provide a reasonable basis for its assertion. How does the service auditor determine whether management has a reasonable basis for its assertion?

Reply—AT section 801 indirectly describes how the service auditor makes this determination. First, paragraph .14a(vii) of AT section 801 indicates, in part, that the service organization’s description of its system should include the service organization’s monitoring activities. Because a service auditor is required to determine whether the description is fairly stated, in doing so the service auditor would determine whether the section of the description that describes monitoring controls is fairly stated. Second, paragraph .A17 of AT section 801, shown subsequently, defines the term *monitoring of controls* and indicates that management’s monitoring activities may provide evidence of the design and operating effectiveness of controls in support of management’s assertion. Similar guidance for SOC 2 engagements is included in appendix A, “Information for Management of a Subservice Organization,” of the SOC 2 guide, in the section titled “Providing a Written Assertion.”

[Issue Date: November 2011.]

.12 Reasonable Basis for Management of a Subservice Organization’s Assertion (SOC 1 and SOC 2 Engagements)

Inquiry—In an inclusive SOC 1 engagement, is the service auditor required to determine whether management of the subservice organization has a reasonable basis for its assertion?

Reply—Paragraph .09c(ii) of AT section 801 states that one of the requirements for a service auditor to accept or continue a type 1 or type 2 engagement is that management acknowledge and accept responsibility for having a reasonable basis for its assertion. Paragraph .A7 of AT section 801 states that when the inclusive method is used, the requirements of AT section 801 also apply to the services provided by the subservice organization, including the requirement to acknowledge and accept responsibility for the matters in paragraph .09c(i)–(vii) of AT section 801 as they relate to the subservice organization. Paragraph .09c(vii) requires a service organization to provide a written assertion; therefore, a subservice organization would also be required to provide a written assertion and have a reasonable basis for its assertion.

In determining whether a subservice organization has a reasonable basis for its assertion, the service auditor would analogize the requirements and guidance in AT section 801 to the subservice organization. Paragraph .14a(vii) of AT section 801 would require that the subservice organization’s description of its system include the subservice organization’s monitoring activities. Because a service auditor is required to determine whether the subservice organization’s description is fairly stated, in doing so the service auditor would determine whether the section of the description that describes monitoring controls is fairly stated. Paragraph .A17 of AT section 801 defines the term *monitoring of controls* and indicates that management’s monitoring activities may provide evidence of the design and operating effectiveness of controls in support of management’s assertion. Similar guidance on this topic for a SOC 2 engagement is included in paragraphs 2.13b–c and 2.15 of the SOC 2 guide.

[Issue Date: November 2011.]

.13 Point in a SOC 1 or SOC 2 Engagement When Management Should Provide Its Written Assertion

Inquiry—At what point in a SOC 1 or SOC 2 engagement should management provide the service auditor with its written assertion?

Reply—Management may provide its written assertion to the service auditor at any time after the end of the period covered by the service auditor's type 2 report and, for a type 1 report, at any time after the as of date of the type 1 report. The date of the service auditor's report should be no earlier than the date on which management provides its written assertion.

[Issue Date: November 2011.]

.14 Implementing Controls Included in Management's Description of the Service Organization's System (SOC 1 and SOC 2 Engagements)

Inquiry—In a type 1 report for a SOC 1 or SOC 2 engagement, do the controls included in management's description of the service organization's system need to be implemented?

Reply—Yes. In order for the description of the service organization's system to be fairly presented, the controls included in the description would have to be placed in operation (implemented). See paragraph 4.01*b* of the SOC 1 guide and paragraph 3.13 of the SOC 2 guide.

[Issue Date: November 2011.]

.15 Responsibility for Determining Whether a SOC 1, SOC 2, or SOC 3 Engagement Should Be Performed

Inquiry—Who determines whether a SOC 1, SOC 2, or SOC 3 engagement should be performed—the service auditor or management of the service organization?

Reply—SOC 1 engagements address a service organization's controls relevant to user entities' ICFR, whereas SOC 2 and SOC 3 engagements address a service organization's controls relevant to the security, availability, or processing integrity of a system or the confidentiality or privacy of the information the system processes. In SOC 2 and SOC 3 engagements, the service auditor uses the criteria in TSP section 100 for evaluating and reporting on controls relevant to the security, availability, or processing integrity of a system, or the confidentiality or privacy of the information processed by the system. In TSP section 100, these five attributes of a system are known as *principles*. A service auditor may be engaged to report on a description of a service organization's system and the suitability of the design and operating effectiveness of controls relevant to one or more of the trust services principles. The criteria in TSP section 100 that are applicable to the principle(s) being reported on are known as the *applicable trust services criteria*.

If management of the service organization is not knowledgeable about the differences among these three engagements, the service auditor may assist management in obtaining that understanding and selecting the appropriate engagement. Determining which engagement is appropriate depends on the subject matter addressed by the controls and the risk management and governance needs of the user entities, and it often involves discussion with the user entities regarding their needs.

[Issue Date: November 2011.]

.16 Criteria for SOC 2 and SOC 3 Engagements

Inquiry—Are there a prescribed set of control objectives for SOC 2 and SOC 3 engagements?

Reply—In SOC 1 engagements, the service auditor determines whether controls achieve specified control objectives. In SOC 2 and SOC 3 engagements, the service auditor determines whether controls meet the applicable trust services criteria. Although the terminology is different in these engagements (control objectives versus criteria), the control objectives in a SOC 1 engagement serve as criteria for evaluating the design and, in a type 2 report, the operating effectiveness of controls. Unlike SOC 1 engagements, in which management of the service organization determines the service organization's control objectives based on the nature of the service provided and how the service is performed, in all SOC 2 and SOC 3 engagements, the service organization's controls must meet all of the criteria in TSP section 100 that are applicable to the principle(s) being reported on. The applicable trust services criteria serve as a prescribed set of criteria.

[Issue Date: November 2011.]

.17 Using Existing Set of Controls for a New SOC 2 or SOC 3 Engagement

Inquiry—In the past, many IT service organizations provided their user entities with reports issued under Statement on Auditing Standards (SAS) No. 70, *Service Organizations*, as amended (now superseded), covering their IT services. If a service organization plans to undergo a SOC 2 or SOC 3 examination for the first time and has a fully defined set of controls and control objectives related to its IT services, does the service organization need to adopt a new set of controls to meet the applicable trust services criteria?

Reply—The SOC 2 guide and appendix C of TSP section 100 require the service organization to establish controls that meet all of the applicable trust services criteria. A service organization that is planning to undergo a SOC 2 or SOC 3 engagement for the first time may have controls in place that address all of the applicable trust services criteria. However, the service organization will need to determine whether its existing control objectives align with the applicable trust services criteria and whether its controls address all of the applicable trust services criteria. If not, it will need to implement or revise certain controls to meet all of the applicable trust services criteria.

[Issue Date: November 2011; Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.18 Reporting on Compliance With Other Standards or Requirements in SOC 2 or SOC 3 Engagements

Inquiry—May a SOC 2 or SOC 3 report cover compliance with other standards or authoritative requirements that are substantially similar to the applicable trust services criteria, for example, requirements in Special Publication 800-53, *Recommended Security Controls for Federal Information Systems*, issued by the National Institute of Standards and Technology or in Payment Card Industry (PCI) Security Standards issued by the PCI Security Counsel?

Reply—Yes. A service organization may request that a SOC 2 or SOC 3 report address additional subject matter that is not specifically covered by the applicable trust services criteria. An example of such subject matter is the service organization's compliance with certain criteria established by a regulator, for example, security requirements under the Health Insurance Portability and Accountability Act of 1996 or compliance with performance criteria

established in a service-level agreement. Paragraph 1.39 of the SOC 2 guide states that in order for a service auditor to report on such additional subject matter, the service organization provides the following:

- An appropriate supplemental description of the subject matter
- A description of the criteria used to measure and present the subject matter
- If the criteria are related to controls, a description of the controls intended to meet the control-related criteria
- An assertion by management regarding the additional subject matter

Paragraph 1.40 of the guide states

The service auditor should perform appropriate procedures related to the additional subject matter, in accordance with AT section 101 and the relevant guidance in this guide. The service auditor's description of the scope of the work and related opinion on the subject matter should be presented in separate paragraphs of the service auditor's report. In addition, based on the agreement with the service organization, the service auditor may include additional tests performed and detailed results of those tests in a separate attachment to the report.

[Issue Date: November 2011.]

.19 Issuing Separate Reports When Performing Both a SOC 1 and SOC 2 Engagement for a Service Organization

Inquiry—Does a service organization that wishes to have a practitioner report on controls relevant to user entities' ICFR along with controls that are not relevant to user entities' ICFR need to request two separate reports—SOC 1 and SOC 2?

Reply—Yes. Service organizations need to request two separate SOC reports if the service organization would like to address controls relevant to user entities' ICFR and controls that are not relevant to user entities' ICFR. See paragraph 1.24 of the SOC 2 guide.

[Issue Date: November 2011.]

.20 Deviations in the Subject Matter (SOC 1 and SOC 2 Engagements)

Inquiry—In a SOC 1 or SOC 2 engagement, if the service auditor identifies deviations in the subject matter (that is, the fairness of the presentation of the description, the suitability of the design of the controls, and the operating effectiveness of the controls) and qualifies the report because of these deviations, does management need to revise its assertion to reflect these deviations?

Reply—If management of the service organization agrees with the service auditor's findings regarding the deviations, management would be expected to revise its assertion to reflect the deviations identified in the service auditor's report. If management does not revise its assertion, the service auditor should add an explanatory paragraph to the report indicating that the deficiencies identified in the service auditor's report have not been identified in management's assertion. Similar guidance for a SOC 2 engagement is included in paragraph 3.105 of the SOC 2 guide.

[Issue Date: November 2011.]

.21 Use of a Seal on a Service Organization's Website

Inquiry—Is there a SOC seal that can be displayed on a service organization's website indicating that the service organization has undergone a SOC 1, SOC 2, or SOC 3 engagement?

Reply—A seal is available only for SOC 3 engagements. A SOC 3 SysTrust for Service Organization Seal (seal) may be issued and displayed on a service organization's website. All practitioners who wish to provide this registered seal must obtain a license to provide the seal from by the Canadian Institute of Chartered Accountants (CICA). Typically the seal is linked to the report issued by the practitioner. For more information on licensure, go to www.webtrust.org. It is important to note that a practitioner can perform a SOC 3 engagement and issue a SOC 3 report without issuing a SOC 3 seal. In such cases the practitioner does not need to be licensed by the CICA. The license is only for the issuance of a seal.

In addition, SOC logos are available for use by (a) CPAs for marketing and promoting SOC services and (b) service organizations that have undergone a SOC 1, SOC 2, or SOC 3 engagement within the prior 12 months. These logos are designed to make the public aware of these SOC services and do not offer or represent assurance that an organization obtained an unqualified (or clean) opinion. For additional information about logos, go to www.aicpa.org/interestareas/frc/assuranceadvisoryservices/pages/soclogosinfo.aspx.

[Issue Date: November 2011.]

.22 Attestation Standards and Interpretive Guidance for Reporting on a Service Organization's Controls Relevant to User Entities and for Reporting on an Entity's Internal Control

Inquiry—AICPA professional literature includes a variety of attestation standards and interpretive guidance for reporting on a service organization's controls relevant to user entities and for reporting on an entity's internal control. How does a practitioner determine the applicable attestation standard and interpretive guidance for these engagements?

Reply—The following table identifies a variety of attestation engagements that involve reporting on a service organization's controls relevant to user entities, or reporting on an entity's internal control. The table also identifies the appropriate attestation standard or interpretive guidance to be used in the circumstances.

<i>Engagement</i>	<i>Professional Standard or Other Guidance</i>	<i>Restrictions on the Use of the Report</i>
<p><i>Reporting on Controls at a Service Organization Relevant to User Entities' Internal Control Over Financial Reporting: Controls were not designed by the service organization; management of the service organization will not provide an assertion regarding the suitability of the design of the controls, and the practitioner is reporting on</i></p> <ul style="list-style-type: none"> <li data-bbox="176 743 452 857">• the fairness of the presentation of management's description of the service organization's system and <li data-bbox="176 1216 452 1503">• the operating effectiveness of the service organization's controls relevant to user entities internal control over financial reporting. Such a report may include a description of tests of the operating effectiveness of the controls and the results of the tests. 	<p>Report on the fairness of the presentation of the description under AT section 101, <i>Attest Engagements</i> (AICPA, <i>Professional Standards</i>), using the description criteria in paragraph .14 of AT section 801, <i>Reporting on Controls at a Service Organization</i> (AICPA, <i>Professional Standards</i>), and adapting the relevant requirements and guidance therein</p> <p>Report on the operating effectiveness of controls under AT section 101 or AT section 201, <i>Agreed-Upon Procedures Engagements</i> (AICPA, <i>Professional Standards</i>)</p>	<p>Management of the service organization, user entities, and the auditors of the user entities' financial statements</p> <p>The specified parties that agreed upon the sufficiency of the procedures for their purposes</p>

(continued)

<i>Engagement</i>	<i>Professional Standard or Other Guidance</i>	<i>Restrictions on the Use of the Report</i>
<p><i>Reporting on Controls at a Service Organization Relevant to User Entities' Internal Control Over Financial Reporting: Controls were not designed by the service organization; management of the service organization provides an assertion regarding the suitability of design of controls</i></p>	<p>AT section 801</p>	<p>Management of the service organization, user entities, and the auditors of the user entities' financial statements</p>

<p><i>Engagement</i></p>	<p><i>Professional Standard or Other Guidance</i></p>	<p><i>Restrictions on the Use of the Report</i></p>
<p><i>Reporting on Controls at a Service Organization Relevant to Security Availability, Processing Integrity, Confidentiality, or Privacy: Includes Description of Tests and Results</i></p> <p>Reporting on the fairness of the presentation of management’s description of a service organization’s system; the suitability of the design of controls at a service organization relevant to security, availability, processing integrity, confidentiality, or privacy; and in a type 2 report, the operating effectiveness of those controls</p> <p>A type 2 report includes a description of tests of the operating effectiveness of controls performed by the service auditor and the results of those tests.</p>	<p>AT section 101</p> <p>AICPA Guide <i>Reporting on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy (SOC 2)</i></p>	<p>Parties that are knowledgeable about</p> <ul style="list-style-type: none"> • the nature of the service provided by the service organization • how the service organization’s system interacts with user entities, subservice organizations, and other parties • internal control and its limitations • the criteria and how controls address those criteria • complementary user entity controls and how they interact with related controls at the service organization

(continued)

<i>Engagement</i>	<i>Professional Standard or Other Guidance</i>	<i>Restrictions on the Use of the Report</i>
<p>Reporting on Controls at a Service Organization Relevant to Security Availability, Processing Integrity, Confidentiality, or Privacy: No Description of Tests and Results</p> <p>Reporting on whether an entity has maintained effective controls over its system with respect to security, availability, processing integrity, confidentiality, or privacy</p> <p>If the report addresses the privacy principle, the report also contains an opinion on the service organization's compliance with the commitments in its privacy notice.</p> <p>This report does not contain a description of the service auditor's tests performed and the results of those tests.</p>	<p>AT section 101</p> <p>AICPA/Canadian Institute of Chartered Accountants Trust Services Principles, Criteria, and Illustrations (TSP section 100, <i>Trust Services Principles, Criteria, and Illustrations for Security, Availability, Processing Integrity, Confidentiality, and Privacy</i>)</p>	<p>This is a general-use report.¹</p>

¹ The term *general use* refers to reports for which use is not restricted to specified parties.

<i>Engagement</i>	<i>Professional Standard or Other Guidance</i>	<i>Restrictions on the Use of the Report</i>
<p><i>Reporting on a Service Provider's Controls to Achieve Compliance Control Objectives Relevant to SEC Rules 38a-1 and 206(4)-7</i></p> <p>Reporting on the suitability of the design and operating effectiveness of a service provider's controls over compliance that may affect user entities' compliance</p> <p>This report does not contain a description of the practitioner's tests performed and the results of those tests.</p>	<p>AT section 101</p> <p>Statement of Position (SOP) 07-2, <i>Attestation Engagements That Address Specified Compliance Control Objectives and Related Controls at Entities that Provide Services to Investment Companies, Investment Advisers, or Other Service Providers</i> (AUD sec. 14,430)</p>	<p>Chief compliance officers, management, boards of directors, and independent auditors of the service provider and of the entities that use the services of the service provider</p>
<p><i>Performing the Agreed-Upon Procedures Referred to in Paragraph .03 of AT section 801</i></p> <p>Performing and reporting on the results of agreed-upon procedures related to the controls of a service organization or to transactions or balances of a user entity maintained by a service organization</p> <p>This report contains a description of the procedures performed by the practitioner and the results of those procedures.</p>	<p>AT section 201</p>	<p>The specified parties that agreed upon the sufficiency of the procedures for their purposes</p>

(continued)

<i>Engagement</i>	<i>Professional Standard or Other Guidance</i>	<i>Restrictions on the Use of the Report</i>
<p><i>Reporting on Controls Over Compliance With Laws and Regulations</i></p> <p>Reporting on the effectiveness of an entity's internal control over compliance with the requirements of specified laws, regulations, rules, contracts, or grants</p>	<p>AT section 601, <i>Compliance Attestation</i> (AICPA, <i>Professional Standards</i>)</p>	<p>Use is restricted if the criteria are</p> <ul style="list-style-type: none"> • appropriate for only a limited number of parties who established the criteria or can be presumed to understand the criteria. • available only to specified parties.
<p><i>Reporting on Internal Control in an Integrated Audit</i></p> <p>Reporting on the design and operating effectiveness of an entity's internal control over financial reporting that is integrated with an audit of financial statements</p>	<p>AT section 501, <i>An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements</i> (AICPA, <i>Professional Standards</i>)</p>	<p>This is a general-use report.</p>

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 - .02 Staff Audit Practice Alert No. 2, Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists, December 10, 2007
 - .03 Staff Audit Practice Alert No. 3, Audit Considerations in the Current Economic Environment, December 5, 2008
 - .04 Staff Audit Practice Alert No. 4, Auditor Considerations Regarding Fair Value Measurements, Disclosures, and Other-Than-Temporary Impairments, April 21, 2009
 - .05 Staff Audit Practice Alert No. 5, Auditor Considerations Regarding Significant Unusual Transactions, April 7, 2010
 - .06 Staff Audit Practice Alert No. 6, Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants From Outside the Firm, July 12, 2010
 - .07 Staff Audit Practice Alert No. 7, Auditor Considerations of Litigation and Other Contingencies Arising From Mortgage and Other Loan Activities, December 20, 2010
 - .08 Staff Audit Practice Alert No. 8, Audit Risks in Certain Emerging Markets, October 3, 2011
 - .09 Staff Audit Practice Alert No. 9, Assessing and Responding to Risk in the Current Economic Environment, December 6, 2011
 - .10 Staff Audit Practice Alert No. 10, Maintaining and Applying Professional Skepticism in Audits, December 4, 2012
 - .11 Staff Audit Practice Alert No. 11, Considerations for Audits of Internal Control Over Financial Reporting, October 24, 2013
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Section 100

Select PCAOB Staff Questions and Answers

.01 Staff Questions and Answers — Audits of Financial Statements of Non-Issuers Performed Pursuant to the Standards of the Public Company Accounting Oversight Board, June 30, 2004

Summary

Staff questions and answers set forth the staff's opinions on issues related to the implementation of the standards of the Public Company Accounting Oversight Board ("PCAOB" or "Board"). The staff publishes questions and answers to help auditors implement, and the Board's staff administer, the Board's standards. The statements contained in the staff questions and answers are not rules of the Board, nor have they been approved by the Board.

The following staff questions and answers related to PCAOB Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board* ("Auditing Standard No. 1"), were prepared by the Office of the Chief Auditor. Questions should be directed to C. Gregory Scates, Associate Chief Auditor (202/207-9114; scatesg@pcaobus.org), or Thomas Ray, Deputy Chief Auditor (202/207-9112; rayt@pcaobus.org).

* * *

The Sarbanes-Oxley Act of 2002 (the "Act") directs the Public Company Accounting Oversight Board to establish auditing and related attestation, quality control, ethics and independence standards, to be used by registered public accounting firms in the preparation and issuance of audit reports of issuers.¹ The Act and PCAOB Rules require audits of issuers to be conducted in accordance with PCAOB standards. When issuing an audit report on the financial statements of an issuer, PCAOB Auditing Standard No. 1 requires registered public accounting firms to include a reference to "the standards of the Public Company Accounting Oversight Board (United States)." In contexts other than an audit of the financial statements of an issuer, however, auditors, whether registered or not, may be legally required to, or may agree voluntarily to, perform an engagement in accordance with PCAOB standards or some portion of those standards.² Auditors and other interested persons have raised questions about the implications of Auditing Standard No. 1, as well as the Act and other PCAOB rules, for such engagements. The following staff questions and answers seek to answer some of those questions.

¹ Section 2(a) of the Act defines "issuer" as "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 the Act (15 U.S.C. 781), or that is required to file reports under Section 15(d)(15 U.S.C. 780(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."

² See, e.g., Securities Exchange Act of 1934 Rule 17i-6(d), 17 CFR 240.17i-6(d) (requiring supervised investment bank holding companies to obtain an audit and review "in accordance with the rules promulgated by the Public Company Accounting Oversight Board").

Q1. Must a public accounting firm be registered with the PCAOB to perform an audit of a non-issuer according to PCAOB standards?

A1. No. The Sarbanes-Oxley Act requires only that those public accounting firms that prepare or issue, or participate in the preparation or issuance of, audit reports on the financial statements of issuers be registered.³

Q2. The PCAOB's Auditing Standard No. 1 requires the auditor to include a reference to "the standards of the Public Company Accounting Oversight Board (United States)" in audit reports on the financial statements of issuers. May an auditor refer to "the auditing standards of the Public Company Accounting Oversight Board (United States)" rather than to "the standards of the Public Company Accounting Oversight Board (United States)" in an audit report on an audit of the financial statements of a non-issuer that was performed in accordance with the Board's auditing standards?

A2. Yes. In an audit of the financial statements of a non-issuer, an auditor may wish to be clear that he or she adhered to only the auditing standards of the PCAOB; accordingly, the auditor may include the word "auditing" in the reference to the standards of the PCAOB. Registered public accounting firms, however, are not permitted to limit their reference to the "auditing standards" of the PCAOB in their audit reports on the financial statements of issuers.

Q3. What standards are included in a reference to "the standards of the Public Company Accounting Oversight Board (United States)"?

A3. A reference to "the standards of the Public Company Accounting Oversight Board (United States)" includes the standards of the Board that are applicable in the circumstances of the engagement. For example, in an audit of financial statements that does not involve the use of a specialist, the auditor would not be expected to follow the Board's interim auditing standard, Statement of Auditing Standards No. 73, "Using the Work of a Specialist." Similarly, in an audit of an entity that has immaterial inventory balances, the auditor would not be expected to follow the Board's interim auditing standard, AU Section 331, "Inventories," of Statement on Auditing Standards No. 1, "Codification of Auditing Standards and Procedures." On the other hand, the Board's interim auditing standard, Statement on Auditing Standards No. 99, "Consideration of Fraud in a Financial Statement Audit," would be applicable in all audits of financial statements conducted pursuant to the Board's standards. As another example, quality control standards generally apply to a firm's system of quality control over its accounting and auditing practice and not to individual audit engagements. Thus, a breakdown in the system of quality control does not necessarily mean that a particular audit was not conducted in accordance with the standards of the PCAOB. However, such a breakdown might result in a deficient audit if it caused or contributed to an audit deficiency. In addition, an auditor who states that he or she has performed the audit in accordance with the standards of the PCAOB must be in compliance with the applicable interim independence standards of the Board. These are examples only, and not an exhaustive list of standards that may be applicable to an engagement. While not required by PCAOB rules, auditors of issuers and other entities subject to the SEC's jurisdiction are reminded that they must also comply with applicable

³ The SEC has ordered that broker-dealers that are not issuers need not file with the Commission, and send to their customers, financial statements certified by a registered public accounting firm until January 1, 2005, unless rules are in place regarding Board registration of auditors of such broker-dealers that set an earlier date. See Notice, Broker-Dealer Financial Statement Requirements under Section 17 of the Exchange Act, Rel. No. 34-48281 (August 4, 2003).

Commission requirements, including the Commission's auditor independence requirements.

Q4. By referring to “the auditing standards of the Public Company Accounting Oversight Board (United States)” in an audit report on the financial statements of a non-issuer, does the auditor represent that he or she has adhered to the Board's interim independence standards?

A4. No. Auditors of the financial statements of non-issuers, including nonprofit organizations, government agencies, municipalities and other governments, should look to relevant state and federal laws and regulations relating to auditor independence. Auditors of nonpublic companies should bear in mind, however, that any company that becomes an issuer, as defined in Section 2(a)(7) of the Act, must file with the SEC an audit report prepared and issued by an independent registered public accounting firm, and therefore it may behoove an auditor of a nonpublic company that intends to become an issuer to comply with SEC and PCAOB independence requirements.

Q5. By referring to “the auditing standards of the Public Company Accounting Oversight Board (United States)” or to “the standards of the Public Company Accounting Oversight Board (United States)” in an audit report on the financial statements of a non-issuer, does the auditor represent that he or she has complied with the Commission's auditor independence requirements?

A5. No. A Note to the PCAOB's rule on interim independence standards, PCAOB Rule 3600T, reminds auditors of issuers and other entities subject to the SEC's jurisdiction of their separate obligations under the SEC's rule on auditor independence. The PCAOB's rule on interim independence standards does not, however, incorporate the SEC's auditor independence requirements.

Q6. What are the PCAOB's independence requirements and to whom do they apply?

A6. The PCAOB adopted interim independence standards when it adopted PCAOB Rule 3600T, which is a temporary rule in effect until the Board adopts permanent independence standards. Rule 3600T requires that, when a registered public accounting firm conducts an audit of the financial statements of an issuer, the firm comply with—

- Rule 101 of the AICPA's Code of Professional Conduct, and interpretations and rulings thereunder, as in existence on April 16, 2003; and
- Standards Nos. 1, 2 and 3, and Interpretations 99-1, 00-1, and 002, of the Independence Standards Board.

Registered public accounting firms must also comply with SEC requirements, including its Rule 2-01 of Regulation S-X, relating to auditor independence, when they conduct audits required by the federal securities laws, including audits of financial statements of issuers. The Board did not adopt the SEC's Rule 2-01 because that rule already governs auditor independence from issuers. As a Note to Rule 3600T makes clear, however, in an audit of the financial statements of an issuer, to the extent that a provision of the SEC's rule is more restrictive—or less restrictive—than the Board's interim independence standards, a registered public accounting firm must comply with the more restrictive rule.

Q7. Does a reference to “the auditing standards of the Public Company Accounting Oversight Board (United States)” or to “the standards of the Public Company Accounting Oversight Board (United States)” in an auditor's report

on the financial statements of a non-issuer imply that the non-issuer is subject to, or otherwise complied with, some or all of the provisions of the Act and other securities laws or the Commission's rules and regulations thereunder?

A7. No. An auditor's reference to PCAOB standards in an audit report on the financial statements of a non-issuer does not subject the auditor or the non-issuer to any laws that the auditor or the non-issuer would not otherwise have been required to comply with. Unless the non-issuer is involved in an activity that subjects it to the Act or other securities laws, such as the laws governing broker-dealers, compliance by the auditor or the non-issuer with the Act or other securities laws would be strictly voluntary.

Q8. Does inclusion of a reference to the Board's standards in an auditor's report on the financial statements of a non-issuer cause the audit to become eligible for review as a part of a Board inspection?

A8. No. An audit of the financial statements of a non-issuer does not become subject to PCAOB inspection solely because the auditor performed and reported on the audit in accordance with the standards of the PCAOB. Auditors of the financial statements of non-issuers may, nevertheless, be subject to various forms of state and federal oversight, such as review by federal banking regulators, the U.S. General Accounting Office, or a state board of accountancy.

Q9. If a non-issuer elects to have its financial statements audited pursuant to the Board's standards, must it also have its internal control over financial reporting audited pursuant to the Board's Auditing Standard No. 2, "An Audit of Internal Control Over Financial Reporting Conducted in Conjunction with an Audit of Financial Statement"?

A9. No. Only certain issuers that are subject to Section 404 of the Act are required to include within the scope of the audit an audit of internal control over financial reporting. Although the Board's standards provide for an integrated audit of financial statements and internal control for those issuers that are subject to Section 404 of the Act, the Board's standards also permit auditors to conduct a financial statement-only audit under circumstances, for example, when Section 404 of the Act is not applicable.

Q10. If an auditor refers to either "the standards of the Public Company Accounting Oversight Board (United States)" or "the auditing standards of the Public Company Accounting Oversight Board (United States)" in an audit report on an audit of the financial statements of a non-issuer, is the auditor also required to subject the audit to a "concurring partner review" as required by the Board's adoption of certain of the requirements of the AICPA's former Securities and Exchange Commission Practice Section ("SECPS")?

A10. No. The Board may at some time adopt a standard requiring the performance of a second partner review. At this time, however, the PCAOB interim quality control standards only require registered firms that were members of the SECPS as of April 16, 2003, to have a concurring partner review on audits of issuers. (See PCAOB Release No. 2003-006.)

.02 Staff Questions and Answers — Attest Engagements Regarding XBRL Financial Information Furnished Under the XBRL Voluntary Financial Reporting Program on the Edgar System, May 25, 2005**Summary**

Staff questions and answers set forth the staff's opinions on issues related to the implementation of the standards of the Public Company Accounting Oversight Board ("PCAOB" or "Board"). The staff publishes questions and answers to help auditors implement, and the Board's staff administer, the Board's standards. The statements contained in the staff questions and answers are not rules of the Board, nor have they been approved by the Board.

The following staff questions and answers related to attest engagements regarding XBRL financial information furnished under the XBRL Voluntary Financial Reporting Program on the EDGAR System were prepared by the Office of the Chief Auditor. Additional questions should be directed to Keith Wilson, Associate Chief Auditor (202/207-9134; wilsonk@pcaobus.org).

* * *

Q1. What is XBRL?

A1. XBRL (eXtensible Business Reporting Language) is an open standard for electronic communication of business and financial data. The XBRL standard provides a format for tagging that data so users can extract, exchange, analyze, and present the information.

XBRL information is commonly distributed in the form of XBRL instance documents. These documents are electronic files consisting of financial data along with their corresponding XBRL tags.

To facilitate electronic communication of financial information among many parties, XBRL instance documents must be created using a common set of standards that all parties can understand and use. In XBRL, this is accomplished through taxonomies and specifications. An XBRL taxonomy (or tag list) provides a data structure and vocabulary for interpreting financial information, such as all of the items comprising "net income." An entity may extend the taxonomy by creating additional custom tags for its own use. XBRL specifications have been developed by the XBRL Consortium for creating and extending taxonomies. (See the XBRL website, www.xbrl.org, for more information about XBRL.)

Q2. What is the XBRL Voluntary Financial Reporting Program on the EDGAR System?

A2. The Securities and Exchange Commission ("SEC") has adopted rule amendments¹ allowing issuers to voluntarily submit supplemental tagged financial information using the XBRL² format as exhibits to specified EDGAR filings under the Securities Exchange Act of 1934 and the Investment Company Act of 1940. The amendments include certain requirements regarding the information in those exhibits. This SEC initiative is referred to in the SEC Release as the "XBRL Voluntary Financial Reporting Program on the EDGAR System" (hereinafter referred to as the "SEC Voluntary Program").

¹ *Final Rule: XBRL Voluntary Financial Reporting Program on the EDGAR System*, Securities and Exchange Commission Release Nos. 33-8529, 34-51129, 3527944, 39-2432, IC-26747; File Number S7-35-04 (February 3, 2005) [70 FR 6556].

² The SEC's website, www.sec.gov, has more information about the SEC's XBRL initiative.

The XBRL documents furnished under the SEC Voluntary Program are referred to in the SEC Regulations³ as “XBRL-Related Documents.” The XBRL-Related Documents must contain only certain specified content (“mandatory content” and “optional content”) that appears in a specified format (“voluntary program format”), as set forth in the SEC Regulations.

According to the EDGAR Filer Manual,⁴ issuers who file under the SEC Voluntary Program must create their XBRL-Related Documents using one of the US Generally Accepted Accounting Principles (“US GAAP”) taxonomies, based on XBRL Specification Version 2.1. Issuers also may use one of the Stand Alone Add-on taxonomies provided in the US Financial Reporting Taxonomy Framework for certain content. Any company extensions of those taxonomies must conform to XBRL Specification Version 2.1.

Q3. May an auditor⁵ examine and report on whether the XBRL-Related Documents accurately reflect the information in the corresponding part of the official EDGAR filings? If so, what are the primary engagement standards that apply to those engagements?

A3. Yes, an auditor may be engaged to examine and report on whether the XBRL-Related Documents accurately reflect the information in the corresponding part of the official EDGAR filings. That engagement is an examination under AT section 101 of the PCAOB’s interim attestation standards, *Attest Engagements* (“AT section 101”), as amended.

Q4. The second general attestation standard in paragraph .21 of AT section 101 indicates that the engagement shall be performed by an auditor “having adequate knowledge of the subject matter.” How does this general standard apply to examination engagements regarding XBRL-Related Documents?

A4. In examination engagements regarding XBRL-Related Documents, the auditor must have sufficient knowledge of the applicable SEC Regulations, EDGAR Filer Manual requirements, and XBRL taxonomies and specifications to perform the examination. The auditor must also have sufficient knowledge of the company’s financial statements and underlying financial records to understand how the financial data in the XBRL-Related Documents relates to the corresponding information in the official EDGAR filing.

Q5. The third general attestation standard in paragraph .23 of AT section 101 states that the auditor “shall perform the engagement only if he or she has reason to believe that the subject matter is capable of evaluation against criteria that are suitable and available to users.” How does this general standard apply to examination engagements regarding XBRL-Related Documents?

A5. Paragraphs .24 through .34 of AT section 101 discuss the attributes of suitable and available criteria. The US GAAP Version 2.1 based taxonomies,

³ §232.401 of Regulation S-T, 17 C.F.R. 232.401; and SEC Final Rule Release No. 33-8529 (February 3, 2005).

⁴ EDGARLink Filer Manual, Appendix L. (The EDGARLink Filer Manual comprises Volume 1 of the EDGAR Filer Manual.)

⁵ These PCAOB Staff Questions and Answers assume that the auditor who is engaged to perform this examination has also audited, in accordance with PCAOB standards, the financial statements for at least the latest period to which the XBRL financial information relates and the financial statements for the other periods covered by the XBRL financial information have been audited by the auditor or a predecessor auditor. Therefore, the word “auditor” is used instead of “practitioner.”

Stand Alone Add-on taxonomies, and XBRL Specification Version 2.1 would be considered suitable and available criteria because (a) they were developed by a panel of widely recognized experts that follow due process procedures, including exposure for public comment, and (b) they are available free of charge through the XBRL Consortium.

Company extensions of those taxonomies normally do not go through the same development processes as described in the preceding paragraph. Accordingly, the auditor should evaluate whether company extensions represent suitable and available criteria as described in AT section 101.

Q6. May the auditor assist a company with the creation or tagging of its XBRL-Related Documents and still perform an examination regarding those documents?

A6. The fourth general attestation standard requires the auditor to be independent in order to perform an attest engagement. When evaluating independence, the auditor should apply the independence principles for financial statement audits to the context of the examination engagement. For example, although the auditor may provide technical advice on matters related to the application of the XBRL taxonomy and specifications, the auditor's independence would be impaired (and thus the auditor would be unable to examine a company's XBRL-Related Documents) if he or she prepared those documents or made decisions about the documents for management.

Q7. What are the objectives of the examination procedures regarding the XBRL-Related Documents, and what procedures should be performed to achieve those objectives?

A7. In performing the examination as set forth in AT section 101, the auditor should apply procedures as necessary to obtain sufficient evidence to provide a reasonable basis for an opinion on whether the XBRL-Related Documents accurately reflect the information in the corresponding part of the official EDGAR filings. Thus, the objectives of the examination procedures are to determine whether—

- a. the XBRL data agrees with the official EDGAR filings, and
- b. the XBRL-Related Documents are in conformity with the applicable XBRL taxonomies and specifications, as well as with the SEC requirements for format and content.

The following are examination procedures that the auditor should consider to achieve the engagement objectives:

- Compare the rendered⁶ XBRL-Related Documents to the information in the official EDGAR filing, and agree the corresponding content.
- Determine whether the content in the XBRL-Related Documents conforms to the SEC voluntary program content requirements.
- Determine whether the XBRL-Related Documents (and the related taxonomy documents, as necessary) conform to the SEC voluntary program format requirements. To accomplish this, the auditor should consider the following procedures:
 - a. Test whether the data elements (i.e., text and line item names and associated values, dates and other labels) in the XBRL-Related

⁶ A rendered XBRL-Related Document has been converted from machine readable form into human readable form using a software tool.

Documents reflect the same information as the corresponding official EDGAR filing (i.e., the HTML or ASCII version).

- b. Verify that the data elements in the corresponding official EDGAR filing have not been changed, deleted, or summarized in the XBRL-Related Documents.
 - c. Evaluate whether the XBRL-Related Documents comply with the appropriate XBRL specification and EDGAR-supported XBRL taxonomies.
 - d. Evaluate whether any company extensions of the taxonomy are consistent with the SEC voluntary program format requirements, including conformity with XBRL specifications.
 - e. Test whether data elements in the XBRL-Related Documents are matched with appropriate tags in accordance with the applicable taxonomy.
- Read the EDGAR filing to determine whether it contains the disclosures regarding XBRL-Related Documents required by SEC Regulations.⁷
 - Obtain a representation letter from management that includes a statement that the XBRL-Related Documents comply with SEC requirements.

Q8. What are the reporting requirements for examination engagements regarding XBRL-Related Documents?

A8. The report for this engagement should comply with the requirements of AT section 101, as amended.

If the underlying information in the XBRL-Related Documents has been audited, the examination report should refer to the audit report. If the underlying information was reviewed, and the review report was filed with the SEC, the examination report should refer to the review report. If the underlying information was reviewed, but the review report was not filed with the SEC, the examination report need not refer to the review report but should indicate that the underlying information has not been audited and no opinion is expressed on it. The auditor should disclaim an opinion on any underlying information in the XBRL-Related Documents that is not covered by an audit report or review report.

The auditor may be engaged to report on management's assertion or on the subject matter of the assertion. The following are examples of examination reports for these engagements.

⁷ §232.401(d) of Regulation S-T, 17 C.F.R. 232.401(d).

Report on the Subject Matter of the Assertion**Report of Independent Registered Public Accounting Firm
on XBRL-Related Documents**

We have examined the accompanying XBRL-Related Documents of Sample Volunteer Company, presented as Exhibit [number] to the Company's [Identify EDGAR filing, such as Form 10-K], which reflect the data presented in the [Identify corresponding information in the official EDGAR filing] as of [Month and Day], [Year] and [Year] and for each of the years in the [number]-year period ended [date]. Sample Volunteer Company's management is responsible for the XBRL-Related Documents. Our responsibility is to express an opinion based on our examination.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the financial statements of Sample Volunteer Company as of [Month and Day], [Year] and [Year] and for each of the years in the [number]-year period ended [date], and in our report dated [date], we expressed an unqualified opinion on those financial statements.⁸ In addition, we have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Sample Volunteer Company's internal control over financial reporting as of [Month and Day],

[Year], based on [Identify control criteria], and our report dated [date], expressed [Include nature of opinion].^{9, 10, 11, 12}

Our examination was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States) and, accordingly, included examining, on a test basis, evidence supporting the XBRL-Related Documents. Our examination also included evaluating the XBRL-Related Documents for conformity with the applicable XBRL taxonomies and specifications and the content and format requirements of the Securities and Exchange Commission. We believe that our examination provides a reasonable basis for our opinion.

⁸ If the auditor's opinion on the related financial statements is other than unqualified, this report should disclose that fact along with the reason for the modified report.

⁹ This sentence is necessary if (a) the XBRL-Related Documents include information about the effectiveness of internal control over financial reporting, and (b) that information was covered by an audit report.

¹⁰ If the financial statements have been reviewed and the review report was filed with the SEC, this paragraph should read: "We have also reviewed, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the financial statements of Sample Volunteer Company as of [date], 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 [date], [Describe any modifications of such report]. A review of financial statements is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board, 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."

¹¹ If the financial statements have been reviewed but the review report was not filed with the SEC, this paragraph should read: "We did not audit the financial statements of Sample Volunteer Company (or examine [Identify any other underlying information]), the objective of which would have been the expression of an opinion on them. Accordingly, we do not express an opinion on them."

¹² If the XBRL-Related Documents contain both (a) financial statements that are covered by an audit report or review report filed with the SEC and (b) other information that is not covered by an audit or review report, this paragraph should include a statement such as the following: "We were not engaged to and did not conduct an audit (or review) of [Identify information], the objective 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]."

In our opinion, the XBRL-Related Documents of Sample Volunteer Company referred to above accurately reflect, in all material respects, the data presented in the *[Identify corresponding information in the official EDGAR filing]* in conformity with *[Identify the criteria—for example, the taxonomy, such as “US GAAP—Commercial and Industrial Taxonomy,” and where applicable, the Stand Alone Add-on Taxonomy such as “US Financial Reporting—Management Report Taxonomy,” and the specifications, such as “XBRL Specifications (Version 2.1)”]*.

[Signature]

[City and State or Country]

[Date]

Report on Management's Assertion¹³**Report of Independent Registered Public Accounting Firm
on XBRL-Related Documents**

We have examined management's assertion that *[Identify the assertion—for example, the accompanying XBRL-Related Documents, presented as Exhibit [number] to Sample Volunteer Company's [Identify EDGAR filing, such as Form 10-K] accurately reflect the data presented in the [Identify corresponding information in the official EDGAR filing] as of [Month and Day], [Year] and for each of the years in the [number]-year period ended [date], in conformity with [Identify the criteria—for example, the taxonomy, such as "US GAAP—Commercial and Industrial Taxonomy," and where applicable, the Stand Alone Add-on Taxonomy such as "US Financial Reporting—Management Report Taxonomy," and the specifications, such as "XBRL Specifications (Version 2.1)"]].* Sample Volunteer Company's management is responsible for the assertion. Our responsibility is to express an opinion on the assertion based on our examination.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the financial statements of Sample Volunteer Company as of *[Month and Day]*, *[Year]* and *[Year]* and for each of the years in the *[number]-year* period ended *[date]*, and in our report dated *[date]*, we expressed an unqualified opinion on those financial statements. In addition, we have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Sample Volunteer Company's internal control over financial reporting as of *[Month and Day]*, *[Year]*, based on *[Identify control criteria]*, and our report dated *[date]*, expressed *[Include nature of opinion]*.

Our examination was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States) and, accordingly, included examining, on a test basis, evidence supporting the XBRL-Related Documents. Our examination also included evaluating the XBRL-Related Documents for conformity with the applicable XBRL taxonomies and specifications and the content and format requirements of the Securities and Exchange Commission. We believe that our examination provides a reasonable basis for our opinion.

In our opinion, management's assertion referred to above is fairly stated, in all material respects, in conformity with *[Identify the criteria—for example, the taxonomy, such as "US GAAP—Commercial and Industrial Taxonomy," and where applicable, the Stand Alone Add-on Taxonomy such as "US Financial Reporting—Management Report Taxonomy," and the specifications, such as "XBRL Specifications (Version 2.1)"]].*

[Signature]

[City and State or Country]

[Date]

¹³ See the footnotes to the preceding report example.

.03 Staff Questions and Answers — Adjustments to Prior-Period Financial Statements Audited by a Predecessor Auditor, June 9, 2006

Summary

Staff questions and answers set forth the staff's opinions on issues related to the implementation of the standards of the Public Company Accounting Oversight Board ("PCAOB" or "Board"). The staff publishes questions and answers to help auditors implement, and the Board's staff administer, the Board's standards. The statements contained in the staff questions and answers are not rules of the Board, nor have they been approved by the Board.

The following staff questions and answers related to adjustments to prior-period financial statements audited by a predecessor auditor were prepared by the Office of the Chief Auditor. Additional questions should be directed to Greg Scates, Associate Chief Auditor (202/207-9114; scatesg@pcaobus.org) or Sam Guzman, Assistant Chief Auditor (202/207-9117; guzmans@pcaobus.org).

* * *

General

Q1. Circumstances arise that require a company to make adjustments to prior-period financial statements. Such circumstances include, for example, the reporting of discontinued operations, and the retrospective application of a change in accounting principle or the correction of an error in prior-period financial statements pursuant to Financial Accounting Standards Board Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections* ("FASB Statement 154").¹

If the prior-period financial statements that require adjustments were audited by a predecessor auditor, which auditor, the predecessor or the successor, may audit the adjustments to prior-period financial statements?²

A1. Either the successor auditor or the predecessor auditor may audit the adjustments made to prior-period financial statements so long as the auditor is independent and registered with the PCAOB. Issuers sometimes select the predecessor auditor to audit the adjustments because that auditor has performed the audit of the prior-period financial statements and has knowledge of the transactions that occurred during that period. In addition, the use of the predecessor auditor sometimes can be more cost-effective for performing this work. However, the successor auditor also may audit the adjustments.

Predecessor Auditor Audits the Adjustments to Prior-Period Financial Statements

Q2. If the predecessor auditor audits the adjustments to the prior-period financial statements, how should the predecessor auditor date his or her report on the reissued financial statements?

¹ Pursuant to Financial Accounting Standards Board Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections* ("FASB Statement 154"), the retrospective application of a change in accounting principle also is appropriate when there are no transition requirements specific to a particular accounting pronouncement.

² The term "adjustments to prior-period financial statements" should be understood for purposes of this set of questions and answers to include, among other things, the reporting of discontinued operations, as well as, restatements to correct errors and retrospective applications of changes in accounting principles, as described in FASB Statement 154.

A2. The predecessor auditor should dual-date his or her reissued report in connection with the audit of the adjustments made to the prior-period financial statements. Paragraph .73 of AU section (“sec.”) 508, *Reports on Audited Financial Statements*, states that, “A predecessor auditor’s knowledge of the current affairs of his or her former client is obviously limited in the absence of a continuing relationship. Consequently, when reissuing the report on prior-period financial statements, a predecessor auditor should use the date of his or her previous report to avoid any implication that he or she has examined any records, transactions, or events after that date. If the predecessor auditor revises the report or if the financial statements are restated, he or she should dual-date the report.”

Q3. If the predecessor auditor audits the adjustments made to the prior-period financial statements, what is the successor auditor’s responsibility with regard to those adjustments?

A3. If the predecessor auditor audits the adjustments made to the prior-period financial statements, he or she is responsible for the audit conclusions reached with respect to those adjustments. However, because corrections of errors and the retrospective application of a change in accounting often have the effect of changing the periods in which transactions and events are recognized in the financial statements, the successor auditor should obtain an understanding of the adjustments made to the prior-period financial statements and their effects, if any, on the current-period financial statements.³

In addition, the successor auditor should evaluate the consistency of the application of accounting principles from period to period. Paragraph .24 of AU sec. 420, *Consistency of Application of Generally Accepted Accounting Principles*, states:

When the independent auditor has not audited the financial statements of a company for the preceding year, he should adopt procedures that are practicable and reasonable in the circumstances to assure himself that the accounting principles employed are consistent between the current and the preceding year.

Successor Auditor Audits the Adjustments to Prior-Period Financial Statements

Q4. What factors are relevant to a successor auditor’s determination as to whether he or she is able to audit only the adjustments to prior-period financial statements or whether a reaudit of those financial statements is necessary?⁴

A4. To audit only the adjustments to prior-period financial statements that were audited by a predecessor auditor,⁵ a successor auditor must be able to form an opinion that the adjustments are appropriate and have been

³ See the requirement for the auditor to plan and perform his or her work with due professional care in paragraph .02 of AU section (“AU sec.”) 230, *Due Professional Care in the Performance of Work*.

⁴ This staff question and answer assumes that the predecessor auditor reissues his or her report on the prior-period financial statements before the effects of the adjustments.

⁵ This series of staff questions and answers assumes that the predecessor auditor has not ceased operations as the term “ceased operations” has been defined in footnote 2 of AU sec. 9508, *Reports on Audited Financial Statements: Auditing Interpretations of Section 508*. In cases in which the predecessor auditor has ceased operations, the successor auditor should refer to AU sec. 9508.60–.75.

properly applied.⁶ In determining whether he or she is able to form such an opinion without performing a reaudit of the prior-period financial statements, the successor auditor should consider:

- *The extent of the adjustments.* The less extensive and pervasive the adjustments to prior-period financial statements are, the more likely it is that a successor auditor can form an opinion that the adjustments are appropriate and have been properly applied without performing a reaudit of those financial statements. More extensive and pervasive adjustments make it more likely that a reaudit is necessary.
- *The reason for the adjustments.* A successor auditor is ordinarily more likely to be able to form an opinion that adjustments to prior-period financial statements are appropriate and have been properly applied when those adjustments are due to the retrospective application of an accounting principle rather than when the adjustments are necessary to correct an error.⁷ In the latter situation, the auditor should consider the risk that there may be other undetected misstatements in the prior-period financial statements. In particular, if the adjustments correct an intentional misstatement,⁸ it is more likely that a reaudit is necessary.
- *Cooperation of predecessor auditor.* A successor auditor is more likely to be able to form an opinion that adjustments to prior-period financial statements are appropriate and have been properly applied if he or she has the cooperation of the predecessor auditor. For example, a successor auditor may determine that he or she is able to audit adjustments to prior-period financial statements if he or she has access to the audit documentation relating to the prior periods and if the predecessor auditor is responsive to questions relating to those periods.

After a successor auditor has determined that he or she is likely to be able to form an opinion that adjustments to prior-period financial statements are appropriate and have been properly applied, the auditor might obtain evidence indicating, or otherwise might determine, that the prior-period financial statements are materially misstated in other respects. In this circumstance, the successor auditor should reevaluate whether auditing only the adjustments is appropriate or whether a reaudit of the prior-period financial statements is necessary.⁹

Q5. If the successor auditor audits adjustments to the prior-period financial statements audited by a predecessor auditor, how should the successor auditor report on the results of the audit of those adjustments?

A5. AU sec. 508.74 describes how a successor auditor should report when he or she audits adjustments and the predecessor auditor's report is not presented. The successor auditor may use a similar form of reporting if he or she has audited the adjustments made to prior-period financial statements in

⁶ See paragraph .74 of AU sec. 508, *Reports on Audited Financial Statements*.

⁷ FASB Statement 154 defines an error in previously issued financial statements as an error in recognition, measurement, presentation, or disclosure in financial statements resulting from mathematical mistakes, mistakes in the application of GAAP, or oversight or misuse of facts that existed at the time the financial statements were prepared. Errors, also referred to as misstatements, include those that are intentional or unintentional.

⁸ See paragraph .05 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

⁹ In addition, the successor auditor has responsibilities under paragraphs .21-.22 of AU sec. 315, *Communications Between Predecessor and Successor Auditors*, when the successor auditor becomes aware of information that leads him or her to believe that the prior-period financial statements reported on by the predecessor auditor may require revision.

connection with his or her audit of a subsequent period and if the predecessor auditor also reissues his or her report on the prior-period financial statements. It also is appropriate for the successor auditor to emphasize in the report that he or she was not engaged to audit, review, or apply any procedures to the prior-period financial statements other than with respect to the adjustments.

The following are examples of a paragraph the successor auditor may include in his or her report on the audit of the financial statements of a subsequent period:

Example for retrospective application of a change in accounting

We also have audited the adjustments to the 20X4 financial statements to retrospectively apply the change in accounting [*describe accounting change*], as described in Note X. In our opinion, such adjustments are appropriate and have been properly applied. We were not engaged to audit, review, or apply any procedures to the 20X4 financial statements of the Company other than with respect to the adjustments and, accordingly, we do not express an opinion or any other form of assurance on the 20X4 financial statements taken as a whole.

Example for correction of an error

We also have audited the adjustments described in Note X that were applied to restate the 20X4 financial statements to correct an error. In our opinion, such adjustments are appropriate and have been properly applied. We were not engaged to audit, review, or apply any procedures to the 20X4 financial statements of the Company other than with respect to the adjustments and, accordingly, we do not express an opinion or any other form of assurance on the 20X4 financial statements taken as a whole.

Q6. When a successor auditor audits and reports on adjustments made to prior-period financial statements due to the correction of an error, may the predecessor auditor reissue his or her report on the prior-period financial statements?

A6. Yes. A predecessor auditor may reissue his or her report on prior-period financial statements when a successor auditor has been engaged to audit and report on adjustments made to those prior-period financial statements, provided that the predecessor auditor has determined that the report on those financial statements is still appropriate, other than with respect to the error correction.¹⁰ When determining whether the report is still appropriate, the predecessor auditor may consider factors such as:

- The nature and extent of the adjustments pertaining to the error correction,
- Whether management has withdrawn the prior-period financial statements, and
- Whether the errors were intentional.

Q7. If the predecessor auditor does not reissue his or her report on the prior-period financial statements, may the successor auditor reaudit and report on those financial statements as adjusted?

A7. Yes. A successor auditor or another independent auditor may reaudit and report on prior-period financial statements as adjusted.

¹⁰ See AU sec. 508.71. The predecessor auditor also may decide to withdraw his or her report on those financial statements. See AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

Q8. In circumstances in which a successor auditor audits and reports on adjustments made to prior-period financial statements audited by a predecessor auditor, what procedures should the predecessor auditor perform prior to reissuing his or her report on those financial statements prior to adjustment?

A8. AU sec. 508.71 states that, “a predecessor auditor should (a) read the financial statements of the current period, (b) compare the prior-period financial statements that he or she reported on with the financial statements to be presented for comparative purposes, and (c) obtain representation letters from management of the former client and from the successor auditor. The representation letter from management of the former client should state (a) whether any information has come to management’s attention that would cause them to believe that any of the previous representations should be modified, and (b) whether any events have occurred subsequent to the balance-sheet date of the latest prior-period financial statements reported on by the predecessor auditor that would require adjustment to or disclosure in those financial statements [except for the adjustments]. The representation letter from the successor auditor should state whether the successor’s audit revealed any matters that, in the successor’s opinion, might have a material effect on, or require disclosure in, the financial statements reported on by the predecessor auditor [other than the adjustments disclosed to the predecessor auditor].”

Q9. In circumstances in which a successor auditor audits and reports on adjustments made to prior-period financial statements audited by a predecessor auditor, are there any modifications the predecessor auditor should make to his or her reissued report on the prior-period financial statements?

A9. Yes. If the predecessor auditor was not engaged to audit the adjustments to the prior-period financial statements, the predecessor auditor should modify his or her reissued report to indicate that (a) the reissued opinion relates to the prior-period financial statements before the effects of the adjustments, and (b) he or she was not engaged to audit, review, or apply any procedures to the adjustments.

The following are examples of how the predecessor auditor may modify his or her report:¹¹

Example for retrospective application of a change in accounting
Report of Independent Registered Public Accounting Firm

We have audited, before the effects of the adjustments to retrospectively apply the change in accounting described in Note X, the balance sheet of ABC Company as of December 31, 20X4, and the related statements of income, changes in shareholders’ equity, and cash flows for the year then ended (the 20X4 financial statements before the effects of the adjustments discussed in Note X are not presented herein). The 20X4 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.

[Same second paragraph as the standard report]

In our opinion, the 20X4 financial statements, before the effects of the adjustments to retrospectively apply the change in accounting described in Note X, present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X4, and the results of its operations and its

¹¹ See PCAOB staff question no. 6.

cash flows for the year then ended in conformity with U.S. generally accepted accounting principles.

We were not engaged to audit, review, or apply any procedures to the adjustments to retrospectively apply the change in accounting described in Note X and, accordingly, we do not express an opinion or any other form of assurance about whether such adjustments are appropriate and have been properly applied. Those adjustments were audited by [*name of successor auditor*].

[*Signature*]

[*City and State or Country*]

[*Original Date*]

Example for correction of an error

Report of Independent Registered Public Accounting Firm

We have audited, before the effects of the adjustments for the correction of the error described in Note X, the balance sheet of ABC Company as of December 31, 20X4, and the related statements of income, changes in shareholders' equity, and cash flows for the year then ended (the 20X4 financial statements before the effects of the adjustments discussed in Note X [*have been withdrawn and*] are not presented herein). The 20X4 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.

[*Same second paragraph as the standard report*]

In our opinion, except for the error described in Note X, the 20X4 financial statements present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X4, and the results of its operations and its cash flows for the year then ended in conformity with U.S. generally accepted accounting principles.

We were not engaged to audit, review, or apply any procedures to the adjustments for the correction of the error described in Note X and, accordingly, we do not express an opinion or any other form of assurance about whether such adjustments are appropriate and have been properly applied. Those adjustments were audited by [*name of successor auditor*].

[*Signature*]

[*City and State or Country*]

[*Original Date*]

Q10. When a successor auditor audits and reports on adjustments made to prior-period financial statements audited by a predecessor auditor, how should the predecessor auditor date his or her report on the reissued financial statements?

A10. When the successor auditor has audited and reported on the adjustments made to the prior-period financial statements and the predecessor auditor is reissuing the report on the prior-period financial statements, the predecessor auditor should use the date of the previous report to avoid any implication that he or she has examined any records, transactions, or events after that date.¹²

¹² See AU sec. 508.73.

Successor Auditor Has Not Completed an Audit

Q11. Can a successor auditor audit and report on the adjustments made to the prior-period financial statements if he or she has not yet completed an audit of the current-period financial statements?

A11. No. If the prior-period financial statements have been adjusted, the successor auditor may audit and report on the adjustments made to the prior-period financial statements in connection with the successor auditor's audit of the financial statements of the company for a subsequent period.¹³ Unless the successor auditor has completed an audit of the financial statements of the company, he or she will not have sufficient knowledge of the company and its financial reporting to adequately plan and perform an audit of the adjustments to conclude on whether they are appropriate and have been properly applied. If the successor auditor has not completed an audit of a subsequent period, the successor auditor, or another independent auditor, may be engaged to reaudit the prior-period financial statements and audit the adjustments to those financial statements.

¹³ See AU sec. 508.74.

.04 Staff Questions and Answers — Auditing the Fair Value of Share Options Granted to Employees, October 17, 2006

Summary

Staff questions and answers set forth the staff's opinions on issues related to the implementation of the standards of the Public Company Accounting Oversight Board ("PCAOB" or "Board"). The staff publishes questions and answers to help auditors implement, and the Board's staff administer, the Board's standards. The statements contained in the staff questions and answers are not rules of the Board, nor have they been approved by the Board.

The following staff questions and answers are applicable to audits of financial statements in circumstances in which a company has granted share options to employees that must be accounted for as compensation cost in conformity with Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, issued by the Financial Accounting Standards Board. These staff questions and answers were prepared by the Office of the Chief Auditor. Additional questions should be directed to Greg Fletcher, Assistant Chief Auditor (202/207-9203; fletchergr@pcaobus.org) or Jennifer Rand, Deputy Chief Auditor (202/207-9206; randj@pcaobus.org).

* * *

General

Q1. What is the purpose of these PCAOB staff questions and answers about auditing the fair value of employee share options?

A1. The purpose of these questions and answers is to help auditors implement the PCAOB's existing auditing standards when auditing the fair value of share options granted to employees. The Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 123, *Share-Based Payment* (revised 2004) ("FAS 123R"), which established the accounting requirements for companies that grant share options to employees and generally required that companies recognize as compensation cost the grant-date fair value of the award. In addition, the SEC staff issued Staff Accounting Bulletin 107 ("SAB 107") in March 2005, which, among other things, provides the Securities and Exchange Commission ("SEC") staff's views regarding the valuation of share-based payment arrangements for public companies. Based on these developments, the PCAOB staff believes that there is a need for guidance for implementing the existing auditing standards related to a company's accounting for the fair value of employee share options.¹

Q2. Which auditing standards of the PCAOB provide direction on auditing the fair value of employee share options and what are the general steps involved in auditing them?

¹ This series of PCAOB staff questions and answers addresses the principles and procedures related to auditing the grant-date fair value of employee share options, which is a component of compensation cost associated with the issuance of employee share options. It does not address auditing the other components of determining and reporting compensation cost in the financial statements. Other components include making adjustments for actual pre-vesting forfeitures to arrive at the compensation cost related to the share option grant; determining the periods in which compensation cost is recognized in the financial statements; determining related financial statement effects of employee share options to the company, such as income tax effects; and making the appropriate entries in the general ledger.

A2. Because employee share options are complex financial instruments with no available market, companies generally use option-pricing models to estimate the fair value. As such, these valuations are accounting estimates, and AU sec. 342, *Auditing Accounting Estimates*, and AU sec. 328, *Auditing Fair Value Measurements*, most directly apply. In addition, because fraudulent financial reporting often is accomplished through an intentional misstatement of an estimate, AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, also applies.²

In general, when auditing the fair value of employee share options, the auditor should:

- Obtain an understanding of the process used to develop the estimated fair value of employee share options;
- Assess the risk of misstatement related to the fair value of employee share options; and
- Perform testing on the company's estimated value of employee share options. Testing includes:
 - Evaluating the consistency of the process,
 - Evaluating the reasonableness of (1) the company's model and (2) the assumptions used in the model, such as expected term and expected volatility, and
 - Verifying the accuracy and completeness of the data underlying the fair value measurements.

The auditor also should evaluate whether he or she possesses the necessary skills and knowledge to plan and perform the audit procedures.

Each of these matters is addressed in the following PCAOB staff questions and answers

The Company's Process

Q3. How should the auditor evaluate the company's process for estimating the fair value of employee share option grants?

A3. AU sec. 328.09 requires the auditor to obtain an understanding of the company's process for determining fair value measurements and disclosures and of the relevant controls sufficient to develop an effective audit approach.³ AU sec. 328.23 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. AU sec. 328.23 also identifies three ways in which the auditor may test fair value measurements:

- Testing management's significant assumptions, the valuation model, and the underlying data,
- Developing independent fair value estimates for corroborative purposes, or

² The Board adopted as its interim standards generally accepted auditing standards as described in the AICPA Auditing Standards Board's Statement on Auditing Standards No. 95, *Generally Accepted Auditing Standards*, as in existence on April 16, 2003, to the extent not superseded or amended by the Board, on an initial transitional basis.

³ Paragraph .12 of AU sec. 328, *Auditing Fair Value Measurements and Disclosures*, also provides items that auditors should consider when obtaining an understanding of fair value measurements and disclosures.

- Reviewing subsequent events and transactions.⁴

Because of the complexity involved in developing an independent estimate and the limited usefulness of reviewing subsequent events and transactions to evaluate the fair value of employee share options, in many cases, the second and third approaches are not likely to be practical approaches to auditing the fair value of employee share options. In such cases, the auditor should test management's significant assumptions, the valuation model, and the underlying data related to the fair value estimate.

In applying the provisions of AU sec. 328 to the evaluation of the company's process for estimating the fair value of employee share option grants, the auditor should review the procedures used by the company to make the estimates. These procedures include:

- Evaluating how the terms of the share option awards affect the determination of the grant date, selection of model, and the assumptions used,⁵
- Selecting the option-pricing model;⁶ (See also PCAOB staff question Nos. 5 and 6.)
- Developing the assumptions used in the valuation, including implementation of the guidance in FAS 123R and SAB 107,⁷ that could affect the assumptions;⁸ (See also PCAOB staff question Nos. 7–18.)
- Ensuring that the data upon which the fair value measurements are based (including employee exercises and post-vesting cancellations and lapses) are accurate and complete;⁹ (See also PCAOB staff question No. 19.) and
- Generating the estimated fair value of the employee share options, including executing the calculations required in the option-pricing model.¹⁰ (See also PCAOB staff question No. 20.)

The auditor also should evaluate whether the process is complete, including whether the company considers the relevant factors identified in the accounting literature that affect the assumptions and whether the company applies the process consistently from period to period.¹¹

In addition, in auditing the financial statements, the auditor may determine that it is not practical or possible to restrict detection risk to an acceptable level by performing only substantive tests for one or more assertions. In such circumstances, the auditor should obtain evidence about the effectiveness of

⁴ Similarly, in evaluating the reasonableness of an estimate, paragraph .10 of AU sec. 342, *Auditing Accounting Estimates*, requires the auditor to review and test the process used by management to develop an estimate, develop an independent estimate to corroborate the reasonableness of the company's estimate, or review subsequent events or transactions occurring before the completion of fieldwork.

⁵ See Statement of Financial Accounting Standard No. 123, *Share-Based Payment* (revised 2004) ("FAS 123R"), paragraph A2.

⁶ See FAS 123R, paragraphs A13–A15.

⁷ See SEC Staff Accounting Bulletin 107, *Share-Based Payment* (March 29, 2005).

⁸ See FAS 123R, paragraph A16.

⁹ See AU sec. 328.39.

¹⁰ *Ibid.*

¹¹ AU sec. 328.19 states that the auditor should evaluate whether the company's method (in this case, the company's process) for determining fair value measurements is applied consistently and if so, whether the consistency is appropriate considering possible changes in the environment or circumstances affecting the company, or changes in accounting principles.

both the design and operation of controls to reduce the assessed level of control risk.^{12, 13}

Risk Factors

Q4. What factors affect the auditor's assessment of risk at the financial statement and significant account levels for fair value measurements related to employee share options?

A4. Accounts consisting of amounts derived from accounting estimates have a higher inherent risk than do accounts consisting of relatively routine factual data¹⁴ or having readily determinable values. Therefore, compensation cost based on fair value measurements of employee share options, and related disclosures, often will have a high inherent risk. The auditor should be aware of how changes in assumptions and models affect fair value.

The following are examples of circumstances or conditions that indicate increased risk and might indicate a risk of fraud that would require a specific response from the auditor:¹⁵

- When an assumption that a company uses has the effect of reducing the fair value below what it would have been had the company based the assumption on unadjusted historical information.
- Exclusion of an historical period of time from the inputs to the valuation model, especially when the effect of that exclusion is to lower expected term or expected volatility.¹⁶ (See also PCAOB staff question No. 14.)
- Adjustments to historical exercise behavior or historical share price volatility. For example:
 - The expected term estimate for the current grant of share options is five years when the company has averaged seven years in previous grants of share options;
 - The expected term or expected volatility estimate selected as the most likely was the lowest in a range of possible expected terms or expected volatilities; or
 - The expected term and expected volatility estimates are both lower than the historical averages.
- Adjustments to historical exercise behavior or historical share price volatility are not applied consistently to each option grant in circumstances in which they should have been consistently applied.

¹² See AU sec. 319.03.

¹³ In an integrated audit of the financial statements and internal control over financial reporting, the auditor must obtain evidence about the effectiveness of internal controls. This series of PCAOB staff questions and answers does not illustrate how the auditor should test the design and operating effectiveness of controls related to employee share option compensation cost and disclosures in an integrated audit.

¹⁴ See AU sec. 312.27a.

¹⁵ See AU sec. 316.48b.

¹⁶ See also SAB 107, interpretive response to question 2, Section D.1. SAB 107 states that valid exclusions of periods would be rare.

Model Selection

Q5. Observable market prices generally are not available for employee share options because employee share options are not traded. As a result, companies ordinarily will need to use an option-pricing model to estimate the fair value of employee share options. What factors should the auditor use to evaluate the reasonableness of a company's selection of an option-pricing model for calculating the fair value of employee share options?¹⁷

A5. The auditor should evaluate whether the model selected by the company

- Is applied in a manner consistent with FAS 123R's fair value measurement objective;
- Is based on established principles of financial economic theory; and
- Reflects all of the substantive characteristics of the share options granted to employees.¹⁸

The Black-Scholes-Merton formula, a closed-form option-pricing model, was developed for exchange-traded share options. As developed, it assumes that option exercises occur at the end of an option's contractual term, and that the other factors, expected volatility, expected dividends, and risk-free interest rates, are constant over the option's term. Because employees often exercise before the contractual term expires, FAS 123R requires companies to modify the term used as an input to the original formula by estimating an expected term for the employee share options that is less than the contractual term.

A lattice, or binomial, option-pricing model, however, can accommodate dynamic assumptions of expected volatility and dividends over the option's contractual term, and estimates of expected option exercise patterns during the contractual term (for example, the likelihood that an employee will exercise when the share price reaches a certain multiple of the exercise price). Therefore, the design of a lattice model might more fully reflect the substantive characteristics of a particular employee share option.¹⁹

The auditor should be alert to circumstances in which the selection of the Black-Scholes-Merton formula might not be appropriate. For example, the appropriate model for estimating the fair value of an instrument with a market condition (such as an exercise condition that is satisfied when the share price exceeds a specified value for a specified period of days) must take into account the effect of that market condition.²⁰ The Black-Scholes-Merton option-pricing formula would not generally be an appropriate valuation model for a share option in which the exercisability is conditional on a specified increase in the price of the underlying shares because it is not designed to take into account that type of market condition.²¹

Q6. What steps should the auditor take when a company changes the valuation technique or model chosen to value employee share options?

¹⁷ See FAS 123R, paragraph A2. The fair value of equity instrument share options granted to employees is measured on the date of the grant.

¹⁸ See FAS 123R, paragraph A8, AU sec. 328.18, and AU sec. 328.26b. In addition to the Black-Scholes-Merton formula and a lattice option-pricing model, a Monte Carlo simulation technique also satisfies the requirements in paragraph A8 of FAS 123R. See FAS 123R, footnote 48.

¹⁹ See FAS 123R, paragraph A15.

²⁰ See FAS 123R, paragraph A14.

²¹ See the interpretive response to question 2, section C of SAB 107.

A6. The auditor should evaluate whether the new technique or model meets the fair value measurement objective of FAS 123R. The SEC staff has stated that it would not object to a company changing its valuation technique or model, as long as the new technique or model meets the fair value measurement objective.²² SAB 107 states that a company should take into account the reason for the change in technique or model in determining whether it meets the fair value measurement objective.²³ However, the SEC staff also has stated that it would not expect that a company would frequently switch between valuation techniques or models, particularly when there has been no significant variation in the form of share-based payments being²⁴ As noted in SAB 107, changing a technique or model from period to period for the sole purpose of lowering the fair value estimate of a share option would not meet the fair value measurement objective of FAS 123R.²⁵ Finally, frequent changes in the valuation technique or model also might indicate a risk of fraud that would require a response by the auditor. Accordingly, the auditor should evaluate management's reason for the change.

Assumptions Used In Option-Pricing Models

Q7. Paragraph A18 of FAS 123R states that the valuation technique or model used to estimate the fair value of the share option shall take into account, at a minimum—

- Expected term of the option (in a lattice model, expected term is an output of the model);
- Expected volatility of the price of the underlying share for the expected term of the option;
- Exercise price of the option;
- Current price of the underlying share;
- Risk-free interest rate(s) for the expected term of the option; and
- Expected dividends of the underlying share for the expected term of the option.

How should the auditor assess the possible effect of these six items on the fair value measurement?

A7. The expected term and expected volatility assumptions have the highest risk because they involve the greatest amounts of judgment and have a significant effect on the estimated fair value. PCAOB staff question Nos. 8 through 11. provide direction to the auditor regarding expected term. PCAOB staff question Nos. 12 through 17 provide direction to the auditor regarding volatility.

The exercise price of the option and current price of the underlying shares have a significant effect on the fair value measurement and have a high degree of verifiability. The auditor should verify that the company has properly authorized the share option plan and test whether the company has properly authorized the specific terms of the award, correctly determined the grant date, and accurately entered the exercise price and current share price, as of the measurement date, into the valuation model.

²² See the interpretive response to question 3, section C of SAB 107.

²³ Ibid.

²⁴ Ibid.

²⁵ Ibid.

The risk-free interest rate(s) might have an elevated risk because a mathematical computation could be involved. The expected dividends assumption might have an elevated risk because of potential measurer bias. PCAOB staff question No. 18 provides direction to the auditor regarding risk-free interest rate(s) and expected dividends.

Expected Term of the Option

Q8. The expected term assumption is one of the key drivers of fair value in the Black-Scholes-Merton formula.²⁶ Paragraph A23 of FAS 123R states that assumptions used to estimate the fair value of share options granted to employees should be determined in a consistent manner from period to period. How should the auditor evaluate the reasonableness of the expected term assumption?

A8. When a company is using the Black-Scholes-Merton option-pricing formula, the auditor should apply the following procedures to the expected term assumption:²⁷

- Obtain an understanding of the company's process for estimating expected term, including the extent to which the company evaluates relevant factors in the accounting literature;²⁸
- Verify that the expected term generally is at least equal to the vesting period of the share option grant;²⁹
- Verify that the company (1) has taken into account the contractual term of the option and the effects of employees' post-vesting employment termination behavior, in addition to employees' expected exercise behavior, and (2) has not taken into account pre-vesting employee termination behavior;³⁰
- Evaluate whether adjustments that the company has made to the historical exercise behavior are reasonable and supportable,³¹ including adjustments to the historical exercise behavior of groups (See also PCAOB staff question No. 11); and
- Test the data that the company uses for its estimate, such as data on actual exercise behavior (See also PCAOB staff question No. 19).

The auditor also should evaluate whether the person or persons determining the expected term assumption, including the company's specialists, have experience in valuing employee share options³² and assess how that evaluation affects the audit procedures.

²⁶ Expected term usually is an output of lattice models.

²⁷ See PCAOB staff question No. 10 for a discussion about the "simplified method." If a company's share option plan has the characteristics that are sometimes referred to as "plain vanilla," it may use the simplified method for estimating expected term, as found in SAB 107. However, the SEC staff has stated that it does not expect the simplified method to be used for share option grants after December 31, 2007.

²⁸ For example, see FAS 123R, paragraphs A26–A30.

²⁹ See FAS 123R, paragraph 42. Some awards have graded vesting schedules. These may be accounted for as in-substance multiple awards.

³⁰ Paragraphs A27 and A28 of FAS 123R describe factors that may affect expectations about employees' exercise behavior.

³¹ See FAS 123R, footnote 50.

³² See AU sec. 328.12.

Q9. What should the auditor do to test a company's calculation of its historical exercise experience for employee share options, including consideration of the contractual term and post-vesting employee behavior?

A9. Paragraph A21 of FAS 123R states that historical experience generally is the starting point for developing expectations about the future. Because the expected term estimate is the period of time for which the option is expected to be outstanding (that is, generally the period of time from the grant date to the date of expected exercise or other expected settlement), companies may start by calculating a historical weighted average period of time for which previous grants of share options were outstanding.

The auditor should verify that a company's calculations include options that were not exercised during the contractual term. Failure to include such options could significantly understate average time that options were outstanding. For example, if a company calculates historical exercise behavior based only on the 70 percent of the options exercised over a 10 year contractual term, then it will probably significantly understate the average by not considering the 30 percent of options that may have been outstanding for 10 years and never exercised.

The auditor should:

- Evaluate whether the company's calculations are complete; i.e., that the calculations include all vested options, including those that were never exercised;
- Evaluate whether the company's calculations are mathematically correct, including any separate calculations for groups of employees (See also PCAOB staff question No. 11); and
- Test the underlying data upon which the company's calculations are based, for example, the grant date and exercise date (See also PCAOB staff question No. 19).

The auditor also should be aware of situations in which historical information is not sufficiently complete to enable a company to use it as the sole basis for estimating expected term. For example, if a company issues employee share options for the first time in 20X4 with a three-year vesting period and a ten-year contractual term, it cannot use its unadjusted historical experience in estimating the expected term of additional grants in 20X8 because there will have been only one year in which the earlier grants could have been exercised. The earliest it will have a complete history is at the end of the ten-year contractual term.

In situations in which the company calculated the historical exercise behavior based on incomplete historical information, the auditor should evaluate whether the company's rationale for using this calculation in connection with an estimate of expected term is reasonable and supportable.

Q10. FAS 123R states that expectations based on historical experience should be modified to reflect ways in which currently available information indicates that the future is reasonably expected to differ from the past.³³ What procedures should the auditor perform to evaluate the reasonableness of adjustments to historical exercise behavior?

A10. The auditor should evaluate whether the company's rationale for adjustments to historical exercise behavior are reasonable and supportable.³⁴ The auditor also should evaluate whether the company failed to make a

³³ See FAS 123R, paragraph A21.

³⁴ AU sec. 328 provides general guidance about evaluating a company's assumptions.

necessary adjustment. For example, if the historical experience is based on grants with one-year vesting, an adjustment would be appropriate if current grants have four-year vesting. The volatility of the company's stock price also can affect whether vested employees (1) exercise the options, (2) terminate from the company and exercise the options, (3) terminate from the company and let the options lapse, or (4) stay with the company through the contractual term and let the options lapse. Announced plans for acquisitions, divestitures, and initial public offerings of stock also could affect employee exercises and forfeitures.

The auditor should evaluate whether the amount of an adjustment is reasonable by reviewing the support for the adjustment. The auditor also should be alert to the risk of management override in the adjustments.

Range of expected terms. If a company, after analyzing its historical data, developed a range of possible expected terms that are each equally likely, the auditor should verify that the company selected the average of the amounts in the range (the expected value according to paragraph A20 of FAS 123R).

Use of SAB 107 "simplified method." According to SAB 107, the simplified method of estimating expected term is permitted only for "plain vanilla" options.³⁵ If a company uses the simplified method, the auditor should review the evidence that supports the company's view that it is eligible to use the simplified method. Specifically, the auditor should review the grant documentation to ensure that the terms conform to the "plain-vanilla" requirements, review pre-vesting terminations to ensure that the associated share options were cancelled, and test whether exercises by terminated employees occurred within a limited time after termination (typically 30 to 90 days).

Q11. According to FAS 123R, aggregating individual awards into relatively homogenous groups, with respect to exercise and post-vesting employment termination behaviors, and estimating the fair value of the options granted to each group separately, reduces the risk of potential misstatement of the value of the award.³⁶ How should the auditor evaluate the appropriateness of groups of employees used in the estimate of expected term?

A11. If the company segregates the employees into more than one group (such as executives and non-executives), the auditor should perform the following procedures to evaluate the company's employee groups:

- Evaluate whether the company aggregated individual awards into relatively homogeneous groups with respect to exercise and post-vesting employment termination behaviors and the evidence and rationale supporting the determination of the groups is adequate;
- Evaluate the reasonableness and completeness of groups;
- Evaluate the reasonableness and support for adjustments to historical exercise behavior of groups;

³⁵ The interpretative response to question 5, section D.2 of SAB 107, establishes basic characteristics of share option plans that are sometimes referred to as "plain vanilla." The basic characteristics are: (1) share options are granted at-the-money, (2) exercisability is conditional only on performing service through the vesting date, (3) if an employee terminates service prior to vesting, the employee would forfeit the share options, (4) if an employee terminates service after vesting, the employee would have a limited time to exercise the share options (typically 30 to 90 days), and (5) share options are nontransferable and nonhedgeable. In addition, the SEC staff has stated that it does not expect the simplified method to be used for share option grants after December 31, 2007 (See the interpretative response to question 6, section D.2.).

³⁶ See FAS 123R, paragraph A30. In addition, the interpretive response to Question 4 of section D.2. of SAB 107 states that an entity may generally make a reasonable fair value estimate with as few as one or two groupings.

- Test the underlying data upon which the groups are based (See also PCAOB staff question No. 19); and
- Evaluate whether the company's calculations of historical exercise behavior for each group are mathematically correct.

Expected Volatility

Q12. Paragraph A23 of FAS 123R states that assumptions used to estimate the fair value of share options granted to employees should be determined in a consistent manner from period to period. Paragraphs A32 and A34 provide further guidance related to the company's estimate of expected volatility. How should the auditor evaluate the reasonableness of a company's estimate of the expected volatility of its share price?

A12. The auditor should perform the following procedures to evaluate the reasonableness of a company's estimate of expected volatility:³⁷

- Obtain an understanding of the company's process for estimating expected volatility.
- Evaluate whether the company's process considers all of the applicable factors identified in paragraph A32 of FAS 123R in determining its estimate of expected volatility. The auditor also should evaluate whether the process (1) identifies the information necessary to be able to consider the volatility factors and (2) evaluates and weights that information (as required by paragraph A34 of FAS 123R).
- Evaluate the reasonableness of the assumptions, supporting information, judgments, and weightings. Evidence of reasonableness includes whether the company considered all the volatility factors and how such factors might affect the company's estimate of expected volatility. The auditor also should be alert to the risk of management override of the company's process for estimating expected volatility.
- Evaluate the consistency of the company's process for estimating expected volatility from period to period in evaluating the company's compliance with paragraphs A32 and A34 of FAS 123R.³⁸ However, the auditor also should consider that when circumstances indicate the availability of new or different information which would be useful in estimating expected volatility, SAB 107 directs the company to incorporate that information.³⁹
- In general, for historical volatility, verify that the company's process provides for looking back over the expected term (for a closed-form model) or contractual term (for a lattice model)⁴⁰ to consider the extent to which currently available information indicates that future volatility will differ from historical volatility.⁴¹ A change in a company's business model that results in a material alteration to the company's

³⁷ AU secs. 342 and 328 provide general guidance for reviewing a company's process and evaluating its assumptions.

³⁸ The interpretative response to question 1, section D.1. of SAB 107 states that the process used to gather and review available information to estimate expected volatility should be applied consistently from period to period.

³⁹ Ibid.

⁴⁰ See FAS 123R, paragraph A32a.

⁴¹ See FAS 123R, paragraph A34.

risk profile is an example of a circumstance in which the company's future volatility would be expected to differ from its past volatility.⁴²

- Test the underlying data used in the estimate (See also PCAOB staff question No. 19).

The auditor also should evaluate whether the person or persons determining the expected volatility assumption, including the company's specialists, have experience in valuing employee share options,⁴³ and assess how that evaluation affects the audit procedures.

Historical Volatility

Q13. How should the auditor evaluate the reasonableness of a company's estimate of expected volatility when it uses its historical volatility as its expected volatility?

A13. As discussed in the answer to PCAOB staff question No. 12, the auditor should evaluate whether the company's process provides for looking backward to determine whether currently available information indicates that expected volatility will differ from historical volatility. The auditor should evaluate whether there is other information that the company did not consider and such information indicates that expected volatility will differ from the past. The auditor could base this evaluation on publicly available information related to the company's corporate history and future plans, and knowledge of the industry. In addition, an indication of the reasonableness of the company's process will be the extent to which the company analyzes each factor with respect to its own facts and circumstances.

Additionally, the auditor should consider the criteria established by SAB 107 for exclusive reliance on historical volatility. The SEC staff has stated that it would not object to a public company placing exclusive reliance on historical volatility when the following factors are present, and the methodology is consistently applied, if the company's common shares have been publicly traded for a sufficient period of time:⁴⁴

- The company has no reason to believe that its future volatility over the expected or contractual term, as applicable, is likely to differ from its past;
- The computation of historical volatility uses a simple average calculation method;
- A sequential period of historical data at least equal to the expected or contractual term of the share option, as applicable, is used; and
- A reasonably sufficient number of price observations are used, measured at a consistent point throughout the applicable historical period.

The auditor also should verify that the company has properly calculated the historical volatility.

If a company makes adjustments to historical volatility based on peer company data, the auditor should evaluate the reasonableness of the company's decision to use peer company data. In addition, the auditor should evaluate whether the company is using an appropriate peer group, the company is reasonably comparable to the peer group, and management reasonably blended peer group

⁴² See SAB 107, footnote 55.

⁴³ See AU sec. 328.12.

⁴⁴ See SAB 107, section D.1., "Company B" example.

data and its own company data. The auditor also should be alert to the risk of management override in the area of adjustments to historical volatility.

Q14. FAS 123R indicates that a company should consider historical volatility over a period generally commensurate with the expected term or contractual term, as applicable. How should the auditor evaluate whether a company, in determining its expected volatility, has considered the historical volatility of its share price over an appropriate period of time?

A14. The auditor should evaluate whether the company considered the volatility of its share price over the most recent period that is generally commensurate with the expected term (or contractual term if a lattice model is used). For example, if a company estimated that the expected term of the options is four years, then the company generally should start with its historical volatility for the most recent four-year period in determining the expected volatility.

The following are circumstances that indicate increased inherent risk and might also indicate increased risk of fraud.

- The company used a period of historical data that is longer than the expected term,⁴⁵ and the effect is to lower expected volatility and the resulting fair value, or the company did not consistently use the longer period. Using a period of historical data longer than expected or contractual term is acceptable under SAB 107 if the company reasonably believes that the additional historical information will improve the estimate. However, this situation is similar to the condition described in PCAOB staff question No. 4, in which an adjustment to historical exercise behavior or share price volatility that results in a lower expected term or expected volatility increases inherent risk and might indicate a heightened risk of fraud.
- The company used a method that weights the most recent periods of a company's historical volatility more heavily than earlier periods, especially if the result is a lowering of expected volatility.⁴⁶
- The company excludes a period of time from the calculation of historical volatility, especially if doing so results in a decrease of expected volatility, and hence a decrease in fair value.⁴⁷

Q15. How should the auditor evaluate the company's share price observations for the purpose of determining historical volatility?

A15. The auditor should evaluate whether the company used actual observed prices within intervals that were appropriate based on the facts and circumstances and that provide a basis for a reasonable estimate. For example,

⁴⁵ See the interpretative response to question 2, section D.1 of SAB 107. SAB 107 also points out that paragraph A32a of FAS 123R indicates companies should consider historical volatility over a period generally commensurate with expected or contractual term.

⁴⁶ See SAB 107, interpretative response to question 2, section D.1, including footnote 40. SAB 107 states that such weighting may not be appropriate for longer term employee share options and that an estimate of expected volatility that places "extreme emphasis on the most recent periods" may not be consistent with paragraph A32(a) of FAS 123R.

⁴⁷ See SAB 107, interpretative response to question 2, section D.1. SAB 107 states that if a company disregards a period of historical volatility, it should be prepared to support its conclusion that its historical share price during that previous period is not relevant to estimating expected volatility due to one or more discrete and specific historical events and that similar events are not expected to occur during the expected term of the share option. SAB 107 states that these situations would be rare.

if a company's shares are thinly traded, then weekly or monthly price observations may be more appropriate than daily price observations.⁴⁸ The auditor also should verify that the price observations are taken consistently throughout the period and are consistent with the approach used in prior grants. For example, if a company uses weekly price observations, then the auditor should verify that the company made the observation on the same day of each week. In addition, if the company changes when it makes price observations, for example, from daily price observations to monthly, the auditor should evaluate the reasonableness of the company's rationale for the change.

Implied Volatility

Q16. Implied volatility is inferred by calculating volatility using an option-pricing model (typically Black-Scholes-Merton), where the fair value—the market price of a company's appropriate traded financial instruments—and other variables are known (i.e., share price, exercise price, expected term, risk-free rate, and expected dividends). How should the auditor evaluate a company's use of implied volatility in its estimate of expected volatility?

A16. SAB 107 provides items for a company to consider when using implied volatility. Accordingly, in such situations, the auditor should evaluate whether a company with "appropriate traded financial instruments from which they can derive an implied volatility"⁴⁹ has appropriately taken into account implied volatility in determining the estimate of expected volatility.

For companies with exchange-traded options, or other appropriate traded financial instruments,⁵⁰ the auditor should evaluate whether the company's process for estimating expected volatility is appropriate and consistent from period to period.⁵¹ A company that considers implied volatility will probably do so as part of its overall process for estimating expected volatility. Therefore, the auditor also should consider the concepts described in PCAOB staff question Nos. 3 and 12.

Regarding exclusive reliance on implied volatility, the SEC staff has stated that it would not object to a public company placing exclusive reliance on implied volatility when certain factors are present and the methodology is consistently applied, if the company's common shares have been publicly traded for a sufficient period of time and the company has multiple options on its shares outstanding that are traded on an exchange.⁵²

If the company places exclusive reliance on implied volatility based on its assessment that the factors in SAB 107 are present, the auditor should evaluate that assessment. In addition, the auditor should verify that the company has properly calculated the implied volatility.

Combined Volatility

Q17. How should the auditor evaluate the reasonableness of a company's estimate of expected volatility when it uses a combination of historical and implied volatility in that estimate?

⁴⁸ See SAB 107, footnote 42.

⁴⁹ See SAB 107, interpretative response to question 1, section D.1.

⁵⁰ Ibid. Under SAB 107, appropriate traded financial instruments could include actively traded options or financial instruments with embedded options.

⁵¹ See SAB 107, interpretative responses to question 3, section D.1, regarding the use of implied volatility.

⁵² See SAB 107, section D.1., Company B example, and interpretative response to question 4, section D.1.

A17. The auditor should verify that the company's process for estimating expected volatility includes consideration of the applicable factors for using historical or implied volatility, as discussed in FAS 123R and SAB 107. PCAOB staff question Nos. 13 through 16 provide guidance for the auditor to use when evaluating the company's use of historical volatility, including the effects of any adjustments, and implied volatility in its estimate of expected volatility. In considering the reasonableness of the combined expected volatility, the auditor should evaluate the company's consideration of the factors that affect volatility, including the SEC staff's factors for exclusive use of implied or historical volatility, and the company's support for its conclusions. The factors outlined in SAB 107 for a company's exclusive use of either historical volatility or implied volatility also may provide some relative benchmarks for the auditor to use in evaluating the combined volatility.

Risk-Free Interest Rate(s) and Expected Dividends

Q18. FAS 123R requires that the valuation method, such as the Black-Scholes-Merton formula or lattice models, consider the expected dividends of the underlying shares for the expected term and the risk-free interest rate(s) for the expected term. How should the auditor evaluate whether the company has properly considered these two elements?

A18. The risk-free interest rate(s) and the expected dividends assumption generally are less subjective than the expected term and volatility assumptions and also do not have as significant an effect on the estimate of fair value. However, the auditor still should evaluate the reasonableness of those assumptions.

Risk-free interest rate. In general, the risk-free rate is the yield on a zero-coupon U.S. Treasury bond with a remaining term equal to the option term. A higher risk-free interest rate increases the option value and hence the estimated fair value, all other factors being equal.

If the company uses the Black-Scholes-Merton formula, the auditor should verify that the company used a traded zero-coupon U.S. Treasury bond with a remaining term equal to the expected term, measured on the grant date. The auditor also should verify that the company properly calculated the yield based on the traded price. If the company interpolated a yield because the expected term fell within the remaining terms of two bonds, the auditor should evaluate the accuracy of the interpolation.

If a company's lattice model incorporates a term structure of expected volatilities, the company might use a yield curve for the contractual period. If the company's lattice model uses a yield curve, the auditor should verify that the company properly calculated the yield curve and accurately entered the yields into the lattice model.

Expected dividends. The dividend yield over the option term affects the option value because it reduces the stock price on the ex-dividend date. In general, higher expected dividends decrease the value of the option and hence the estimated fair value. The auditor should:

- Evaluate whether the company has the intent and ability to pay the dividends that are embodied in the expected dividend assumption.

Sufficient cash and observable trends provide evidence of the company's intent and ability to pay dividends.⁵³

- If the company has adjusted its current or historic dividend yield, evaluate the reasonableness of and support for the expected dividend yield. The auditor should evaluate whether the expected dividend yield is consistent with management's plans and information available to market participants by reviewing evidence such as press releases on dividend policy changes and historical dividend yield rates. This evaluation should include whether the company failed to make an adjustment to expected dividends.
- Test the underlying data (See also PCAOB staff question No. 19).

Validation of Data and the Option-Pricing Model

Q19. How should the auditor test the underlying data that supports a company's estimate of fair value, and the related entries?

A19. Pursuant to AU sec. 328.39, the auditor should test the data used to develop the fair value measurements and evaluate whether the fair value measurements have been properly determined from such data and management's assumptions. This includes evaluating whether the data on which the fair value measurements are based, including the data used in the work of a specialist, are accurate, complete, and relevant; and whether fair value measurements have been properly determined using such data and management's assumptions. In considering the controls over data pursuant to AU sec. 328.12, the auditor should consider the effectiveness of the design of controls intended to safeguard the integrity and reliability of the data.

A number of systems, which can be automated or manual, often provide data relevant to the estimate of fair value. The auditor should identify the automated or manual systems that might be subject to testing. Record-keeping systems for stock plan information and awards are usually critical because information about forfeitures and exercises supports the company's estimate of expected term. Payroll, human resources, and tax systems also could be critical if they contain information about awards, forfeitures, and exercises that is used in the estimation process.⁵⁴

The auditor also should establish that any data used that resides outside the company are reliable, such as peer group data. AU sec. 329.16 provides guidance for evaluating the reliability of such data.

Q20. How should the auditor evaluate whether the model has appropriately calculated the fair value estimate for share options?

A20. If the company is using the Black-Scholes-Merton formula, the auditor should verify that the company is using the correct formula and recalculate the fair value. If the company is using a lattice option-pricing model, the auditor should obtain evidence that the model is functioning properly.

⁵³ AU sec. 328.17 states that the auditor should evaluate management's intent to carry out specific courses of action where intent is relevant to the use of fair value measurement and that the auditor also should evaluate management's ability to carry out those courses of action.

⁵⁴ See AU sec. 328.12. When obtaining an understanding of the company's process for determining fair value measurements and disclosures, the auditor should consider the extent to which the company relies on a service organization to provide data that supports the measurement. When a company uses a service organization, the auditor should consider the requirements of AU sec. 324, *Service Organizations*.

Role of Specialists

Q21. What is the role of a specialist in auditing estimates of the fair value of employee share option grants?

A21. AU sec. 328 provides guidance on auditing fair value measurements and disclosures, including auditing the fair value of employee share option grants. According to AU 328.12, as part of obtaining an understanding of the process management uses to determine fair value, such as the fair value of employee share option grants, the auditor should consider the extent to which management engages or employs specialists.

When testing fair value measurements and disclosures, the auditor should, among other things, perform procedures to evaluate whether management's assumptions are reasonable and to evaluate the source and reliability of evidence supporting management's assumptions.⁵⁵ According to AU sec. 328.05, footnote 2, management's assumptions include any assumptions developed by a specialist engaged or employed by management. Thus, the auditor should perform procedures in accordance with AU sec. 328 to evaluate the assumptions developed by a specialist engaged or employed by management.

Pursuant to AU sec. 328.20, the auditor should consider whether to engage a specialist and use the work of that specialist as evidential matter in performing substantive tests to evaluate material financial statement assertions related to the fair value of employee share option grants. In making this decision, the auditor⁵⁶ should evaluate whether he or she has the necessary skill and knowledge to plan and perform audit procedures related to the fair value of employee share option grants, including the reasonableness of the assumptions that the company or its specialist used.

The following circumstances related to the company's fair value measurement under FAS 123R often are particularly complex, involve assumptions that have a significant effect on fair value and, thus, might result in a higher assessment of risk by the auditor. Accordingly, the auditor should evaluate whether he or she has the necessary skill and knowledge to plan and perform audit procedures in these areas.

- Use of a lattice model, including obtaining evidence that the model is functioning properly. (See PCAOB staff questions No. 5, 18, and 20.)
- Exclusion of periods of historical data. (See PCAOB staff questions No. 4 and 14.)
- Adjustments to historical exercise behavior or historical share price volatility that result in shorter expected term or lower expected volatility than the company's historical experience. (See PCAOB staff questions No. 4, 10, and 14.)
- Use of a method that weights the most recent periods of a company's historical volatility more heavily than earlier periods, especially if the result is a lowering of expected volatility. (See PCAOB staff question No. 14.)
- Use of combined volatility. (See PCAOB staff question No. 17.)

⁵⁵ See AU secs. 328.26a and 328.31.

⁵⁶ In this context, the term *auditor* includes employees of the auditor's firm who possess relevant special skill or knowledge and who participate in the audit as a member of the audit team.

Q22. What should the auditor do to satisfy the requirement that he or she evaluate the qualifications of a specialist?

A22. Valuation specialists may have certain areas of experience. When evaluating the qualifications of a specialist in accordance with AU sec. 336.08,⁵⁷ the auditor should evaluate whether the specialist has experience in valuing employee share options. In doing this, the auditor should evaluate the experience of the specialist's firm and of the individual specialist, or specialists, performing the service.

⁵⁷ Pursuant to AU sec. 336.08a and b, the auditor should also consider the specialist's certification, license, or other recognition of competence and the specialist's reputation.

.05 Staff Questions and Answers — Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees, April 3, 2007

Summary

Staff questions and answers set forth the staff's opinions on issues related to the implementation of the standards of the Public Company Accounting Oversight Board ("PCAOB" or "Board"). The staff publishes questions and answers to help auditors implement, and the Board's staff administer, the Board's standards. The statements contained in the staff questions and answers are not rules of the Board, nor have they been approved by the Board.

The following staff questions and answers related to ethics and independence rules concerning independence, tax services, and contingent fees were prepared by the Office of the Chief Auditor. Questions should be directed to Bella Rivshin, Associate Chief Auditor (202/207-9180; rivshinb@pcaobus.org) or Greg Scates, Associate Chief Auditor (202/207-9114; scatesg@pcaobus.org).

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Rule 3522. Tax Transactions

Q1. Does Rule 3522(a), Confidential Transactions, apply when conditions of confidentiality are imposed by tax advisors who are not employed by or affiliated with the registered public accounting firm?

A1. Yes. Under Rule 3522(a), a registered public accounting firm is not independent of its audit client if the firm, or any affiliate of the firm, during the audit and professional engagement period, provides any non-audit service to the client related to marketing, planning, or opining in favor of the tax treatment of a confidential transaction. Under Rule 3501(c)(i)(1), a confidential transaction is a transaction that is offered to a taxpayer under conditions of confidentiality and for which the taxpayer has paid an advisor a fee. As stated in the Board's adopting release, PCAOB Release 2004-015 (July 26, 2005), "Rule 3501(c) defines confidential transactions in terms of confidentiality restrictions imposed by tax advisors generally, not specifically auditors." Therefore, Rule 3522(a) applies not only when conditions of confidentiality have been imposed by a tax advisor that is employed by or affiliated with the registered public accounting firm, but also when conditions of confidentiality have been imposed by any tax advisor, including one that has no relationship with the registered public accounting firm.

Q2. For purposes of Rule 3522(a), Confidential Transactions, can a registered public accounting firm, when marketing, planning, or opining in favor of the tax treatment of a transaction, rely on representations from its audit client that another tax advisor did not impose conditions of confidentiality in connection with the specific tax transaction?

A2. Yes. In determining if any tax advisor imposed conditions of confidentiality in connection with a specific tax transaction, the registered public accounting firm may rely on representations from its audit client, provided that the firm does not know, or have reason to know, that those representations are incorrect or incomplete.

Q3. In planning a tax transaction, may a registered public accounting firm advise an audit client on the tax consequences of alternative ways of structuring the transaction?

A3. Yes, as long as the auditor does not recommend an alternative tax transaction structure: (1) that is not more likely than not to be allowable under applicable tax laws, and (2) a significant purpose of which is tax avoidance. Rule 3522(b) provides that a registered public accounting firm is not independent of the audit client if the firm, or any affiliate of the firm, provides an audit client any non-audit service related to marketing, planning, or opining in favor of the tax treatment of a transaction that was initially recommended by the 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. In planning a tax transaction for an audit client that is permitted under Rule 3522(b), the firm may need or want to inform the client about the tax consequences of alternative tax transaction structures, some of which may not be more likely than not to be allowable and have a significant purpose of tax avoidance. As long as the firm does not recommend that the audit client engage in such a transaction, the firm will not violate Rule 3522(b).

Q4. How is a registered public accounting firm's independence affected by the Internal Revenue Service's ("IRS") subsequent listing of a transaction that the firm marketed, planned, or opined in favor of, as described in Rule 3522(b), Aggressive Tax Position Transactions?

A4. The listing by the IRS of a transaction after the firm marketed, planned, or opined in favor of the tax treatment of the transaction would not retroactively affect the firm's independence. Whether the firm was independent when it planned, marketed, or opined in favor of the transaction would instead depend on the facts available at that time. An analysis under Rule 3522 would consider, among other things, whether the tax treatment of the transaction was, at the relevant time, at least more likely than not to be allowable under applicable tax laws, including whether the transaction was itself listed or substantially similar to a listed transaction.

After a transaction marketed, planned or opined on by the firm becomes listed, however, the firm's independence may, depending on the circumstances, become impaired. For example, even if a firm was independent at the time the tax transaction was executed, because it reasonably and correctly concluded the transaction was not the same as, or substantially similar to, a listed transaction, once a transaction is actually listed (or a substantially similar transaction becomes listed), the firm that participated in the transaction may find its independence impaired. In this situation, a mutuality of interest could be created by the fact that once a transaction is listed, the firm or client, or both, may be required to defend the tax treatment of the transaction and, in some cases, pay penalties. When a tax transaction in which the firm participated is subsequently listed (or is substantially similar to a transaction that is subsequently listed) by the IRS, the firm should evaluate the potential effect on its independence and discuss it, as appropriate, with the audit client's audit committee.

Rule 3523. Tax Services for Persons in Financial Reporting Oversight Roles

Q5. Rule 3523 restricts the provision of tax services to a person in a Financial Reporting Oversight Role (“FROR”) at an audit client or an immediate family member of such person. FROR is defined under both SEC and PCAOB rules as a role in which a person is in a position to or does exercise influence over the contents of the financial statements or anyone who prepares them. For purposes of Rule 3522, must the auditor evaluate whether persons are in a FROR at any entities other than the one being audited?

A5. Yes. Auditors must evaluate whether a person is in a FROR at an “audit client.” Because Rule 3501(a)(iv) defines “audit client” to include “any affiliates of the audit client,” a person in a financial reporting oversight role at an affiliate of the audit client (and that person’s immediate family members) are covered by Rule 3523, subject to two important exceptions. First, a firm’s independence is not impaired under Rule 3523 if it provides tax services to a person who is in a financial reporting oversight role at the audit client (or an immediate family member of such a person) only because of the person’s relationship to an affiliate whose financial statements are not material to the consolidated financial statements of the entity being audited. See Rule 3523(b)(1). Second, a firm’s independence is not impaired under the rule if it provides tax services to a person who is in a financial reporting oversight role at the audit client (or an immediate family member of such a person) only because of the person’s relationship to an affiliate whose financial statements are audited by an auditor other than the firm. See Rule 3523(b)(2).

Q6. What types of situations does the term “other change in employment event” in Rule 3523(c) encompass?

A6. Rule 3523(c) provides a time-limited exception to Rule 3523’s restrictions on the provision of tax services to persons in financial reporting oversight roles at an audit client and certain of its affiliates. The exception applies when, among other things, a person becomes subject to the rule through a hiring, promotion, or “other change in employment event.” Whether there has been an “other change in employment event” depends on the changed status of a person at an audit client. A change experienced by a company, such as a change in auditor or a change from a private company to a public one, is not, by itself, an “other change in employment event.”

Some changes experienced by a company could, however, result in an “other change of employment event” for a particular person. For example, a person who is not in a financial reporting oversight role might, as a result of a business combination, be assigned additional duties and responsibilities that put him or her into a financial reporting oversight role. A business combination could also result in a change in a person’s employer – for example, from an acquired company to a surviving company. A change in employer is also an “other change in employment event” under Rule 3523(c). For example, if Company A acquires Company B, a person who was in a financial reporting oversight role at Company B would experience an “other change in employment event” if he or she became an employee of Company A in a financial reporting oversight role as a result of the acquisition. If such a person had been receiving tax services from Company A’s registered public accounting firm pursuant to an engagement in process before the acquisition, the time-limited exception in Rule 3523(c) would apply.

.06 Staff Questions and Answers — Registration of Broker-Dealer Auditors, February 19, 2009**Summary**

The questions and answers below set forth staff guidance to assist auditors of non-public broker-dealers considering registration with the Public Company Accounting Oversight Board (“PCAOB” or “Board”). This guidance does not constitute Board rules, nor has it been approved by the Board.

The staff questions and answers below were prepared by the Division of Registration and Inspections to supplement PCAOB Release No. 2003-011B, *Frequently Asked Questions Regarding Registration with the Board*. Questions should be directed to the PCAOB’s registration staff, by emailing registration-help@pcaobus.org or by calling 202-207-9329. The Securities and Exchange Commission (“SEC”) staff and the Financial Industry Regulatory Authority (“FINRA”) have also each published guidance on issues related to the requirement that auditors of non-public broker-dealers register with the Board. The SEC staff guidance can be found at www.sec.gov/divisions/marketreg/faq-pcaobregbdauditors.htm. The FINRA guidance can be found at www.finra.org/Industry/Regulation/Notices/2009/P117689.

* * *

Overview of Registration

Q1. My firm audits broker-dealers but does not audit or participate in audits of public companies. Does my firm have to register with the Board?

A1. Yes. Section 17(e) of the Securities Exchange Act of 1934 (as amended by the Sarbanes-Oxley Act of 2002) provides that every registered broker or dealer shall annually file with the SEC certain financial statements that are certified by a firm that is registered with the PCAOB. Until recently, an order of the Securities and Exchange Commission (the “SEC Order”) had provided non-public broker-dealers with relief from that requirement. As a result of the SEC Order’s recent expiration, financial statements of non-public broker-dealers for fiscal years ending after December 31, 2008 must be certified by a registered public accounting firm.

Q2. What does my firm have to do to become registered with the Board?

A2. To register with the Board, your firm must submit a registration application and the Board must approve it. Links to the instructions to Form 1 and to Section 2 of the Board’s rules (which govern the registration process) may be found at <http://pcaobus.org/Rules/Pages/default.aspx>. You may also view a sample registration application by clicking on “Sample Registration Form 1” located on the Registration page of the Board’s website (www.pcaobus.org/Registration). You can read a discussion of the information Form 1 requires by going to <http://pcaobus.org/Rules/Rulemaking/Pages/Docket001.aspx> and clicking on Release 2003-007. The Board has also published answers to frequently asked questions concerning the application process generally, which you can find on the Registration page. This document, PCAOB Release No. 2003-011B, *Frequently Asked Questions Regarding Registration with the Board*, is referred to below as “Board FAQs” and can be found at http://pcaobus.org/Registration/Information/Documents/Registration_FAQ.pdf.

In addition to submitting the Form 1 registration application, your firm will have to pay a non-refundable registration fee prior to Board consideration of your application. If your firm audited no issuers during the previous calendar

year, the registration fee is \$250. “Issuer” is defined in the Sarbanes-Oxley Act of 2002 and PCAOB rules and does not include a non-public broker-dealer.

Q3. Will PCAOB registration affect the manner in which my firm audits broker-dealers?

A3. The Board does not determine, inspect for compliance with, or enforce the standards applicable to audits of entities that are not issuers. In addition, the SEC staff has published guidance indicating that the requirement to register with the PCAOB does not affect the existing requirement, under SEC rules, that audits of the financial statements of non-public broker-dealers be conducted according to generally accepted auditing standards. See “PCAOB Registration of Auditors of Non-Public Broker-Dealers Frequently Asked Questions” (Question 5), available at www.sec.gov/divisions/marketreg/faq-pcaobregbdauditors.htm.

Q4. If my firm becomes registered with the Board, what ongoing obligations will it have to the PCAOB?

A4. Board rules currently pending with the SEC would require all registered firms, including those that do not audit issuers, to comply with the PCAOB’s annual and special reporting requirements. Once those rules are effective, you will have to file with the Board an annual report, providing basic information about your firm. You will also have to file a special report if certain, specified events occur. These rules, once effective, will also require firms to pay an annual fee. The amount of that fee has not yet been announced. You can read a full description of the annual and special reporting rules adopted by the Board in PCAOB Release No. 2008-004 at <http://pcaobus.org/Rules/Rulemaking/Pages/Docket019.aspx>.

In any given year, both the requirement to file an annual report and the requirement to pay an annual fee apply only to firms that are registered as of March 31 of that year. Firms that become registered after March 31 of a given year would not file an annual report or pay an annual fee that year.

A firm’s failure to comply with the reporting and fee requirements, as well as a failure to comply with the requirements to provide complete and accurate information in the application process, could result in disciplinary sanctions, potentially including revocation of a firm’s registration.

Mechanics of Registration

Q5. How does my firm submit a registration application?

A5. Registration applications are electronic and can only be obtained by accessing the Board’s secure registration system. To gain access to the registration system, go to the Registration page of the Board’s website (www.pcaobus.org/Registration) and click on “Register with the PCAOB” in the gray box on the right. You will be presented with a log-in box and instructions to establish a user ID and password by submitting an “Online Entitlement Request Form.” Follow the instructions to establish a user ID and password, and return to this log-in page to access PCAOB’s secure registration system, where you may download the PDF version of the Form 1 registration application. (Note: The registration system also offers the option to submit Form 1 using XML. See Board FAQ #3 for further information on this option). Complete the application on your computer, making sure to take careful note of the name and location of the file containing your application.

To submit the registration application, log back into the registration system and follow the instructions to upload your completed Form 1. After Form 1 is uploaded, the system will calculate your firm's registration fee and present you with an invoice. You will be given a link to a site where you can submit your payment electronically. Once you've paid, your application will be deemed submitted.

Q6. How long will it take my firm to get registered?

A6. The Board has up to 45 days after the date your firm submits its application to take action on the application. The actual number of days until approval will vary depending on the information contained in the application and the number of applications that are pending at the same time as your firm's application. However, if the Board requests additional information concerning the application, a new 45-day period will begin when the additional information is received. In addition, if the Board cannot determine whether it is in the public interest to approve a firm's application, the Board may hold a hearing. While the applicant could elect to treat the hearing notice as a denial, if it does not do so, it will have waived the 45-day requirement for Board action. See Board FAQ #14 for additional information concerning notices of hearing.

Content of the Registration Application

Q7. My firm does not participate in audits of issuers. Are there sections of the registration application we can skip?

A7. Before responding to any item in the registration application, an applicant should give careful attention to the definitions of terms used in the item. Of particular significance in this context are the definitions of "issuer" (which does not include a non-public broker-dealer), "audit" and "audit report" (which are limited to work and reports relating to the financial statements of issuers), and "associated person" of the applicant (which encompasses only persons that perform work in connection with an audit of an issuer).

If your firm did not, in the current calendar year or in the year preceding submission of its application, participate at all in the audit of an issuer, and your firm does not expect to do so in the current calendar year, it will have no information responsive to Part II (Listing of Applicant's Public Company Audit Clients and Related Fees) or to Item 7.1 (Listing of Accountants Associated with Applicants), and may not have information responsive to other items on the application. The form contains "NA" boxes that you should check to indicate that particular parts of the form do not apply to your firm. A firm that certifies financial statements of broker-dealers, however, should, when filling out an application, also bear in mind the answer to question no. 9 below.

Before concluding that it does not participate in audits of issuers, an applicant should understand that audit work performed for a non-public entity could nevertheless constitute participation in an audit of an issuer if that work is used by another firm in connection with the other firm's audit of an issuer, such as a parent company. In that circumstance, applicants should carefully consider whether they have played, or expect in the current calendar year to play, a "substantial role" in the audit of an issuer as that defined term is used in the registration application.

Q8. Part IV of the registration application requires my firm to provide a statement of its quality control policies. How detailed should we be in describing our quality control policies?

A8. Your firm's discussion of quality control policies should be a summary description presented in a clear, concise and understandable format. You should not provide us with your entire internal quality control manual, but should prepare a brief document that provides an overview of your firm's policies with respect to independence, integrity and objectivity; engagement performance; personnel management; acceptance and continuance of clients and engagements; and monitoring.

Q9. Should my firm provide any specific information relevant to its work for broker-dealers?

A9. In light of the expiration of the SEC order, the staff believes that certain specific information may be relevant to the Board's consideration of an application. In order to avoid the Board seeking the information through a formal request for additional information, which could delay Board action on the application until 45 days after all requested additional information is submitted, the staff urges all applicants who have certified financial statements for SEC filings by broker-dealer clients in the two-year period preceding submission of the application and who intend to continue to do so to (a) indicate that fact in the "Applicant Profile" section on the first page of Form 1 by checking the box for item number 2, and (b) provide the following information:

1. Broker-dealer clients: Include in Exhibit 4.1, in addition to a description of the firm's quality control policies, a separate file listing (a) all broker-dealers for which the firm certified financial statements in the current or preceding calendar year, including the business address of each broker-dealer and, as to each, the dates of any such certification by the firm; and (b) any additional broker-dealers for which the firm expects to certify financial statements in the current calendar year, including the business address of each.

2. Individuals' disciplinary histories: Include in Exhibit 5.3 a statement indicating whether any proprietor, partner, principal, shareholder, or officer of the firm, or any accountant employed by the firm who participates in the firm's work relating to certification of broker-dealer financial statements, has a history that meets any of the criteria described in Item 5.1.a. of Form 1. If any of those individuals has such a history, provide as to each matter the information described in Item 5.1.b. of Form 1. In considering the criteria described in Item 5.1.a.1., please give careful attention to Board FAQ #33.

Q10. Are registration applications made public? If so, can my firm protect any of the information it provides in the application from public disclosure?

A10. The Board makes registration applications available to the public by posting them to its web site as soon as practicable after approving or disapproving them. If your firm wishes to protect information in its registration application from public disclosure, it may request confidential treatment for that information by checking the box labeled "CR" that appears in the application relating to the exact item of information that you want to be treated confidentially. Your firm will be notified of the Board's determination with respect to your request after the Board has acted on your application.

For each request for confidential treatment, your firm must attach, as exhibit 99.1, an explanation as to why you believe the information should be treated confidentially. Refer to Board Rule 2300 (http://pcaobus.org/Rules/PCAOBRules/Pages/Section_2.aspx) for the test the Board will apply in considering whether to grant your requests.

Requesting confidential treatment of a portion of a text exhibit to Form 1 requires your firm to submit two versions of the exhibit – one version should contain all the information in the exhibit and the other version should redact those portions of the exhibit as to which the firm is seeking confidential treatment and show with a notation each redaction that has been made.

Further Questions About Registration

Q11. What should I do if I have further questions?

A11. If you have questions, you should first review the Board's FAQs on Registration, the Board's rules and Instructions to Form 1, and the Instructions for filling out Form 1 that are available for download after you log in to the registration system. If you still have questions, you can email the PCAOB's registration staff at registration-help@pcaobus.org, or call the registration staff's help line at (202) 207-9329. The hours of operation for the help line are 9 a.m. to 5 p.m. EDT, Monday through Friday.

.07 Staff Questions and Answers — References to Authoritative Accounting Guidance in PCAOB Standards, September 2, 2009

Summary

Staff questions and answers set forth the staff's opinions on issues related to the implementation of the standards of the Public Company Accounting Oversight Board ("PCAOB" or "Board"). The staff publishes questions and answers to help auditors implement, and the Board's staff administer, the Board's standards. The statements contained in the staff questions and answers are not rules of the Board, nor have they been approved by the Board.

The following staff questions and answers regarding descriptions of and references to authoritative accounting guidance contained in the standards of the PCAOB were prepared by the Office of the Chief Auditor. Additional questions should be directed to Barbara Vanich, Associate Chief Auditor (202/207-9363; vanichb@pcaobus.org) or Greg Scates, Deputy Chief Auditor (202/207-9114; scatesg@pcaobus.org).

FASB Accounting Standards Codification

On June 30, 2009, the Financial Accounting Standards Board ("FASB") issued FASB Statement of Financial Accounting Standards No. 168, *The FASB Accounting Standards Codification™ and the Hierarchy of Generally Accepted Accounting Principles—a replacement of FASB Statement No. 162* ("FAS 168"). That standard establishes the FASB Codification ("Codification") as the source of authoritative non-Commission accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with U.S. generally accepted accounting principles ("U.S. GAAP").¹ The Codification is effective for financial statements issued for interim and annual periods ending after September 15, 2009.

Descriptions of and References to U.S. GAAP

Q1. Certain PCAOB standards include descriptions of and references to U.S. GAAP and accounting requirements. What is the status of those descriptions of and references to U.S. GAAP and accounting requirements upon the effective date of the Codification?

A1. Certain PCAOB standards contain descriptions of and references to U.S. GAAP that existed prior to the Codification. Those descriptions and references were not intended to represent and do not represent authoritative sources of U.S. GAAP.

Some PCAOB standards include descriptions of and references to accounting requirements that are no longer current. Further, some PCAOB standards include descriptions of accounting requirements that may not represent the final language as adopted in the Codification.

The accounting standards set by the FASB are recognized by the U.S. Securities and Exchange Commission ("SEC" or "Commission") as generally accepted

¹ See U.S. Securities and Exchange Commission ("SEC" or "Commission") Release Nos. 33-9062A; 34-60519A; FR-80A, *Commission Guidance Regarding the Financial Accounting Standards Board's Accounting Standards Codification* (August 19, 2009).

under Section 108 of the Sarbanes-Oxley Act of 2002.² Therefore, auditors should disregard descriptions of and references to accounting requirements in PCAOB standards that are inconsistent with the Codification.

Auditors should look to the relevant sections of the Codification and to SEC requirements to identify the applicable accounting and reporting requirements for the company under audit. The FASB's web site contains a cross-reference search function to assist users in transitioning to the Codification.³

The PCAOB plans to revise these descriptions and references in its future standards-setting projects.

Auditor's Responsibilities Regarding the Codification

Q2. What is the auditor's responsibility if, in using the Codification, the auditor believes that an item in the financial statements should be accounted for differently under the Codification than under pre-Codification U.S. GAAP?

A2. The FASB has stated that, generally, the Codification does not represent a change in U.S. GAAP. The FASB, however, has acknowledged that through the process of drafting the Codification, certain wording changes might theoretically lead an issuer to conclude differently on an accounting matter.⁴ To address those types of changes, the FASB will continue to accept feedback on Codification content after the effective date to improve content and address unintentional changes, when applicable.⁵ The FASB also has acknowledged that in reviewing the Codification issuers might discover guidance of which they were previously unaware that now indicates that an error may exist in previously issued financial statements.⁶

If an issuer reaches a different conclusion on an accounting matter, an auditor should evaluate management's conclusion on whether the different accounting treatment is a change in an accounting principle or an error, following the guidance in Codification Topic 250, Accounting Changes and Error Corrections.⁷

If the different accounting treatment is a change in an accounting principle, the auditor should follow the direction in:

- AU sec. 508, *Reports on Audited Financial Statements*
- PCAOB Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*

If the different accounting treatment is an error, the auditor should follow the direction in:

- AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*
- AU sec. 508, *Reports on Audited Financial Statements*

² See SEC Release Nos. 33-8221; 34-47743, *Commission Statement of Policy Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter* (April 25, 2003).

³ The Codification cross-reference table is available at: http://asc.fasb.org/crossref&analyticsAssetName=home_page_crossreference.

⁴ See FAS 168, paragraph A15.

⁵ *Ibid.*, paragraph A17.

⁶ *Ibid.*, paragraph A16.

⁷ This Codification topic was formerly referred to as FAS 154, *Accounting Changes and Error Corrections*.

- PCAOB Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*
- PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, on evaluating deficiencies in an integrated audit, and AU sec. 325, *Communications About Control Deficiencies in an Audit of Financial Statements*, on evaluating deficiencies in an audit of financial statements only.

Q3. What are the other responsibilities of an auditor with respect to the Codification?

A3. Auditors will need to become knowledgeable about using the Codification. Additionally, for reviews of interim financial information and audits of financial statements for periods ending after September 15, 2009, when referencing or including an excerpt from U.S. GAAP in audit documentation, the relevant Codification topic is the appropriate source for that reference or excerpt. It may be desirable, but is not necessary, to update certain existing audit documentation (e.g., audit schedules, memoranda) containing previous references to U.S. GAAP prepared prior to the Codification.

Audits of Financial Statements Prepared in Conformity with International Financial Reporting Standards

Q4. What consideration, if any, should an auditor give to descriptions of and references to U.S. GAAP in the standards of the PCAOB if he or she is auditing the financial statements of a foreign private issuer (“FPI”)⁸ prepared in conformity with International Financial Reporting Standards (“IFRS”),⁹ as issued by the International Accounting Standards Board?

A4. In an audit of an FPI’s financial statements that are prepared in conformity with IFRS, the auditor needs to consider SEC requirements and IFRS to determine the applicable accounting and reporting requirements and should disregard descriptions of and references to U.S. GAAP in PCAOB standards.

⁸ See Rule 3b-4(c) of the Securities Exchange Act of 1934 for the definition of “foreign private issuer.”

⁹ See Form 20-F, General Instruction E(c), and items 17 and 18; 17 C.F.R. 249.220f; and SEC Release Nos. 33-8879; 34-57026; International Series Release No. 1306; File No. S7-13-07 (December 21, 2007).

.08 Staff Questions and Answers — Special Reporting on Form 3, January 12, 2010**Summary**

The questions and answers below set out staff guidance to assist registered public accounting firms with respect to the requirement to file with the Public Company Accounting Oversight Board (“PCAOB” or “Board”) special reports on Form 3. This guidance does not constitute Board rules, nor has it been approved by the Board.

The questions and answers below were prepared by the PCAOB staff to supplement PCAOB Release No. 2008-004, *Rules on Periodic Reporting by Registered Public Accounting Firms* (June 10, 2008) and the instructions to Form 3, which can be found at http://pcaobus.org/Rules/Rulemaking/Docket019/2008-06-10_Release_No_2008-004.pdf. Please note that the instructions to Form 3 include various “notes” intended to address anticipated questions.

* * *

Overview of the Requirements Relating to Special Reporting on Form 3

Q1. What is the general nature of the obligation to file special reports on Form 3?

A1. The PCAOB’s reporting framework includes two types of reporting obligations. Each registered firm must provide basic information once a year, covering a 12-month period that ends March 31, by filing an annual report on Form 2. Separately, there are certain events (“Form 3 events”) that, if they occur, a firm must report on Form 3 within specified time frames. The reportable events described on Form 3 are not events that routinely occur, and some firms might never experience an event required to be reported on Form 3.

Q2. Does the requirement to file special reports on Form 3 apply to all registered firms, regardless of the nature of the firm’s practice?

A2. Yes. Each firm that is registered with the PCAOB, regardless of the reason the firm is registered, regardless of whether the firm is required to be registered, and regardless of whether the firm plays any role in audits of issuers, must comply with the requirement to file special reports on Form 3 if any of the reportable events described in Form 3 occur with respect to the firm.

Q3. What are the time frames within which events must be reported on Form 3?

A3. The deadlines for filing special reports on Form 3 are set out in Rule 2203(a). In general, any Form 3 event that occurs while a firm is registered must be reported on Form 3 within 30 days after the event occurs. There are, however, two special situations involving one-time reporting deadlines for firms to “bring current” certain information that was submitted on a firm’s registration application.

The first situation relates to firms that are registered as of December 31, 2009, when Rule 2203(a) took effect. For those firms, a specified subset of Form 3 events must be reported if they occurred before December 31, 2009 and information concerning them continues to be current as of December 31, 2009. This reporting requirement is described in detail in General Instruction No. 4

to Form 3. Any firm registered as of December 31, 2009 should review General Instruction No. 4 to determine whether it has any “bring current” reporting obligation, and any such report must be filed on Form 3 by February 1, 2010.

The second situation relates to firms that become registered after December 31, 2009. For those firms, any Form 3 events that occur between the cut-off date used by the firm for purposes of providing information on its registration application and the date the firm receives notice of approval of its application for registration must be reported on Form 3 within 30 days of receiving notice of approval of the application. With respect to events that occur while a firm’s registration application is pending, however, firms should also take account of Q&A 18 in the Board’s Frequently Asked Questions Regarding Registration with the Board (PCAOB Release 2003-011C), which encourages applicants to notify the staff in writing if information contained in the application changes in any significant way while the application is pending.

Q4. What are the consequences of failing to file a special report after a Form 3 event occurs, or of a late filing?

A4. The failure to file a timely special report after a Form 3 event occurs is a violation of PCAOB Rule 2203(a). As with any violation of PCAOB rules, a registered firm that violates Rule 2203(a), and any associated person who causes that violation, could be subject to disciplinary proceedings and disciplinary sanctions, which, in appropriate circumstances, could include revoking a firm’s registration and barring an individual from being an associated person of a registered firm.

In addition, the annual report on Form 2 that every firm must file, for each 12-month period ending March 31, requires the firm to certify that it filed all required special reports on Form 3 with respect to events that occurred during that 12-month reporting period. If a firm overlooked the special reporting requirements for some period of time, the firm would eventually discover that it needed to become current on its Form 3 obligations, even if that meant late filing of a Form 3, so that it could provide the certification required in order to satisfy the annual reporting requirement.

Q5. What happens if the firm does not know of the Form 3 event within 30 days of its occurrence?

A5. The reportable events in Form 3 are described in a way such that either the firm would necessarily be in a position to know about them as they occur (*e.g.*, the firm has changed its name) or that the event triggering the reporting obligation is the firm *becoming aware* of certain information. With respect to that latter category of events, the instructions to Form 3 specify that the firm is deemed to have become aware of the relevant facts on the date that any partner, shareholder, principal, owner, or member of the firm first becomes aware of the facts. The Board’s release adopting the special reporting requirements noted that it is reasonable to expect a firm to have controls designed to ensure that any such person who becomes aware of relevant facts understands the firm’s reporting obligation and brings the matter to the attention of persons responsible for compliance with the obligation.

Q6. If a firm has requested leave to withdraw from registration by filing Form 1-WD, and that request is pending with the Board, must the firm continue to comply with the requirement to file special reports on Form 3?

A6. No. PCAOB Rule 2107(c) provides that the obligation to file special reports on Form 3 is suspended for any firm that has pending before the Board a Form 1-WD requesting leave to withdraw from registration. In the event that the firm decides to withdraw a pending Form 1-WD, PCAOB Rule 2107(f)

requires that the firm file any special report that the firm would have been required to file had the Form 1-WD not been pending.

Events Required to be Reported on Form 3

Q7. What events are required to be reported on Form 3?

A7. The events that must be reported on Form 3 are described in Part II (and the instructions to Part II) of Form 3. For quick reference, a single page summary of the categories of reportable events is set out at the end of this document, but firms should refer to the more detailed descriptions in Part II of Form 3 for the specific events that must be reported. Firms should not attempt to report via Form 3 any events that are not described in Part II of Form 3. For example, while firms must report certain categories of legal proceedings involving the firm or certain firm personnel, firms are not required to report *all* legal proceedings involving the firm or its personnel, and firms should not attempt to use Form 3 to report proceedings not described in Part II of Form 3.

In reviewing the descriptions of events that must be reported, firms should bear in mind that some terms used in those descriptions are defined, for these purposes, in ways that may differ from a firm's common usage of the terms. Defined terms used in Form 3 are italicized, and the definitions can be found in PCAOB Rule 1001 or by clicking on an italicized term in the online form.

Q8. One of the reportable events on Form 3 is a firm's withdrawal of a previously issued audit report. Must a firm file Form 3 in every case where the firm withdraws an audit report or withdraws its consent to the use of its name by an issuer?

A8. No. If the issuer in question complies with its obligation to disclose the matter pursuant to Item 4.02 of a Form 8-K filed with the Securities and Exchange Commission, the firm need not, and should not, separately report the matter on Form 3. However, in the event the issuer fails to make the required Form 8-K filing within the time required by the Commission's rules, the firm must report that event on Form 3 within 30 days after that Form 8-K filing deadline, unless, within that 30-day period, the issuer reports the matter on a late-filed Form 8-K.

Q9. Reportable events on Form 3 include a firm entering into certain relationships with persons or entities who are currently the subject of specified PCAOB sanctions or Securities and Exchange Commission orders. Does a firm need to report such a relationship even if the person or entity does not participate in audits of issuers?

A9. Yes. Those relationships must be reported on Form 3 regardless of whether the relevant person or entity participates in audits of issuers.

Q10. Reportable relationships referred to in the preceding question include certain relationships with entities that are currently the subject of a PCAOB sanction disapproving the entity's application for registration. What does it mean to be "currently the subject" of such a sanction?

A10. An entity is considered to be "currently the subject" of a Board sanction disapproving registration if either of the following is true: (1) the Board order disapproving registration identified a date after which the Board would not treat the violations described in the order as a sole basis for possible disapproval of a new registration application, and that date has not passed, or

(2) the Board order identifies no such date, and the entity has not subsequently become registered with the Board.

Q11. For purposes of Form 3's reporting requirements, is a person or entity considered to be "currently the subject of" a specified PCAOB sanction if the sanction has not yet taken effect because it is pending review by the Securities and Exchange Commission?

A11. A person or entity is not "currently the subject of" a PCAOB sanction if the imposition of the sanction has been stayed, pursuant to Section 105(e) of the Act, by virtue of an application to the Commission for review, and the stay has not been lifted.

Q12. The obligation to report new relationships with persons or entities currently the subject of certain PCAOB sanctions and Commission orders is not by its terms limited to situations in which the firm has become aware of such sanctions or orders. What if the firm is not aware of them?

A12. The sanctions and orders that give rise to this reporting obligation are public information. A firm generally should be able to identify this information as to any person or entity with whom or which it enters into a new relationship, even if the person or entity is not forthcoming about it.

Q13. One of the reportable events on Form 3 is a change in a registered firm's name. Should a firm file a report on Form 3 to report all name changes, including those that occur in connection with a merger or other change in the firm's legal form?

A13. No. A change in a firm's name should be reported on Form 3 if, and only if, other than the name change, the firm remains the same legal entity that it was before the name change. If the name change is in connection with a more significant change in which the firm, as previously constituted, ceases to exist – such as a change in the legal form of the firm or a merger resulting in a new legal entity – the new entity does not automatically succeed to the registration status of the former entity and may not report the event on Form 3 as a mere name change. In that event, the firm should consider whether, pursuant to the provisions of Rule 2108, the firm can make the representations required in a Form 4 filing to enable the firm to succeed to the predecessor firm's registration status.

Q14. If the address of a firm's headquarters changes, must the firm report that change on Form 3?

A14. The only address change that must be reported on Form 3 is a change in the business mailing address (and other contact information) of the person that the firm designates as its primary contact with the PCAOB. If a firm changes its headquarters address, but the contact information for that primary contact person remains unchanged, the firm should not report the headquarters address change on Form 3 but should simply provide the new address in the firm's next annual report on Form 2.

Completing Form 3

Q15. Which portions of Form 3 must be completed if a firm is reporting only a single event?

A15. For any Form 3 filing, a firm must complete Parts I, II, and VIII of Form 3 and at least one of Parts III through VII. Part I identifies the firm and

Part VIII certifies the accuracy of the report. In Part II, the firm must check a box, or boxes, to indicate which of the events described there the firm is reporting. Depending upon which box or boxes the firm checks in Part II, the firm must complete one or more of Parts III through VII to provide certain details.

Q16. May a firm use a single Form 3 filing to report multiple Form 3 events?

A16. A firm may file a Form 3 to report a single event or to report multiple events. Timeliness of reporting, however, is judged with respect to each reported event.

Q17. May a firm combine in a single Form 3 filing the “bring current” reporting described in Q&A 3 above and reporting on other events that occur within the 30-day period before the “bring current” report is due?

A17. Yes, but attention should be given to ensure compliance with the “bring current” reporting requirement. A firm registered as of December 31, 2009 must file a Form 3 by February 1, 2010 to report certain information that is current *as of* December 31, 2009, and it must do so even if that information is superseded by events that occur between December 31, 2009 and February 1, 2010 that must also be reported on Form 3. Similarly, a firm that becomes registered after December 31, 2009 would, within 30 days of becoming registered, need to file a Form 3 to report events that occurred before the date it became registered, even if the relevant information were superseded by other events occurring before the firm filed that “bring current” report. In those situations, a firm would need to file one Form 3 to satisfy the “bring current” obligation and a separate Form 3 to report the subsequent change to that information.

Amending a Previously Filed Form 3

Q18. What should a firm do if it discovers that it provided incorrect information in a filed Form 3 or omitted information that should have been included?

A18. Special reports on Form 3 should be complete and accurate, and an individual in the firm must, on behalf of the firm, certify that the form does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which the statements were made, not misleading. Inaccuracies or omissions could form the basis for disciplinary sanctions for failing to comply with the reporting requirements, and it is therefore in a firm’s interest to correct such errors as soon as possible. A firm may do so by filing an amendment pursuant to PCAOB Rule 2205 and the Form 3 instructions specific to amendments.

Q19. Should a firm amend a previously filed Form 3 to update previously reported information that has changed since the original filing?

A19. Amendments are appropriate only to correct information that was incorrect at the time of the filing, or to supply omitted information that should have been supplied at the time of the filing. The amendment process should not be used to update information reported on a Form 3. In the event of changes, the firm should consider whether a new Form 3 reporting obligation has been triggered.

Requesting Confidential Treatment

Q20. How does a firm request confidential treatment for information that it provides on Form 3?

A20. A firm may request confidential treatment for information provided in certain, though not all, items in Form 3. General Instruction No. 8 to Form 3 identifies the items with respect to which a firm may request confidential treatment. In filling out the form, the firm may request confidential treatment by checking the “CR” box associated with each such item for which the firm wants to request confidential treatment.

The requirements concerning what a firm must submit in support of a request for confidential treatment have changed effective December 31, 2009 and so, for most firms, are different than they were when the firm submitted its registration application. As amended, PCAOB Rule 2300(c) requires both a representation that the information has not otherwise been publicly disclosed and either (1) a detailed explanation of the grounds on which the information is considered proprietary, or (2) a detailed explanation of the basis for asserting that the information is protected by law from public disclosure and a copy of the specific provision of law.

A special report on Form 3 will be published on the PCAOB Web site promptly upon submission. That public version of the Form will not display information for which confidential treatment is requested unless and until a determination to deny the request becomes final. As a safeguard, as a firm prepares to submit a completed Form 3 to the PCAOB’s Web-based system, the system allows a firm to view two separate versions of the completed form – one showing all of the information the firm has entered and the other showing what the publicly available version of the form will look like, with redactions where confidential treatment is requested. Before finally submitting the form, the firm should carefully review the redacted version to make sure that the firm has requested confidential treatment where it intended to do so.

Withholding Information on the Basis of Non-U.S. Legal Restrictions

Q21. May a firm refrain from reporting information on Form 3 if non-U.S. law prohibits the firm from providing or obtaining the information, just as the PCAOB allows firms to withhold information from Form 1 registration applications on that basis?

A21. A non-U.S. firm may withhold certain information from a required special report on Form 3 because of non-U.S. legal restrictions, but the related process, which is governed by PCAOB Rule 2207, is significantly different from the process in the context of a registration application on Form 1.

A legal conflict can be asserted on Form 3 only if the firm is actually withholding information that the form requires. A separate section at the end of each relevant part of Form 3 instructs the firm that if any portion of its response in that part is incomplete because of an asserted legal conflict, the firm must, in that separate section, identify the specific items with respect to which the firm actually has withheld, or been precluded from obtaining, responsive information.

Also, unlike the case with Form 1, the materials that a firm must compile in support of its position that a conflict exists – a copy of the relevant provisions of law, a legal opinion, and a written explanation of the firm’s efforts to seek

consents or waivers that would overcome the conflict – need not routinely be submitted when the firm files Form 3. Rather, the firm must certify on Form 3 that it has those materials in its possession, and it must submit them only in the event of a follow-up request from the Board or the Director of the Division of Registration and Inspections.

Q22. To comply with the requirement to have a legal opinion relevant to the asserted conflict of law, must a firm secure a new legal opinion specific to each Form 3 that the firm files?

A22. The supporting materials maintained by the firm need only contain a legal opinion that the firm has reason to believe is current with respect to the relevant point of law. Rule 2207 does not attempt to specify the ways in which a firm may satisfy this requirement, and various approaches might be satisfactory. Compliance does, however, depend upon a firm implementing in good faith some mechanism for generally being aware of relevant changes in the law, rather than relying on a particular legal opinion in perpetuity without genuine regard for whether the law changes.

Q23. If a non-U.S. firm takes the position that non-U.S. law prohibits it from providing any of the details required by Parts III through VII of Form 3 with respect to a particular matter, is the firm still required to file a Form 3 concerning that matter?

A23. Yes. The firm must still file a Form 3 completing Parts I, II, and VIII, and checking the relevant boxes in Parts III through VII to indicate the items as to which information is being withheld.

The Mechanics of Reporting Through the PCAOB Web-Based System

Q24. How does a firm submit Form 3 to the Board?

A24. To submit Form 3, your firm will need to access the PCAOB's Registration, Annual and Special Reporting system at <https://rasr.pcaobus.org/Security/Login.aspx>. Your firm will need to provide the Username and Password issued in connection with the registration process to gain access. Registered firms may email registration-help@pcaobus.org for assistance with log-in information. Firms that are already registered with the Board should not request a new user name and password through the Board's web site—this functionality is for firms seeking to register with the Board and is not appropriate for registered firms needing login assistance.

Q25. What formats will the system accept? What software is needed to properly prepare and submit Form 3?

A25. To properly communicate with the Board's system, you will need Internet Explorer 6.0 or later, or Firefox 2.0 or later. To complete Form 3, you may fill it out online as a web form, or you may submit it in XML, which is a computer language. If you have large amounts of information going into Form 3, you may find that XML is a more convenient way to submit the data because you would be able to load the data into your XML file directly or indirectly from other databases. If you would like to make your submission in XML, you must download the XML Schema from the Board's system. Using XML will likely require the assistance of a programmer who is versed in that computer language.

Form 3 may require you to submit various documents to be labeled as exhibits. The system will accept exhibits in PDF, GIF or JPEG format. You can convert text documents or scan documents for submission, as long as they are submitted in PDF, GIF or JPEG.

Q26. Is assistance available on how to create a web form in the Board's system?

A26. You may view an online tutorial on how to create a web form in the Board's system by going to the Registration, Annual and Special Reporting page of the Board's web site (<http://pcaobus.org/Registration/Pages/SampleForms.aspx>) and viewing the system tutorial entitled "Create a Form."

Further Questions About Reporting on Form 3

Q27. What should I do if I have further questions?

A27. If you have questions, you should first review the Board's release adopting the reporting requirements, including the rules and Instructions to Form 3, which can be found at http://pcaobus.org/Rules/Rulemaking/Docket019/2008-06-10_Release_No_2008-004.pdf, and the instructions for filling out Form 3 that are available for download after you log into the registration and reporting system. The instructions to Form 3 include various notes intended to address anticipated questions. If you still have questions, you can email the PCAOB's registration staff at registration-help@pcaobus.org.

Summary of Form 3 Reportable Events

- The firm has withdrawn an audit report on financial statements, and the issuer failed to comply with Commission reporting requirements (Item 4.02 of Commission Form 8-K) concerning the matter.
- With respect to the 100 issuer audit client threshold that determines the frequency of Board inspections under Rule 4003, the firm has crossed to a different side of the threshold than the firm was on in the preceding calendar year.
- The firm, or a partner, shareholder, principal, owner, member, or audit manager of the firm (in some cases limited to those who provided at least ten hours of audit services for any issuer during the firm's current or most recently completed fiscal year), has become a defendant in certain types of criminal proceedings, or any such proceeding has been concluded as to the firm or the individual.
- The firm, or a partner, shareholder, principal, owner, member, or audit manager of the firm (in some cases limited to those who provided at least ten hours of audit services for any issuer during the firm's current or most recently completed fiscal year), has become a defendant or respondent in a government-initiated civil proceeding, or an administrative or disciplinary proceeding (other than a Board proceeding), arising out of conduct in the course of providing professional services, or any such proceeding has been concluded as to the firm or the individual.
- The firm, or a parent or subsidiary, has become the subject of a petition filed in bankruptcy court or certain similar proceedings.
- The firm has taken on individuals or entities meeting certain criteria regarding disciplinary history, or entered into an arrangement to receive from such individuals or entities services related to the firm's

audit practice or related to services the firm provides to issuer audit clients.

- The firm has obtained or lost authorization to engage in the business of accounting or auditing in a particular jurisdiction, or that authorization has become subject to conditions or contingencies.
- Contact information for the firm's Board contact person has changed.
- The firm has changed its legal name, while otherwise remaining the same legal entity that it was before the name change.

**.09 Staff Questions and Answers — Succession to Registration Status—
Form 4, January 12, 2010****Summary**

The questions and answers below set out staff guidance to assist registered public accounting firms with respect to succeeding to a predecessor firm's registration status with the Public Company Accounting Oversight Board ("PCAOB" or "Board") by filing Form 4. This guidance does not constitute Board rules, nor has it been approved by the Board.

The questions and answers below were prepared by the PCAOB staff to supplement PCAOB Release No. 2008-005, *Rules on Succeeding to the Registration Status of a Predecessor Firm* (July 29, 2008) and the instructions to Form 4, which can be found at http://pcaobus.org/Rules/Rulemaking/Docket020/2008-07-29_Release_No_2008-005.pdf. Please note that the instructions to Form 4 include various "notes" intended to address anticipated questions.

Q1. What is Form 4?

A1. In the circumstances in which it is available, the Form 4 succession process allows an unregistered firm to succeed to the PCAOB registration status of a predecessor firm that was registered without any interruption in the registration status. Under certain circumstances, however, that registration status may only be temporary, as discussed in Q&A 9 below.

Q2. What are the circumstances in which a firm can succeed to a predecessor's registration status by filing Form 4?

A2. The Form 4 succession process is available (1) if there has been a change in a registered firm's form of organization, or the registered firm has changed the jurisdiction under the law of which it is organized; or (2) if a registered firm is acquired by an unregistered firm, or combines with any other entity or entities, including other registered firms, to form a new public accounting firm. Form 4 can be used only in those circumstances and only if the firm seeking to succeed to registration status makes certain representations required in the form. In the absence of those conditions, a firm cannot use Form 4 to succeed to the registration status of a predecessor and would need to file a registration application on Form 1 if it wished to seek registration.

Q3. Is a firm that results from the circumstances described in Q&A 2 above required to file Form 4?

A3. A firm that results from the circumstances described in Q&A 2 above should not assume that it is registered with the PCAOB just because a predecessor firm was registered with the PCAOB. If the firm wishes to be registered with the PCAOB, Form 4 provides an optional route to registration, but the firm is not required to use the Form 4 process and can choose, instead, to file an application for registration on Form 1.

Q4. Can or should Form 4 be filed in circumstances in which a registered firm has acquired another firm?

A4. If a registered firm acquires another firm in such a way that the acquiring registered firm continues to exist as the same legal entity, that firm continues to be registered and need not, and cannot, file Form 4. The acquiring registered firm would, however, need to report the acquisition when it files its annual report on Form 2 for the period in which the acquisition occurred.

Q5. By when must Form 4 be filed to be timely?

A5. PCAOB Rule 2109(a) governs the timeliness of Form 4 filings. With respect to changes or combinations that take effect on or after December 31, 2009 (the effective date of Rule 2109), a Form 4, to be timely, must be filed within 14 days after the change or combination takes effect.

Q6. If a firm resulted from circumstances described in Q&A 2 above that occurred after a predecessor firm became registered but before December 31, 2009, can and should the firm file a Form 4 to succeed to the predecessor's registration status? If so, when must the form be filed to be timely?

A6. Form 4 can be filed with respect to changes or combinations that took effect before December 31, 2009, and should be filed if the firm intends to operate, and believes it has been operating, under the registration status of the predecessor. For firms in that situation, Form 4 must be filed by January 14, 2010 to be timely. *Even if a firm in that situation has previously informally reported the change or combination to the PCAOB staff and provided requested representations, the firm still would need to file Form 4 to succeed to the predecessor's registration status.*

Q7. If a firm files Form 4 to succeed to the registration status of a registered firm, how soon will it be deemed to have succeeded to the predecessor's registration status?

A7. If a firm files a timely Form 4, succession to the predecessor's registration status is automatic. As discussed below, however, in some cases that registration status may only be temporary.

Q8. If a firm can make the representations required by Form 4 but has failed to file a timely Form 4, is it still possible for the firm to succeed to a predecessor's registration status?

A8. Under PCAOB Rule 2108(d), a firm that is in a position to file Form 4 but has failed to do so timely may submit a completed Form 4 along with a request for leave to file the form out of time. The submission must be accompanied by an exhibit describing the reasons the form was not timely filed and a statement of the grounds on which the firm asserts that the Board should grant leave to file the form out of time. The Board will evaluate the request in light of the relevant facts and circumstances and the public interest and may, in its discretion, grant or deny the request.

During the period that a request for leave to file out of time is pending with the Board, a firm should not assume that it is a registered public accounting firm. A Board decision to grant the request would effectively confer registered status on the firm back to the date of the transaction that is the subject of the Form 4 filing (just as with a timely filed Form 4), but a Board decision to deny the request would mean that the firm was not registered during that period.

Q9. In what circumstances would a firm's succession to the registration status of a predecessor firm through Form 4 be only temporary?

A9. If the event giving rise to the Form 4 filing is an unregistered firm's acquisition of a registered firm or a combination of firms into a new firm, the firm must address three yes-or-no questions, set out in Item 3.2.e. If the firm answers yes to any one of those questions or, in the case of a non-U.S. firm,

declines to answer any one of those questions on the ground that non-U.S. law prevents it from doing so, the firm can succeed to the predecessor's registration status, but only temporarily. In that situation, to succeed temporarily, the firm must also represent that it either has filed an application for registration on Form 1 or will do so no later than 45 days after the date of the acquisition or combination giving rise to the Form 4 filing.

Q10. How long does temporary succession to registration last?

A10. In general, temporary registration ceases to be effective on the earlier of the 91st day after the effective date of the acquisition or combination as reported on Form 4 or the date on which the Board approves a Form 1 registration application submitted by the firm. Temporary registration can be extended in certain circumstances, as described in PCAOB Rule 2108(b)(2)(iii)-(iv).

Q11. A firm seeking to file a Form 4 would, necessarily, be an unregistered firm. How does such a firm access the PCAOB's Web-based system to be able to file the form?

A11. In every situation in which a Form 4 can be filed, there is necessarily at least one firm involved that was a registered firm before the change or combination that gives rise to the Form 4 filing. The firm that seeks to file a Form 4 must identify that firm (or one of those firms) on Form 4 as the predecessor firm to whose registration status the firm is succeeding. The firm should access the PCAOB system using that firm's user ID and password.

Q12. Should the predecessor registered firm, to whose registration status the firm is succeeding, file Form 1-WD to withdraw from registration?

A12. No, the firm designated in Form 4 as the predecessor must not withdraw from registration.

Q13. In the event that a combination of firms giving rise to a Form 4 filing involves any registered firms other than the firm designated in Form 4 as the predecessor, should those other firms file Form 1-WD to withdraw from registration?

A13. Yes, any such firms should file Form 1-WD seeking to withdraw from registration, and the firm filing Form 4 must represent that each such registered firm has done so.

Q14. What should a firm do if it discovers that it provided incorrect information in a filed Form 4 or omitted information that should have been included?

A14. Form 4 filings should be complete and accurate, and an individual in the firm must, on behalf of the firm, certify that the form does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which the statements were made, not misleading. Inaccuracies or omissions could form the basis for disciplinary sanctions for failing to comply with the rules and instructions relating to Form 4, and it is therefore in a firm's interest to correct such errors as soon as possible. A firm may do so by filing an amendment pursuant to PCAOB Rule 2205 (which applies to Form 4 through PCAOB Rule 2109(d)) and the Form 4 instructions specific to amendments.

Q15. If a Form 4 as filed appears on its face to be timely, but a subsequent amendment reveals that the original filing was in fact untimely, what is the firm's registration status?

A15. In that circumstance, the original Form 4 filing would be voided and its effect would be null. If the firm still wanted to try to succeed to the predecessor's registration status, it would need to submit a new Form 4 and request leave to file out of time.

Q16. Can a firm make changes to a Form 4 that has been submitted with a request for leave to file out of time and is pending in that status?

A16. In that circumstance, a firm can withdraw the pending submission and replace it with a new submission. A note to General Instruction No. 7 of Form 4 describes the process.

Q17. Once a firm has filed a timely Form 4, or the Board has granted leave to file a Form 4 out of time, should any subsequent changes to information that was provided on the Form 4 be submitted through an amendment to the Form 4?

A17. No. Amendments are appropriate only to correct information that was incorrect at the time of the filing, or to supply omitted information that should have been supplied at the time of the filing. The amendment process should not be used to update information that has changed since the Form 4 was filed. To the extent, however, that the subsequent changes are events that are required to be reported on a special report on Form 3, the firm should report them on Form 3 in accordance with Rule 2203.

Q18. Can a firm request confidential treatment for information on Form 4?

A18. A firm may request confidential treatment for certain limited aspects of a Form 4 filing, which are identified in General Instruction No. 9 to Form 4. Confidential treatment requests are not automatically granted. The requirements concerning what a firm must submit in support of a confidential treatment request have changed effective December 31, 2009 and so, for most firms, are different than they were when the firm submitted its registration application. As amended, PCAOB Rule 2300(c) requires both a representation that the information has not otherwise been publicly disclosed and either (1) a detailed explanation of the grounds on which the information is considered proprietary, or (2) a detailed explanation of the basis for asserting that the information is protected by law from public disclosure and a copy of the specific provision of law.

Q19. May a firm refrain from providing information on Form 4 if non-U.S. law prohibits the firm from providing or obtaining the information?

A19. If a non-U.S. firm complies with the requirements of PCAOB Rule 2207 (which applies to Form 4 through PCAOB Rule 2109(d)) and the relevant instructions to Form 4, it may withhold certain limited information because of asserted non-U.S. legal restrictions and still succeed to a predecessor's registration status. PCAOB Rules nevertheless reserve to the Board the right to subsequently require the information. In addition, while a non-U.S. firm may withhold answers to the yes-or-no questions discussed in Q&A 9 on the basis of a non-U.S. legal restriction, doing so will result in succession to registration being temporary only, and the firm would need to file a registration application on Form 1 to seek registration beyond the period of the temporary registration.

Q20. Does the Form 4 process affect any aspect of Securities and Exchange Commission Rules or Commission staff guidance concerning the consequences of mergers or similar transactions involving accounting firms?

A20. No. The Form 4 process has no affect on such matters; it merely allows the new entity to be registered with the PCAOB.

Q21. What should I do if I have further questions?

A21. If you have questions, you should first review the Board's release adopting the reporting requirements, including the rules and Instructions to Form 4, which can be found at http://pcaobus.org/Rules/Rulemaking/Docket020/2008-07-29_Release_No_2008-005.pdf, and the instructions for filling out Form 4 that are available for download after you log into the registration and reporting system. The instructions to Form 4 include various notes intended to address anticipated questions. If you still have questions, you can email the PCAOB's registration staff at registration-help@pcaobus.org.

.10 Staff Questions and Answers — Auditing Standard No. 7, *Engagement Quality Review*, February 19, 2010

Summary

Staff questions and answers set forth the staff's opinions on issues related to the implementation of the standards of the Public Company Accounting Oversight Board ("PCAOB" or "Board"). The staff publishes questions and answers to help auditors implement, and the Board's staff administer, the Board's standards. The statements contained in the staff questions and answers are not rules of the Board, nor have they been approved by the Board.

The following staff question and answer related to Auditing Standard No. 7, *Engagement Quality Review* was prepared by the Office of the Chief Auditor. Additional questions should be directed to Dima Andriyenko, Associate Chief Auditor (202/207-9130; andriyenkod@pcaobus.org) or Greg Scates, Deputy Chief Auditor (202/207-9114; scatesg@pcaobus.org).

* * *

Auditing Standard No. 7

On January 15, 2010, the U.S. Securities and Exchange Commission ("SEC") approved Auditing Standard No. 7, *Engagement Quality Review* ("AS No. 7,"), which was adopted by the PCAOB on July 28, 2009.¹ AS No. 7 supersedes the Board's interim standard,² applies equally to all registered firms,³ and requires an engagement quality review ("EQR") and concurring approval of issuance for each audit engagement and for each engagement to review interim financial information conducted pursuant to the standards of the PCAOB.⁴

In its order approving AS No. 7, the SEC encouraged the PCAOB to provide further implementation guidance on the documentation requirements of the standard in light of comments the SEC received during its comment period. The following staff question and answer provides implementation guidance.

Documentation of an EQR

Q. Page 21 of the adopting release provides the following example of the application of the standard's documentation requirements:

[I]f a reviewer identified a significant engagement deficiency to be addressed by the engagement team, the engagement team should document its response to the identified deficiency in accordance with [Auditing Standard No. 3, *Audit Documentation*]. Because AS No. 7 does not require duplication of documentation prepared by the engagement team, the engagement quality reviewer does not have to separately document the engagement team's response. Rather, the EQR documentation should contain sufficient information to enable an experienced auditor, having no

¹ See SEC Release No. 34-61363 (Jan. 15, 2010); PCAOB Release 2009-004, *Auditing Standard No. 7, Engagement Quality Review and Conforming Amendment to the Board's Interim Quality Control Standards* (Jul. 28, 2009) (the "adopting release").

² Requirements of Membership of the Securities and Exchange Commission Practice Section ("SECPS") of the American Institute of Certified Public Accountants ("AICPA") Section 1000.08(f).

³ The Board's interim standard applied only to registered firms that were members of the SECPS as of April 16, 2003.

⁴ See paragraph 1 of AS No. 7.

previous connection with the engagement, to understand, e.g., the significant deficiency identified, how the reviewer communicated the deficiency to the engagement team, why such matter was important, and how the reviewer evaluated the engagement team's response.

Does this example suggest that the standard requires documentation of all of the interactions between the engagement quality reviewer and the engagement team, including all of the interactions before a matter is identified as a significant engagement deficiency?

A. No. The example in the adopting release illustrates how the documentation requirements of AS No. 7 should be applied once a reviewer concludes that a significant engagement deficiency exists.

Paragraph 19 of AS No. 7 establishes a requirement⁵ that “[d]ocumentation of an engagement quality review should contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the procedures performed by the engagement quality reviewer, and others who assisted the reviewer, to comply with the provisions of this standard....”

[The next page is 11,201.]

⁵ Specific documentation requirements are also set forth at Paragraph 19a-c.

Section 200
[Reserved]



[The next page is 11,301.]

Section 300

Staff Views

.01 An Audit of Internal Control That Is Integrated With an Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies

January 23, 2009

Introduction

The information in this publication is intended to help auditors apply the provisions of the Public Company Accounting Oversight Board's ("PCAOB" or "Board") Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* ("Auditing Standard No. 5"),¹ to audits of smaller, less complex public companies ("smaller, less complex companies"). If used appropriately, it can help auditors design and execute audit strategies that will achieve the objectives of Auditing Standard No. 5. This publication is not, however, a rule of the Board and does not establish new requirements. All audits of internal control over financial reporting—regardless of the size of the company—must comply with the requirements of Auditing Standard No. 5. Also, this publication does not address all of the requirements and direction in Auditing Standard No. 5 or all issues that may be encountered in audits of smaller, less complex companies.

In adopting Auditing Standard No. 5, one of the Board's objectives was to make the audit of management's assessment of the effectiveness of internal control over financial reporting ("audit of internal control") more clearly scalable for smaller, less complex companies. Thus, the standard contains direction to auditors on scaling the audit based on a company's size and complexity. This publication discusses how that direction may be applied to audits of smaller, less complex companies, including smaller companies that are not complex, and how auditors may address some of the challenges that might arise in audits of those companies.

Development of This Publication

This publication was developed by the staff of the Board's Office of the Chief Auditor ("OCA"). To develop the information in this publication, OCA organized a working group composed of auditors who have experience with audits of internal control over financial reporting in smaller, less complex companies. These auditors identified issues that pose particular challenges in auditing internal control in smaller, less complex companies. The auditors provided insights and examples based on their experiences in addressing these issues, and they assisted in drafting a preliminary version of the guidance. In developing that preliminary guidance, OCA also consulted with financial executives from smaller public companies, who helped the staff evaluate whether it appropriately reflected the smaller, less complex company environment.

The staff issued the preliminary guidance for public comment on October 17, 2007, and received 23 comments. After considering those comments, the staff made certain changes in this final version that clarify or enhance the guidance.

¹ PCAOB Release 2007-005A, "Auditing Standard No. 5 – *An Audit Of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements and Related Independence Rule and Conforming Amendments*" (June 12, 2007)

Appendix B to this publication discusses comments received and related changes.

References

This publication assumes that the user is familiar with the provisions of Auditing Standard No. 5 and the following publications:

- Committee of Sponsoring Organizations of the Treadway Commission (“COSO”), *Internal Control—Integrated Framework*²
- COSO, *Internal Control over Financial Reporting—Guidance for Smaller Public Companies* (June 2006) (“COSO Small Companies Guidance”)
- SEC Release No. 33-8810, Commission Guidance Regarding *Management’s Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934* (June 20, 2007) (“SEC Management Guidance”)

The following publications also provide information that might be relevant to the audit of internal control over financial reporting:

- SEC Release No. 33-8809, *Amendments to Rules Regarding Management’s Report on Internal Control Over Financial Reporting* (June 20, 2007)
- SEC Release No. 33-8829, *Definition of the Term Significant Deficiency* (August 3, 2007)
- SEC Release No. 33-8238, *Management’s Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports* (June 5, 2003)
- SEC Office of the Chief Accountant, Division of Corporation Finance, *Management’s Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports: Frequently Asked Questions* (September 24, 2007)

Internal Control Examples in this Publication

This publication discusses certain types of controls and provides examples of those controls to help auditors understand the types of controls that might be encountered in the audit of a smaller, less complex company and to provide a context for the discussion of audit strategies for evaluating the effectiveness of those controls. The discussions and examples of controls do not establish internal control requirements and are not intended as guidance to management regarding establishing or evaluating internal control over financial reporting.

Chapter 1

Scaling the Audit for Smaller, Less Complex Companies

Auditing Standard No. 5 establishes requirements and provides direction that applies when an auditor is engaged to perform an audit of internal control over financial reporting that is integrated with an audit of the financial statements.

The complexity of a company is an important factor in the auditor’s risk assessment and determination of the necessary audit procedures. Auditing

² Auditing Standard No. 5 states that the auditor should use the same internal control framework that management uses in its assessment of internal control. Although this publication uses certain terms and concepts from COSO’s *Internal Control—Integrated Framework*, the principles in this publication could be applied to other internal control frameworks.

Standard No. 5 provides direction on scaling the audit of internal control based on the size and complexity of a company. Scaling is important for audits of internal control of all companies, especially smaller, less complex companies. This chapter highlights principles for scaling the audit of internal control over financial reporting set forth in Auditing Standard No. 5 and discusses considerations for applying the principles in audits of smaller, less complex companies.

The audit of internal control should be integrated with the audit of the financial statements, so the auditor must plan and perform the work to achieve the objectives of both audits.¹ This direction applies to all aspects of the audit, and it is particularly relevant to tests of controls. This chapter discusses testing of controls in an integrated audit of a smaller, less complex company. Appendix A illustrates an audit approach for the integrated audit.

Scaling the Audit of Internal Control

Scaling the audit of internal control involves tailoring the audit approach to fit the individual facts and circumstances of the company. Many smaller companies have less complex operations, and they typically share many of the following attributes:

- Fewer business lines
- Less complex business processes and financial reporting systems
- More centralized accounting functions
- Extensive involvement by senior management in the day-to-day activities of the business
- Fewer levels of management, each with a wide span of control.²

The attributes of a smaller, less complex company can affect the particular risks that could result in material misstatement of the company's financial statements and the controls that a company might establish to address those risks. Consequently, these attributes have a pervasive effect on the audit of internal control, including assessing risk, determining significant accounts and disclosures and relevant assertions, selecting controls to test, and testing the design and operating effectiveness of controls. The following are examples of internal control-related matters that might be particularly affected by the attributes of a smaller, less complex company—

- *Use of entity-level controls to achieve control objectives.* In smaller, less complex companies, senior management often is involved in many day-to-day business activities and performs duties that are important to effective internal control over financial reporting. Consequently, the auditor's evaluation of entity-level controls can provide a substantial amount of evidence about the effectiveness of internal control over financial reporting. Chapter 2 discusses methods of evaluating entity-level controls and explains how that evaluation can affect the testing of other controls.
- *Risk of management override.* The extensive involvement of senior management in day-to-day activities and fewer levels of management can provide additional opportunities for management to override controls or intentionally misstate the financial statements in smaller, less complex companies. In an integrated audit, the auditor should consider the risk of management override and company actions to address that

¹ See Auditing Standard No. 5, paragraphs 6 and 7.

² See Auditing Standard No. 5, paragraph 9.

risk in connection with assessing the risk of material misstatement due to fraud and evaluating entity-level controls.³ Chapter 3 discusses these considerations in more detail.

- *Implementation of segregation of duties and alternative controls.* By their nature, smaller, less complex companies have fewer employees, which limits the opportunity to segregate incompatible duties. Smaller, less complex companies might use alternative approaches to achieve the objectives of segregation of duties, and the auditor should evaluate whether those alternative controls achieve the control objectives.⁴ This is discussed in Chapter 4.
- *Use of information technology (IT).* A smaller, less complex company with less complex business processes and centralized accounting operations might have less complex information systems that make greater use of off-the-shelf packaged software without modification. In the areas in which off-the-shelf software is used, the auditor's testing of information technology controls might focus on the application controls built into the pre-packaged software that management relies on to achieve its control objectives and the testing of IT general controls might focus on those controls that are important to the effective operation of the selected application controls. Chapter 5 discusses IT controls in more detail.
- *Maintenance of financial reporting competencies.* Smaller, less complex companies might address their needs for financial reporting competencies through means other than internal staffing, such as engaging outside professionals. The auditor may take into consideration the use of those third parties when assessing competencies of the company. Chapter 6 discusses the evaluation of financial reporting competencies in more detail.
- *Nature and extent of documentation.* A smaller, less complex company typically needs less formal documentation to run the business, including maintaining effective internal control over financial reporting. The auditor may take that into account when selecting controls to test and planning tests of controls. Chapter 7 discusses this in more detail.

In some audits of internal control, auditors might encounter companies with numerous or pervasive control deficiencies. Smaller, less complex companies can be particularly affected by ineffective entity-level controls, as these companies typically have fewer employees and fewer process-level controls. The auditor's strategy can be influenced by the nature of the control deficiencies and factors such as the availability of audit evidence and the effect of the deficiencies on other controls. Chapter 8 discusses these situations in more detail.

Tests of Controls in an Integrated Audit

Auditing Standard No. 5 provides direction on selecting controls to test and testing controls in an audit of internal control. The standard also provides direction on testing controls for the audit of the financial statements. The following paragraphs discuss how the auditor might apply the directions in Auditing Standard No. 5 to an audit of a smaller, less complex company.

³ See Auditing Standard No. 5, paragraphs 14 and 24.

⁴ See Auditing Standard No. 5, paragraph 42.

Selection of Controls to Test

Appropriate selection of controls helps focus the auditor's testing on those controls that are important to the auditor's conclusion about whether the company's internal control over financial reporting is effective. The decision about whether to select a control for testing depends on which controls, individually or in combination, sufficiently address the assessed risk of misstatement in a given relevant assertion rather than on how the control is labeled (e.g., entity-level control, transaction-level control, control activity, monitoring control, preventive control, or detective control). A practical starting point for identifying these controls is to consider the controls that management relies on to achieve its objectives for reliable financial reporting.

Besides the overriding consideration of whether a control addresses the risk of misstatement, as a practical matter, the auditor might also consider the following factors when selecting controls to test:

- Is the control likely to be effective?
- What evidence exists regarding operation of the control?

When selecting controls to test, the auditor could seek to select controls that are more likely to be effective in addressing the risk of misstatement in one or more relevant assertions.⁵ If none of the controls that are intended to address a risk for a relevant assertion is likely to be effective, the auditor can take that into account in determining the evidence needed to support a conclusion about the effectiveness of controls for this assertion.⁶ Chapter 8 discusses in more detail how auditors could design their audit strategies in a situation when internal control over financial reporting is likely to be ineffective because of the presence of pervasive control deficiencies that result in one or more material weaknesses.

The auditor needs to be able to obtain enough evidence about a control's operation to conclude on its effectiveness. The auditor could take into account the nature and availability of audit evidence when selecting controls to test and determining the nature, timing, and extent of tests of controls. For example, if two or more controls adequately address the risk of misstatement for a relevant assertion, the auditor may select the control for which evidence of operating effectiveness can be obtained more readily. Chapter 7 discusses documentation and audit evidence in more detail.

Tests of Operating Effectiveness of Controls

Historically, the approach for financial statement audits of smaller, less complex companies has been to focus primarily on testing accounts and disclosures, with little or no testing of controls. The internal control reporting requirements under Sections 103 and 404 of the Sarbanes-Oxley Act of 2002 (the "Act") give auditors the opportunity to re-consider their traditional approach to the financial statement audit portion of the integrated audit. The principles in Auditing Standard No. 5 also give auditors latitude to determine an appropriate testing strategy to—

- (a) Obtain sufficient evidence to support the auditor's opinion on internal control over financial reporting as of year-end, and

⁵ There might be more than one control that addresses the assessed risk of misstatement for a particular relevant assertion; conversely, one control might address the assessed risk of misstatement to more than one relevant assertion. It is neither necessary to test all controls related to a relevant assertion nor necessary to test redundant controls, unless redundancy is itself a control objective. See Auditing Standard No. 5, paragraph 40.

⁶ Auditing Standard No. 5, paragraph 47, indicates that, generally, less evidence is needed to support a conclusion that controls are not operating effectively.

- (b) Obtain sufficient evidence to support the auditor's control risk assessments in the audit of the financial statements.⁷

To express an opinion on internal control over financial reporting taken as a whole, the auditor must obtain evidence about the effectiveness of selected controls over all relevant financial statement assertions. Because the auditor's opinion on internal control over financial reporting is as of a point in time, Auditing Standard No. 5 indicates that he or she should obtain evidence that internal control over financial reporting has operated effectively for a sufficient period of time, which may be less than the entire period (ordinarily one year) covered by the company's financial statements.⁸

In an audit of financial statements, the objective of tests of controls is to assess control risk. To assess control risk at less than the maximum, the auditing standards require the auditor to obtain evidence that the relevant controls operated effectively during the entire period upon which the auditor plans to place reliance on those controls.⁹ However, the auditor is not required to assess control risk at less than the maximum for all relevant assertions, and, for a variety of reasons, the auditor may choose not to do so.¹⁰

The auditor's assessment of control risk at the maximum for one or more relevant assertions in an audit of financial statements does not necessarily preclude the auditor from issuing an unqualified opinion in an audit of internal control. The objectives of the two audits are not identical. The auditor could obtain sufficient evidence to support his or her opinion on internal control over financial reporting, even if the auditor decides not to test controls over the entire period of reliance to support a control risk assessment below the maximum. However, if the auditor assesses control risk at the maximum because of identified control deficiencies, the auditor should evaluate the severity of the deficiencies, individually or in combination, to determine whether a material weakness exists.¹¹

The auditor's decision about relying on controls in an audit of financial statements may depend on the particular facts and circumstances. In some areas, the auditor might decide to rely on certain controls to reduce the substantive testing of accounts and disclosures. For other areas, the auditor might perform primarily substantive tests of the assertions without relying on controls. For example, the auditor might test a company's controls over billings and cash receipts processing to cover the entire period of reliance in order to reduce the extent of confirmation of accounts receivable balances but might perform primarily substantive tests of the allowance for doubtful accounts. In this case, the auditor might perform the tests of controls over the allowance for doubtful accounts only as necessary for the audit of internal control over financial reporting.

For some significant accounts, the auditor might decide that a relevant assertion can be tested effectively and efficiently through substantive procedures without relying on controls. For example, the auditor might decide to confirm an outstanding loan payable with the lender rather than rely on controls. In that situation, the auditor may test controls of the relevant assertions only as necessary to support his or her opinion on the company's internal control over financial reporting at year-end.

⁷ See Auditing Standard No. 5, paragraph 7.

⁸ See Auditing Standard No. 5, paragraph B2.

⁹ See paragraph B4 of Auditing Standard No. 5 and paragraph .66 of AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*.

¹⁰ See Auditing Standard No. 5, paragraph B4, and AU sec. 319.65.

¹¹ See Auditing Standard No. 5, paragraph 62.

To obtain evidence about whether a selected control is effective, the control must be tested; the effectiveness of a control cannot be inferred from the absence of misstatements detected by substantive procedures. The absence of misstatements detected by substantive procedures, however, is one of a number of factors that inform the auditor's risk assessments in determining the testing necessary to conclude on the effectiveness of a control.¹² See the section entitled Specific Responses—Substantive Procedures and Tests of Controls in Appendix A to this publication for more discussion on this topic.

Chapter 2

Evaluating Entity-Level Controls

An important aspect of performing an audit of internal control is the process of identifying and evaluating entity-level controls. This chapter discusses entity-level controls and explains how they can affect the nature, timing, and extent of the auditor's procedures in an audit of internal control for a smaller, less complex company.

For the purposes of this discussion, entity-level controls are controls that have a pervasive effect on a company's internal control. These controls include¹ –

- Controls related to the control environment;
- Controls over management override;
- The company's risk assessment process;
- Centralized processing and controls, including shared service environments;
- Controls to monitor results of operations;
- Controls to monitor other controls, including activities of the audit committee² and self-assessment programs;³
- Controls over the period-end financial reporting process; and
- Policies that address significant business control and risk management practices.

In smaller, less complex companies, senior management often is involved in many day-to-day business activities and performs many controls—including entity-level controls—that are important to effective internal control over financial reporting. When this is the case, the auditor's evaluation of entity-level controls can be an important source of evidence about the effectiveness of internal control over financial reporting.

Effective controls related to the control environment and controls that address the risk of management override are particularly important to the effective functioning of controls performed by senior management. Chapter 3 discusses the auditor's evaluation of the risk of management override and mitigating actions.

¹² See Auditing Standard No. 5, paragraphs 47, 58, and B9.

¹ See Auditing Standard No. 5, paragraph 24.

² If no audit committee exists, all references to the audit committee in this publication apply to the entire Board of Directors of the company. See 15 U.S.C. 78c(a)58 and 7201(a)(3).

³ Some smaller, less complex companies might have an internal audit function, especially in regulated industries. If the activities of the internal audit function include controls to monitor other controls, those controls also are entity-level controls.

Auditors might find that limited formal documentation is available regarding the operation of some entity-level controls. Chapter 7 discusses how the auditor can obtain evidence about controls when less formal documentation is available.

Evaluation of Entity-Level Controls and Testing of Other Controls

Auditing Standard No. 5 requires the auditor to test those entity-level controls that are important to the auditor's conclusion about whether the company has effective internal control over financial reporting. This includes evaluating the company's control environment and period-end financial reporting process.⁴

Identifying Entity-Level Controls

The process of identifying relevant entity-level controls could begin with discussions between the auditor and appropriate management personnel for the purpose of obtaining a preliminary understanding of each component of internal control over financial reporting (i.e., control environment, risk assessment, control activities, monitoring, and information and communication).

While evaluating entity-level controls, auditors might identify controls that are capable of preventing or detecting misstatements in the financial statements. The period-end financial reporting process and management's monitoring of the results of operations are potential sources of such controls.

Assessing the Precision of Entity-Level Controls

Auditing Standard No. 5 indicates that entity-level controls vary in nature and precision—

- Some entity-level controls, such as certain control environment controls, have an important, but indirect, effect on the likelihood that a misstatement will be detected or prevented on a timely basis. These controls might affect the other controls the auditor selects for testing and the nature, timing, and extent of procedures the auditor performs on other controls.
- Some entity-level controls monitor the effectiveness of other controls. Such controls might be designed to identify possible breakdowns in lowerlevel controls, but not at a level of precision that would, by themselves, sufficiently address the assessed risk that misstatements to a relevant assertion will be prevented or detected on a timely basis. These controls, when operating effectively, might allow the auditor to reduce the testing of other controls. [See Example 2-1.]
- Some entity-level controls might be designed to operate at a level of precision that would adequately prevent or detect on a timely basis misstatements to one or more relevant assertions. If an entity-level control sufficiently addresses the assessed risk of misstatement, the auditor need not test additional controls relating to that risk.⁵ [See Example 2-2.]

As noted previously, the key consideration in assessing the level of precision is whether the control is designed in a manner to prevent or detect on a timely basis misstatements in one or more assertions that could cause the financial statements to be materially misstated and whether such control is operating

⁴ See Auditing Standard No. 5, paragraph 22, and 25–27.

⁵ See Auditing Standard No. 5, paragraph 23.

effectively.⁶ Factors that auditors might consider when judging the level of precision of an entity-level control include the following:

- *Purpose of the control.* A procedure that functions to prevent or detect misstatements generally is more precise than a procedure that merely identifies and explains differences.
- *Level of aggregation.* A control that is performed at a more granular level generally is more precise than one performed at a higher level. For example, an analysis of revenue by location or product line normally is more precise than an analysis of total company revenue.
- *Consistency of performance.* A control that is performed routinely and consistently generally is more precise than one performed sporadically.
- *Correlation to relevant assertions.* A control that is indirectly related to an assertion normally is less likely to prevent or detect misstatements in the assertion than a control that is directly related to an assertion.
- *Criteria for investigation.* For detective controls, the threshold for investigating deviations or differences from expectations relative to materiality is an indication of a control's precision. For example, a control that investigates items that are near the threshold for financial statement materiality has less precision and a greater risk of failing to prevent or detect misstatements that could be material than a control with a lower threshold for investigation.
- *Predictability of expectations.* Some entity-level controls are designed to detect misstatements by using key performance indicators or other information to develop expectations about reported amounts. The precision of those controls depends on the ability to develop sufficiently precise expectations to highlight potentially material misstatements.

When forming an opinion on the effectiveness of a company's internal control over financial reporting, the auditor should evaluate evidence obtained from all sources, including misstatements detected during the financial statement audit.⁷ Evidence regarding detected misstatements also might be relevant in assessing the level of precision of entity-level controls.

Effect of Entity-Level Controls on Testing of Other Controls

The auditor's evaluation of entity-level controls can result in increasing or decreasing the testing that the auditor otherwise might have performed on other controls. For example, if the auditor has designed an audit approach with an expectation that certain entity-level controls (e.g., controls in the control environment) will be effective and those controls are not effective, the auditor might re-evaluate the planned audit approach and decide to expand his or her audit procedures.

⁶ The auditor should test the design effectiveness of controls by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatement of the financial statements. The auditor should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control has the necessary authority and competence to perform the control effectively. See Auditing Standard No. 5, paragraphs 42 and 44.

⁷ See Auditing Standard No. 5, paragraph 71.

On the other hand, the auditor's evaluation of some entity-level controls can result in a reduction of his or her testing of other controls, such as controls over corresponding relevant assertions. The degree to which the auditor might be able to reduce testing of controls over relevant assertions in such cases depends on the precision of the entity-level controls.

Example 2-1 – Monitoring the Effectiveness of Other Controls

Scenario: A small public video game developer conducts business in the United States and other countries, requiring the company to maintain a multitude of bank accounts. A staff accountant is charged with performing bank reconciliations for the accounts according to a predetermined schedule (some of the accounts have a different closing date). Through inquiries of management, the auditor learns that the company's chief financial officer ("CFO"), who is an experienced accountant, reviews on a monthly basis the bank reconciliations prepared by the staff accountant as a means to determine—

- whether reconciliations are being prepared on a timely basis,
- the nature of reconciling items identified through the process, and
- whether reconciling items are investigated and resolved on a timely basis.

Audit Approach: In this example, the purpose of the control is one of the factors that the auditor considers in assessing precision of the CFO's review. The auditor has noted that the purpose of the CFO's review is to check that the staff has performed the reconciliations as described above. Therefore, the auditor does not expect the CFO's review of the reconciliations to be sufficiently precise to detect misstatements by itself. However, the CFO's review could still influence the auditor's assessment of risk because it provides additional information about the nature and consistency of the reconciliation procedures. The auditor obtains evidence about the CFO's review through inquiry and document inspection, evaluates the review's effectiveness, and determines the amount of direct testing of the reconciliation controls that is needed based on the assessed level of risk. If the auditor concludes that the CFO's review is effective, she could reduce the direct testing of the reconciliation controls, absent other indications of risk.

Example 2-2 – Entity-Level Controls Related to Payroll Processing

Scenario: A manufacturer of alternative fuel products and systems for the transportation market has union labor, supervisors, managers, and executives. All plants run two shifts six days a week, with each having approximately the same number of employees.

The chief financial officer (“CFO”) has been with the company for 10 years and thoroughly understands its business processes, including the payroll process, and reviews weekly payroll summary reports prepared by the centralized accounting function. With the company’s flat organizational design and smaller size, the CFO’s background with the company and his understanding of the seasons, cycles, and workflows, and close familiarity with the budget and reporting processes, the CFO quickly identifies any sign of improprieties with payroll and their underlying cause—whether related to a particular project, overtime, hiring, layoffs, and so forth. The CFO investigates as needed to determine whether misstatements have occurred and whether any internal control has not operated effectively, and takes corrective action.⁸ Based on the results of audit procedures relating to the control environment and controls over management override, the auditor observes that the CFO demonstrates integrity and a commitment to effective internal control over financial reporting.

Audit Approach: The auditor evaluates the effectiveness of the CFO’s reviews, including the precision of those reviews. She inquires about the CFO’s review process and obtains other evidence of the review. She notes that the CFO’s threshold for investigating significant differences from expectations is adequate to detect misstatements that could cause the financial statements to be materially misstated. She selects some significant differences from expectations that were flagged by the CFO and determines that the CFO appropriately investigated the differences to determine whether the differences were caused by misstatements. Also, in considering evidence obtained throughout the audit, the auditor observes that the results of the financial statement audit procedures did not identify likely misstatements in payroll expense.

The auditor decides that the reviews could detect misstatements related to payroll processing because the CFO’s threshold for investigating significant differences from expectations is adequate. However, she determines that the control depends on reports produced by the company’s IT system, so the CFO’s review can be effective only if controls over the completeness and accuracy of those reports are effective.

After performing the tests of the relevant computer controls, the auditor concludes that the review performed by the CFO, when coupled with relevant controls over the reports, meets the control objectives for the relevant aspects of payroll processing described above. (See Chapter 5 for a discussion of tests of controls over such reports.)

⁸ Adapted from the COSO Small Companies Guidance, Volume II: Guidance, page 90.

Chapter 3

Assessing the Risk of Management Override and Evaluating Mitigating Actions

The risk of management override of controls exists in all organizations, but the extensive involvement of senior management in day-to-day activities and fewer levels of management can provide additional opportunities for management to override controls in smaller, less complex companies. Company actions to mitigate the risk of management override are important to the consideration of the effectiveness of internal control over financial reporting.

In an integrated audit, the auditor should consider the risk of management override in connection with assessing the risk of material misstatement due to fraud, as he or she evaluates mitigating actions in connection with the evaluation of entity-level controls and selecting other controls to test.¹ This chapter discusses the auditor's consideration of the risk of management override of internal control and evaluation of actions that companies take to mitigate that risk.

Assessing the Risk of Management Override

AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, requires the auditor to assess the risk of material misstatement due to fraud ("fraud risk"). As part of that assessment, the auditor is directed to perform the following procedures to obtain information to be used in identifying fraud risks, which includes procedures to assess the risk of management override² —

- *Conducting an engagement team discussion regarding fraud risks.* This discussion includes brainstorming about how and where management could override controls to engage in or conceal fraudulent financial reporting.
- *Making inquiries of management, the audit committee, and others in the company to obtain their views about the risks of fraud and how those risks are addressed.* These inquiries can provide information about the possibility of management override of controls.
- *Considering fraud risk factors.* Fraud risk factors include events or conditions that indicate incentives and pressures for management to override controls, opportunities for management override, and attitudes or rationalizations that enable management to justify override of controls.

After identifying fraud risks, the auditor should assess those risks, taking into account an evaluation of the company's programs and controls that are intended to address those risks.³

Because of the characteristics of fraud, the auditor's exercise of professional skepticism is particularly important when considering the risk of material misstatement due to fraud, including the risk of management override of controls.

¹ See Auditing Standard No. 5, paragraph 14.

² See AU sec. 316.14–34.

³ See AU sec. 316.43–45.

Evaluating Mitigating Controls

Auditing Standard No. 5 directs the auditor to evaluate whether the company's controls sufficiently address identified risks of material misstatement due to fraud and controls intended to address the risk of management override of other controls as part of the evaluation of entity-level controls.⁴

Smaller, less complex companies can take a number of actions to address the risk of management override. The following are examples of some of the controls that might address the risk of management override—

- Maintaining integrity and ethical values;
- Active oversight by the audit committee;
- Maintaining a whistleblower program; and
- Controls over certain journal entries.

When assessing a company's anti-fraud programs and controls, the auditor should evaluate whether the company has appropriately addressed the risk of management override.⁵ Often, a combination of actions might be implemented to address the risk of management override.

Evaluating Integrity and Ethical Values

An important part of an effective control environment is sound integrity and ethical values, particularly of top management, which are communicated and practiced throughout the company. A code of conduct or ethics policy is one way that a company can communicate its policies with respect to ethical behavior. This type of control can be effective if employees are aware of the company's policies and observe the policies in practice.

Auditors should evaluate integrity and ethical values as part of the assessment of the control environment component of internal control.⁶ One approach for testing the effectiveness of the company's communications regarding integrity and ethical values is to gain an understanding of what the company believes it is communicating to employees and interview employees to determine if they are aware of the existence of the company's policies for ethical behavior and what they understand those policies to be. A discussion with employees regarding observed behaviors can assist the auditor further in understanding management's past actions and determining whether management's behavior demonstrates and enforces the principles in its code of conduct. The auditor's experience with the company also can be an important source of information about whether management demonstrates integrity and ethical values in its business practices and supports the achievement of effective internal control in its day-to-day activities.

Evaluating Audit Committee Oversight

An active and independent audit committee evaluates the risk of management override, including identifying areas in which management override of internal control could occur, and assesses whether those risks are appropriately addressed within the company. As part of their oversight duties, the audit committee might perform duties such as meeting with management to discuss

⁴ See Auditing Standard No. 5, paragraph 14.

⁵ See Auditing Standard No. 5, paragraphs 14 and 24.

⁶ See Auditing Standard No. 5, paragraph 25.

significant accounting estimates and reviewing the reasonableness of significant assumptions and judgments.⁷

The consideration of the effectiveness of the audit committee's oversight is part of the evaluation of the control environment. In connection with the auditor's inquiries of the audit committee, required by AU sec. 316.22, the auditor may interview audit committee members to determine their level of involvement and their activities regarding the risk of management override. For example, the auditor might read minutes of audit committee discussions on matters related to the committee's oversight or might observe some of those discussions if the auditor attends the meetings in connection with the audit. In addition, the auditor can examine evidence of the board of directors' or audit committee's activities that address the risk of management override, such as monitoring of certain transactions.

Evaluating Whistleblower Programs

A whistleblower program provides an outlet for employees or others to report behaviors that might have violated company policies and procedures, including management override of controls. A key aspect of an effective whistleblower program is the appropriateness of responses to concerns expressed by employees through the program. The audit committee may review reports of significant matters and consider the need for corrective actions.⁸

Audit procedures relating to a whistleblower program are intended to assess whether the program is appropriately designed, implemented, monitored, and maintained. Such procedures might include inquiry of employees, inspection of communications to employees about the program, and, if tips or complaints have been received, follow-up procedures to evaluate whether remedial actions were taken as necessary.

Evaluating Controls over Journal Entries

Controls that prevent or detect unauthorized journal entries can reduce the opportunity for the quarterly and annual financial statements to be intentionally misstated. Such controls might include, among other things, restricting access to the general ledger system, requiring dual authorizations for manual entries, or performing periodic reviews of journal entries to identify unauthorized entries.

As part of obtaining an understanding of the financial reporting process, the auditor should consider how journal entries are recorded in the general ledger and whether the company has controls that would either prevent unauthorized journal entries from being made to the general ledger or directly to the financial statements or detect unauthorized entries.⁹ Tests of controls over journal entries could be performed in connection with the testing of journal entries required by AU sec. 316.

⁷ When a company does not have an audit committee, the entire board of directors is considered the audit committee under Section 2(b)(3) of the Act. In such circumstances, Principle 2, *Board of Directors* of COSO Small Companies Guidance states, "[w]hen a board chooses not to have an audit committee, the full board performing the activities described should have a sufficient number of independent members."

⁸ Section 10A(m)(4) of the Securities Exchange Act of 1934 requires audit committees to "establish procedures for (A) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and (B) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters." The SEC has implemented this provision by adopting rules directing the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the audit committee requirements mandated by the Act.

⁹ See Auditing Standard No. 5, paragraphs 26 and 34; AU sec. 316.58–60.

Considering the Effects of Other Evidence

The auditor might identify indications of management override in other phases of the integrated audit. For example, AU sec. 316 requires the auditor to perform procedures in response to the risk of management override, including examining journal entries for evidence of fraud, reviewing accounting estimates for bias, and evaluating the business rationale for significant, unusual transactions.¹⁰ Also, if the auditor performs walkthroughs during the audit of internal control,¹¹ he or she could obtain information about potential management override by asking employees about their knowledge of override. Also, the auditor might identify indications of management override when evaluating the results of tests of controls or other audit procedures.

If the auditor identifies indications of management override of controls, he or she should take such indications into account when evaluating the risk of override and the effectiveness of mitigating actions.¹²

Example 3-1 – Audit Committee Oversight

Scenario: The audit committee of a small utility company discusses in executive session at least annually its assessment of the risks of management override of internal control, including motivations for management override and how those activities could be concealed. The audit committee performs the following procedures to address the risk of management override: (a) reviews the reasonableness of management's assumptions and judgments used to develop significant estimates; and (b) reviews the functioning of the company's whistleblower process and related reports, and from time to time, inquires of managers not directly responsible for financial reporting (including personnel in sales, procurement, and human resources, among others), obtaining information regarding concerns about ethics or indications of management override of internal controls.¹³

Audit approach: In this situation, the auditor can draw upon several sources of evidence to evaluate the audit committee's oversight. The auditor might attend selected meetings of the audit committee where the risks of override and whistleblower programs are discussed or review minutes of meetings where those matters are discussed. In connection with its inquiries of the audit committee about the risk of fraud, as required by AU sec. 316, the auditor can discuss matters relating to the risk of override, including how the audit committee assesses the risk of management override, what information, if any, the audit committee has obtained about possible management override, and how the audit committee's concerns about the risk of management override have been addressed. This information can inform the auditor's consideration of the risk of management override and the testing of mitigating controls.

¹⁰ See AU sec. 316.57–.66.

¹¹ Auditing Standard No. 5, paragraph 34, sets forth the objectives that should be achieved to further understand likely sources of misstatement and as part of selecting controls to test. The standard states that performing walkthroughs will frequently be the most effective way to achieve the objectives in paragraph 34. Paragraphs 37–38 of Auditing Standard No. 5 provide direction on walkthroughs.

¹² See Auditing Standard No. 5, paragraph 15.

¹³ Adapted from the COSO Small Companies Guidance, Volume II: Guidance, page 26.

Chapter 4

Evaluating Segregation of Duties and Alternative Controls

Segregation of duties refers to dividing incompatible functions among different people to reduce the risk that a potential material misstatement of the financial statements would occur without being prevented or detected. Assigning different people responsibility for authorizing transactions, recording transactions, reconciling information, and maintaining custody of assets reduces the opportunity for any one employee to conceal errors or perpetrate fraud in the normal course of his or her duties.¹

When a person performs two or more incompatible duties, the effectiveness of some controls might be impaired. For example, reconciliation procedures may not effectively meet the control objectives if they are performed by someone who also has responsibilities for transaction recording or asset custody.

Smaller, Less Complex Companies' Approach to Segregation of Duties

By their nature, smaller, less complex companies have fewer employees, which limits their opportunities to implement segregation of duties. Due to these personnel restrictions, smaller, less complex companies might approach the control objectives relevant to segregation of duties in a different manner from larger, more complex companies. Despite personnel limitations, some smaller, less complex companies might still divide incompatible functions by using the services of external parties. Other smaller, less complex companies might implement alternative controls intended to achieve the same objectives as segregation of duties for certain processes.

This chapter discusses the auditor's evaluation of the company's approach to achieving the objectives of segregation of duties at a smaller, less complex company.

Audit Strategy Considerations

It is generally beneficial for the auditor and the company to identify concerns related to segregation of duties early in the audit process to allow the auditor to design procedures that effectively respond to those concerns. Also, management might have already identified, as part of its risk assessment, risks relating to inadequate segregation of duties and alternative controls that respond to those risks. Where walkthroughs are performed, those procedures can help identify matters related to segregation of duties.

When management implements an alternative control or combination of controls that address the same objectives as segregation of duties, the auditor should evaluate whether the alternative control or controls effectively meet the related control objectives.² The auditor's approach to evaluating those alternative control or controls depends on the control objectives, the nature of the controls, and the associated risks. The following sections of this chapter discuss how the auditor can evaluate common approaches to the objectives of segregation of duties.

¹ See the COSO Small Companies Guidance, Volume II: Guidance, page 5, for discussion of management's actions relevant to segregation of duties issues.

² See Auditing Standard No. 5, paragraph 42.

Use of External Resources

Some small companies use external parties to assist with some of their financial reporting-related functions. Use of external parties also can help achieve segregation of certain incompatible duties without investing in additional full-time resources.

A company might use one or more types of external-party arrangements in meeting its control objectives. Consultants, other professionals, or temporary employees can assist companies in performing some controls or other duties. For more complex or specialized portions of internal control, such as cash receipts handling, payroll processing, or securities recordkeeping, the company might use an external party to perform an entire function.

When controls over a relevant assertion depend on the use of an external party to perform a particular function, the auditor could evaluate that function in relation to the company's other relevant controls and procedures. The audit approach used with respect to the externally performed function depends on the circumstances. For those controls that are documented or are observable by the auditor (e.g., controls performed by external professionals at the company's premises), the auditor's evaluation may be similar to what he or she could perform for the company's other controls. For some externally performed functions, the direction relating to use of service organizations may be relevant.³

Management Oversight and Review

A smaller, less complex company might address some segregation of duties matters through alternative controls involving management oversight and review activities, e.g., reviewing transactions, checking reconciliations, reviewing transaction reports, or taking periodic asset counts.⁴ Many of those types of management activities could be entity-level controls. Chapter 2 discusses the auditor's evaluation of entity-level controls at a smaller, less complex company.⁵ Example 4-1 below, and Example 5-1 in Chapter 5 illustrate the testing of certain types of alternative controls.

When the auditor applies a top-down approach to select the controls to test, starting at the financial statement level and evaluating entity-level controls,⁶ the auditor might identify entity-level controls that are designed to operate at a level of precision to effectively address the risk of misstatement for one or more relevant assertions. In those cases, the auditor could select and test those entity-level controls rather than test the process controls that could be affected by inadequate segregation of duties.

³ See Auditing Standard No. 5, paragraphs B17 – B27, for discussion of the auditor's consideration of a company's use of a service organization in an audit of internal control.

⁴ See the COSO Small Companies Guidance, Volume II: Guidance, page 5, for examples of the types of management actions that might be used as alternatives to segregation of duties.

⁵ As discussed in Chapter 2, controls related to the control environment and controls over the risk of management override are particularly important to the effective functioning of the controls performed by senior management. Chapter 3 discusses assessing the risk of management override and evaluating mitigating controls.

⁶ See Auditing Standard No. 5, paragraph 21.

Example 4-1 – Alternative Controls over Inventory

Scenario: A provider of office furnishings and equipment uses a locked storeroom to store certain key components. The person responsible for the components has access to both the storeroom and the related accounting records. To address the risks related to undetected loss of components, the manager responsible for purchasing performs periodic spot-checks of the components and reconciles them to the general ledger in addition to the inventory ledger. The components also are included in the company's year-end inventory count. IT access controls are implemented to prevent the person responsible for the components from entering transactions or modifying related account balances in the general ledger.⁷

Audit approach: The auditor observes the company's year-end inventory counting process. He inspects documentation for some of the periodic spot-checks and the related reconciliations. For discrepancies in the counts or reconciliations inspected, he performs inquiries and inspects the accounting records to determine whether those items were appropriately resolved. Relevant IT access controls are evaluated in connection with the evaluation of IT general controls. (See Chapter 5.)

Chapter 5

Auditing Information Technology Controls in a Less Complex Information Technology Environment

A company's use of information technology (IT) can have a significant effect on the audit of internal control. The IT environment is a consideration in the auditor's risk assessments, selection of controls to test, tests of controls, and other audit procedures.

This chapter discusses the auditor's evaluation of IT controls in a smaller company with a less complex IT environment. It explains how the auditor could decide which IT controls to evaluate and how the auditor could evaluate those controls. In addition, it provides an overview of the major categories of IT controls and related testing considerations for a smaller, less complex IT environment.

Characteristics of Less Complex IT Environments

In smaller companies, less complex IT environments tend to have the following characteristics:

- *Transaction processing.* Data inputs can be readily compared or reconciled to system outputs. Management tends to rely primarily on manual controls over transaction processing.
- *Software.* The company typically uses off-the-shelf packaged software without programming modification. The packaged software requires relatively little user configuration to implement.¹
- *Systems configurations and security administration.* Computer systems tend to be centralized in a single location, and there are a limited number of interfaces between systems. Access to systems is typically managed by a limited number of personnel.

⁷ Adapted from the COSO Small Companies Guidance, Volume II: Guidance, page 60.

¹ Significant user configuration might create additional risks that require additional controls.

- *End-user computing.* The company is relatively more dependent on spreadsheets and other user-developed applications, which are used to initiate, authorize, record, process, and report the results of business operations, and, in many instances, perform straightforward calculations using relatively simple formulas.

The complexity of the IT environment has a significant effect on the risks of misstatement and the controls implemented to address those risks. The auditor's approach in an environment with the preceding characteristics may be different from the approach in a more complex IT environment.

Some smaller, less complex companies outsource certain of their IT functions to service organizations. Auditing Standard No. 5, paragraphs B17–B27, provides direction on the auditor's consideration of a company's use of a service organization in an audit of internal control.

Determining the Scope of the Evaluation of IT Controls

The following matters affect the scope of the auditor's evaluation of IT controls in a smaller company with a less complex IT environment—

- The risks, i.e., likely sources of misstatement, in the company's IT processes or systems relevant to financial reporting, and the controls that address those risks.²
- The reports produced by IT systems that are used by the company for performing important controls over financial reporting.
- The automated controls that the company relies on to maintain effective internal control over financial reporting.

The IT controls that are important to effective internal control over financial reporting generally relate to at least one of the preceding matters, which are discussed in more detail in the following paragraphs. IT control categories and testing procedures are discussed later in this chapter.

IT-Related Risks Affecting Financial Reporting

Paragraph .19 of AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*, lists the following types of IT-related risks that could affect the reliability of financial reporting—

- 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.

² Auditing Standard No. 5, note to paragraph 36, indicates that the identification of risks and controls within IT is not a separate evaluation. Instead, it is an integral part of the top-down approach used to identify significant accounts and disclosures and their relevant assertions, and the controls to test, as well as to assess risk and allocate audit effort as described by the standard.

The IT-related risks that are reasonably possible to result in material misstatement of the financial statements depend on the nature of the IT environment. In a less complex environment, the auditor could identify many of the risks by understanding the software being used and how it is installed and used by the company.

After understanding the relevant IT-related risks, the auditor should identify the controls that address those risks.³ These controls could include automated controls and IT-dependent controls and the IT general controls that are important to the effective operation of the selected controls. For example, even the simplest IT environments generally rely on controls that are designed to make sure that necessary software updates are appropriately installed, access controls that are designed to prevent unauthorized changes to financial data, and other controls that address potential loss of data necessary for financial statement preparation.

As the complexity of the software or environment increases, the type and number of potential IT risks increase, which could lead the auditor to devote more attention to IT controls.

IT-Dependent Controls

Many controls that smaller, less complex companies rely on are manual controls. Some of those controls are designed to use information in reports generated by IT systems, and the effectiveness of those controls depends on the accuracy and completeness of the information in the reports. When those IT-dependent controls are selected for testing, it also may be necessary to select controls over the completeness and accuracy of the information in the reports in order to address the risk of misstatement. Example 5-1 presents an illustration involving IT-dependent controls.

Other Automated Controls

Although smaller, less complex companies tend to rely primarily on manual controls, they could rely on certain automated controls built into the packaged software to achieve some control objectives. For example, software controls can be used to maintain segregation of duties, prevent certain data input errors, or to help make sure that certain types of transactions are properly recorded. The auditor might focus some of his or her testing on these automated controls and the IT general controls that are important to the effective operation of the automated controls.⁴

Consideration of Deficiencies in General Controls on Tests of Other Controls

IT general controls support operation of the application controls by ensuring the proper access to, and functioning of, the company's IT systems. Deficiencies in the IT general controls may result in deficiencies in the operation of the automated or IT-dependent controls. One of the factors in the auditor's evaluation of the identified deficiencies in the IT general controls, is the interaction of an IT general control and the related automated or IT-dependent controls.⁵

In some situations, an automated or IT-dependent control might be effective even if deficiencies exist in IT general controls. For example, despite the presence of deficient program change controls, the auditor might directly test

³ See Auditing Standard No. 5, paragraph 36.

⁴ See Auditing Standard No. 5, paragraph 47.

⁵ According to paragraph 65 of Auditing Standard No. 5, one of the risk factors that affects the severity of a deficiency is "The interaction or relationship of the control with other controls, including whether they are interdependent or redundant."

the related automated or IT-dependent manual control, giving consideration to the risk associated with the deficient change controls in his or her risk assessment and audit strategy. If the testing results were satisfactory, the auditor could conclude that the automated or IT-dependent manual controls operated effectively at that point in time e.g., as of the issuer's fiscal year end. On the other hand, deficient program change controls might result in unauthorized changes to application controls, in which case the auditor could conclude that the application controls are ineffective.

Example 5-1 – IT-Dependent Controls

Scenario: A company has a small finance department. For the accounting processes that have a higher risk of misstatement, senior management performs a number of business process reviews and analyses to detect misstatements in transaction processing.

The company has a small IT department that supports a packaged financial reporting system whose software code cannot be altered by the user. Since the company uses packaged software, and there have been no changes to the system or processes in the past year, the IT general controls relevant to the audit of the internal control over financial reporting are limited to certain access controls and certain computer operation controls related to identification and correction of processing errors. Management uses several system-generated reports in the business performance reviews, but these reports are embedded in the application and programmed by the vendor and cannot be altered.

Audit Approach: The auditor determines that senior management personnel performing the business process reviews and analyses are not involved with incompatible functions or duties that impair their ability to detect misstatements. Based on the auditor's knowledge of the financial reporting system and understanding of the transaction flows affecting the relevant assertions, the auditor selects for testing certain process reviews and analyses and certain controls over the completeness and accuracy of the information in the reports used in management's reviews. The tests of controls could include, for example

- Evaluating management's review procedures including assessing whether those controls operate at an appropriate level of precision. (See Chapter 2.)
- Evaluating how the company assures itself regarding the completeness and accuracy of the information in the reports used by management in the reviews. Matters that might be relevant to this evaluation include how the company determines that –

The data included in the report are accurate and complete. This evaluation might be accomplished through testing controls over the initiation, authorization, processing, and recording of the respective transactions that feed into the report.

The relevant computer settings established by the software user are consistent with the objectives of management's review. For example, if management's review is based on items in an exception report, the reliability of the report depends on whether the settings for reporting exceptions are appropriate.

The auditor verifies that the code in the packaged software cannot be changed by the user. The auditor also evaluates the IT general controls that are important to the effective operation of the IT-dependent controls (such as the access controls and operations controls previously described).

Categories of IT Controls

The remaining sections of this chapter discuss major categories of IT controls and considerations for testing them in a smaller, less complex IT environment.

IT General Controls

IT general controls are broad controls over general IT activities, such as security and access, computer operations, and systems development and system changes.

Security and Access

Security and access controls are controls over operating systems, critical applications, supporting databases, and networks that help ensure that access to applications and data is restricted to authorized personnel.

In a small, less complex IT environment, security administration is likely to be centralized, and policies and procedures might be documented informally. A small number of people or a single individual typically supports security administration and monitoring on a part-time basis. Controls for mitigating the risk caused by a lack of segregation of duties over operating systems, data, and applications tend to be detective controls rather than preventive. Access controls tend to be monitored informally.

Tests of security and access controls could include evaluating the general system security settings and password parameters; evaluating the process for adding, deleting, and changing security access; and evaluating the access capabilities of various types of users.

Computer Operations

Computer operations controls relate to day-to-day operations and help ensure that computer operational activities are performed as intended, processing errors are identified and corrected in a timely manner, and continuity of financial reporting data is maintained through effective data backup and recovery procedures.

A smaller, less complex IT environment might not have a formal operations function. There might not be formal policies regarding problem management or data storage and retention, and backup procedures tend to be initiated manually.

Tests of controls over computer operations could include evaluating the backup and recovery processes, reviewing the process of identifying and handling operational problems, and, if applicable, assessing control over job scheduling.

Systems Development and System Changes

Systems development and system change controls are controls over systems selection, design, implementation, and configuration changes that help ensure that new systems are appropriately developed, configured, approved, and migrated into production, and controls over changes—whether to applications, supporting databases, or operating systems—that help to ensure that those changes are properly authorized and approved, tested, and implemented. Although they might be viewed as separate categories, in less complex environments, systems development and system change procedures often are combined for ease of implementation, training, and ongoing maintenance.

A smaller, less complex IT environment typically includes a single or small number of off-the-shelf packaged applications that do not allow for modification of source code. Modifications to software are prepared by and, in some cases, implemented by, the software vendor in the form of updates or patches or via

a network connection between the vendor and the organization. Typically, a small number of individuals or a single individual (employees or consultants) support all development and production activities.

Examples of possible tests of controls over systems development and system changes include examining the processes for selecting, acquiring, and installing new software; evaluating the process for implementing software upgrades or patches; determining whether upgrades and patches are authorized and implemented on a timely basis; and assessing the process for testing new applications and updates.

Application Controls

Application controls are automated or IT-dependent controls intended to help ensure that transactions are properly initiated, authorized, recorded, processed, and reported. For example, in a three-way match process, received vendor invoices are entered into the system, which matches them automatically to the purchase order and goods receipt based on the document reference numbers, price, and quantity. The system's simultaneous matching of the information within the three documents upon their entry to authorize a payment to the vendor is an automated application control. Management's review and reconciliation of an exception report generated by the system is an example of an IT-dependent manual control.⁶

The general nature of application controls tends to be similar in most IT environments, although in less complex environments, the controls tend to be manual and detective rather than automated and preventive. The testing procedures also could be similar. In most IT environments, the auditor could focus on error correction procedures over inputting, authorizing, recording, processing, and reporting of transactions when evaluating application controls. However, in less complex IT environments there might be fewer financial applications affecting relevant assertions and fewer application controls within those applications.

Regardless of the complexity of the IT environment, the audit plan for testing application controls could include a combination of inquiry, observation, document inspection, and re-performance of the controls. Efficiencies can be achieved through altering the nature, timing, and extent of testing procedures performed related to automated and IT-dependent application controls if IT general controls are designed and operating effectively. In some situations, benchmarking of certain automated controls might be an appropriate audit strategy.⁷

End-User Computing Controls

End-user computing refers to a variety of user-based computer applications, including spreadsheets, databases, ad-hoc queries, stand-alone desktop applications, and other user-based applications. These applications might be used as the basis for making journal entries or preparing other financial statement information. End-user computing is especially prevalent in smaller, less complex companies.

End-user computing controls are controls over spreadsheets and other user-developed applications that help ensure that such applications are adequately documented, secured, backed up, and reviewed regularly for process integrity.

⁶ See Example 5-1 for an illustration of how those types of controls might be tested in a small, less complex IT environment.

⁷ Auditing Standard No. 5, paragraphs B28–B33, discuss benchmarking of automated controls.

Enduser computing controls include general and application controls over user-developed spreadsheets and applications.

Tests of controls over end-user computing could include assessing access controls to prevent unauthorized access; testing of controls over spreadsheet formulas or logic of queries and scripts; testing of controls over the completeness and accuracy of information reported by the end-user computing applications; and reviewing the procedures for backing up the applications and data.

Chapter 6

Considering Financial Reporting Competencies and Their Effects on Internal Control

To maintain effective internal control over financial reporting, a company needs to retain individuals who are competent in financial reporting and related oversight roles.¹ Smaller, less complex companies can face challenges in recruiting and retaining individuals with sufficient experience and skill in accounting and financial reporting. Also, resource limitations might prevent a smaller, less complex company from employing personnel who are familiar with the accounting required for unique, complex, or nonroutine transactions or relevant changes in rules, regulations, and accounting practices. Smaller, less complex companies might address their needs for financial reporting competencies through means other than internal staffing, such as engaging outside professionals.

This chapter discusses the auditor's consideration of financial reporting competencies at a smaller, less complex company, including situations in which a smaller, less complex company enlists outside assistance in financial reporting matters.

Understanding and Evaluating a Company's Financial Reporting Competencies

The evaluation of competence is one aspect of evaluating the control environment and the operating effectiveness of certain controls. For example, when evaluating entity-level controls, such as risk assessment and the period-end financial reporting process, the auditor could obtain information about whether—

- Management identifies the relevant financial reporting issues on a timely basis (e.g., issues arising from new transactions or lines of business or changes to accounting standards); and
- Management has the competence to ensure that events and transactions are properly accounted for and that financial statements and related disclosures are presented in conformity with generally accepted accounting principles (“GAAP”).

For recurring clients, the auditor's experience in prior audit engagements can be a source of information regarding management's financial reporting competencies. The auditor could be aware of specific accounts or disclosures that have caused problems in prior engagements, or of management's response to past changes in accounting pronouncements. These experiences can inform the auditor about management's financial reporting competencies, including whether and how management identifies and responds to financial reporting

¹ See e.g., Principle 5 of the COSO Small Companies Guidance.

risks. The procedures performed to evaluate the period-end financial reporting process also could be valuable to the evaluation of financial reporting competency.

The auditor's inquiries and observations pertaining to the company's overall commitment to competence, which is part of the evaluation of the control environment, also can inform the auditor's assessment of financial competency. The auditor can consider whether and how the company and management—

- Establish and agree on the knowledge, skills and abilities needed to carry out the required responsibilities prior to hiring individuals for key financial reporting positions,
- Train employees involved in financial reporting processes and provide them with the appropriate tools and resources to perform their responsibilities, and
- Periodically review and evaluate employees relative to their assigned roles, including whether the audit committee (or board of directors) evaluates the competencies of individuals in key financial reporting roles, such as the chief executive and financial reporting officers.

Auditors may keep in mind that company financial reporting personnel do not need to be experts in all areas of accounting and financial reporting but need to be sufficiently competent with respect to the accounting for current and anticipated transactions and changes in accounting standards to identify and address the risks of misstatement.

Supplementing Competencies with Assistance from Outside Professionals

Some smaller, less complex companies might not have personnel on staff with experience in certain complex accounting matters that are encountered. In these circumstances, a company might engage outside professionals to provide the necessary expertise (i.e., an individual or firm possessing special skill or knowledge in the particular accounting and financial reporting matter).² When assessing the competence of the personnel responsible for the company's financial reporting and associated controls, the auditor may consider the combined competence of company personnel and other parties that assist with functions related to financial reporting.

When an outside professional provides accounting assistance related to relevant assertions or the period-end financial reporting process, the auditor might begin by considering how the company assures itself that events and transactions are properly accounted for and that financial statements and the related disclosures are free of material misstatement. The company might have differing levels of involvement with outside professionals, depending upon the nature of the services provided. The auditor could evaluate management's oversight to determine whether the company, with the assistance of the professional, is adequately identifying and responding to risks.³ In performing this evaluation, the auditor can consider—

² This section of the chapter does not pertain to management's use of a service organization that supports routine accounting functions, such as processing payroll transactions or supporting the company's information technology systems. It also does not apply to management's use of specialists in matters outside of accounting and financial reporting, such as actuaries, engineers, environmental consultants, and geologists. See Auditing Standard No. 5, AU sec. 324, *Service Organizations*, and AU sec. 336, *Using the Work of Specialists*, for direction on these matters.

³ If the audit committee has oversight over the use of service providers, the auditor may also consider the nature and extent of that oversight.

- Whether management recognizes situations for which additional expertise is needed to adequately identify and address risks of misstatement.
- How management determines that the outside professionals possess the necessary qualifications. For example, management might obtain information from the professional about his or her skills and competence.
- Whom management designates to oversee the services and whether they possess the suitable skill, knowledge, or experience to sufficiently oversee the outside professionals. (Note: Management is not required to possess the expertise to perform or re-perform the services.)
- Whether management has established controls over the work of the outside accounting professional and over the completeness and accuracy of the information provided to the outside professional. For example, in addition to reviewing the work of the outside professional, management might inquire about the professional's monitoring and review procedures related to the work performed by the professional for the company.
- How management participates in matters involving judgment, for example, whether management understands and makes significant assumptions and judgments underlying accounting calculations prepared by an outside professional.
- How management evaluates the adequacy and the results of the services performed, including the form and content of the outside accounting professional's findings, and accepts responsibility for the results of the services.

In gathering evidence to support this evaluation, the auditor could hold discussions with both management and the outside professional, perhaps while obtaining an understanding of the period-end financial reporting process. The auditor also could inspect documentation that provides support for management's oversight of the outside professional.⁴

⁴ Refer to Chapter 7 for discussion of how the auditor can obtain sufficient evidence when less formal documentation is available.

Example 6-1 – Assistance from Outside Professionals

Scenario: A small developer of analytical software products does not have an individual with strong tax accounting expertise on staff. The company retains a thirdparty accounting firm (not its auditor) to prepare the income tax provision. Management obtains information from the third-party accounting firm about the training and experience of the staff assigned to do this work. The company's CFO, who has basic knowledge of tax accounting, reviews and discusses the tax provision with the accounting firm that prepared it, and compares the provision to CFO's expectations based on past periods, budgets, and knowledge of business operations.⁵

Audit Approach: The auditor observes that management identifies risks to financial reporting related to accounting for income taxes and engages an outside professional to provide technical assistance. Further, the auditor evaluates management's oversight to determine whether the company, with the assistance of the professional, is adequately identifying and responding to risks of material misstatement regarding the income tax provision. As part of this evaluation, the auditor inspects the engagement letter, other correspondence between the company and the third-party firm, and the tax schedules and other information produced by the third-party firm. The auditor also evaluates the controls over the completeness and accuracy of the information furnished by the company to the third-party firm. The auditor also assesses whether the third-party accounting firm has the proper skills and staff assigned to do this work.

Chapter 7

Obtaining Sufficient Competent Evidence When the Company Has Less Formal Documentation

Implementing and assessing effective internal control over financial reporting by a company's management generally involves some level of documentation. A smaller, less complex company often has different needs for documentation, and the nature of that documentation might differ from that of a larger or more complex organization. Differences in the form and extent of control documentation of smaller, less complex companies generally relate to their operating characteristics, particularly to fewer resources and more direct interaction of senior management with controls.¹

The nature and extent of a company's documentation of internal control over financial reporting can have a significant effect on the auditor's strategy regarding the audit of internal control. This chapter discusses how the auditor could adapt his or her audit strategy to obtain sufficient competent evidence in an environment with less formal documentation.

Audit Strategy Considerations

The auditor must plan and perform the audit to obtain competent evidence that is sufficient to obtain reasonable assurance about whether material weaknesses exist as of the date specified in management's assessment.² The auditor can obtain this evidence through direct testing or using the work of others, as appropriate. Procedures the auditor could perform to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the

⁵ Adapted from the COSO Small Companies Guidance, Volume II: Guidance, page 34.

¹ The COSO Small Companies Guidance, Volume II: Guidance, pages 12–13, discusses circumstances that affect the need for documentation of internal control.

² See Auditing Standard No. 5, paragraph 3.

company's operations, inspection of relevant documentation, and re-performance of the control. The nature, timing, and extent of tests of controls depend on the risk associated with the controls. As the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases.³

PCAOB standards establish the documentation requirements for these audits. Those documentation requirements apply only to the auditor.

Documentation of Processes and Controls

Larger companies with complex operations are more likely to have formal documentation of their processes and controls, such as in-depth policy manuals and systems flowcharts of processes. In a smaller, less complex company, documentation of processes and controls might take a variety of forms. For example, information about processes and controls might be found in other documentation, such as memoranda, questionnaires, software manuals, source documents, or job descriptions. This documentation might not cover every process and might not be in a consistent form across all processes.

Where walkthroughs are performed, auditors could use those procedures to obtain an understanding of the flow of transactions affecting relevant assertions and to assess the design effectiveness of certain controls, even when documentation is limited.

Documentation of Operating Effectiveness of Controls

In a smaller, less complex business, the nature and extent of documentation of the operating effectiveness of controls may vary. Also, evidence of a control's operation might exist only for a limited period.

The type and availability of evidence regarding controls to be tested can affect the auditor's testing strategy.⁴ In particular, company documentation can influence the nature and timing of audit procedures performed. For example, the nature of some audit procedures e.g., document inspection, requires documentation. Also, the timing of some tests of controls might be determined, in part, based on when the evidence of the controls' operation is available.

Obtaining sufficient evidence about the operating effectiveness of controls can be challenging when there is limited documentation of their operation. In those situations, inquiry combined with other procedures, such as observation of activities, inspection of documentation produced or used by the controls,⁵ and reperformance of certain controls, might provide sufficient evidence about whether a control is effective.

As a practical matter, the auditor also needs to obtain documentation of the work of others to use that work to reduce the auditor's own testing.⁶

Other Considerations

When auditing a smaller, less complex company with limited documentation, it generally is helpful to obtain an understanding of the nature and availability

³ Auditing Standard No. 5, paragraph 46. Paragraph 47 discusses the factors that affect the risk associated with a control.

⁴ As discussed in Chapter 8, a pervasive lack of documentation and other audit evidence could prevent the auditor from being able to obtain sufficient evidence to support an opinion on internal control.

⁵ Examples of documentation that might be produced or used by controls include exception reports, memoranda, or documented communications between management and employees.

⁶ The auditor's use of the work of others also is dependent on such factors as the nature of the subject matter and the competence and objectivity of the individuals performing the work. See Auditing Standard No. 5, paragraphs 16–19.

of audit evidence relating to internal control over financial reporting as early in the audit process as practical. This understanding ordinarily includes consideration of existing documentation regarding—

- Company processes and procedures, particularly for transactions affecting relevant assertions and controls that the auditor is likely to select for testing
- Monitoring of other controls performed by management or others

The auditor can then identify gaps in important documentation so alternatives can be explored. For example, if the CFO prepares contemporaneous documentation of certain controls and retains it for a limited period, the auditor might arrange to obtain access to that documentation for testing purposes. Early conversations with management about these matters can help provide auditors with the most flexibility in developing efficient and effective audit strategies.

If the company does not have formal documentation of its processes and controls, the auditor may consider whether other documentation is available before drafting formal descriptions of processes and controls for the audit documentation. A practical way to identify such other documentation is to look at the information that the company uses to run the business.

As discussed in Chapter 1, one of the practical considerations when selecting controls to test and determining the nature, timing, and extent of testing is the nature and availability of evidence of operating effectiveness. For example, if two or more controls adequately address the risk of misstatement for a relevant assertion, the auditor could select the control for which evidence of operating effectiveness can be obtained more readily.

Example 7-1 – Obtaining Information about Processes and Controls

Scenario: A small manufacturer in the electronics industry periodically makes large purchases of specialty components. The company has established procedures covering the initiation, authorization, and recording of these purchases, although the company has not developed an in-depth policies and procedures manual. The company's procedures provide for completion of a form that describes the product requirements and payment terms and indicates how to record the purchase. The forms are reviewed and approved by the CEO and CFO before the purchase is executed. When the goods are received, they are matched with the purchase form and accounted for as indicated on the form.

Audit Approach: The auditor inspects a copy of a completed purchase form and related documentation to obtain an initial understanding of the flow of the purchase transactions. She follows up with inquiries of personnel involved in the process of authorizing, sending, and accounting for the purchases and traces the recording of the transactions through the accounting system. She summarizes her understanding of the transaction flow in a memo and includes a copy of a purchase form in the workpapers. The auditor uses her understanding of the purchase process to plan and perform tests of selected controls over the purchases.

Example 7-2 – Obtaining Evidence about Operating Effectiveness of Controls

Scenario: One control that management relies on with respect to the period-end financial reporting process is the CFO's review of the quarterly financial statements prepared by the controller. The CFO does not create separate documentation of her review but does retain copies of the financial statements with her handwritten notes and other markings for reference purposes. She sends her review comments to the controller via email, and the company's email system retains the email messages. If errors are identified, the controller prepares adjusting entries, which are approved by the CFO.

Each quarter, the CFO and controller prepare and present to the audit committee a financial package, explaining significant trends in the company's financial condition, operating results, and cash flows, as well as comparisons to budgeted amounts and comparable prior periods.

Audit Approach: The auditor can draw upon multiple sources of audit evidence to evaluate whether the control is in place and operating effectively to detect errors in the period-end financial reporting process. He can make inquiries of the CFO to obtain an understanding of the frequency, nature, timing, and level of precision⁷ of the CFO's review. He can corroborate this understanding and evaluate the operating effectiveness of the review by, for selected items, inspecting copies of the reviewed drafts of the financial statements, reviewing comments sent to the controller, and reviewing adjusting entries and supporting information. He can also talk to other employees to find out if the CFO contacts them to ask questions, what types of questions are asked, and how those questions are resolved. In addition, he can read the information in the financial package delivered to the audit committee and might observe the CFO's financial review with the audit committee, if the auditor attends the meetings in connection with the audit.

Chapter 8

Auditing Smaller, Less Complex Companies with Pervasive Control Deficiencies

In some audits of internal control, auditors might encounter companies with numerous or pervasive deficiencies in internal control over financial reporting. Smaller, less complex companies can be particularly affected by ineffective entity-level controls, as these companies typically have fewer employees and fewer process-level controls.

Auditing internal control over financial reporting in companies with pervasive deficiencies can be challenging. The auditor's strategy is influenced by the nature of the control deficiencies and factors such as the effect of the deficiencies on other controls and the availability of audit evidence. Although the facts and circumstances can vary significantly, the auditor might not be able to express an unqualified opinion on the effectiveness of internal control over financial reporting in some of these situations.¹

This chapter discusses how auditors could design their audit strategies in response to situations involving pervasive deficiencies.

⁷ Level of precision is discussed in more detail in Chapter 2.

¹ To enable the auditor to express an unqualified opinion on internal control, the company would need to remediate all of its material weaknesses early enough before year-end to enable the auditor to obtain sufficient competent audit evidence about the remediated controls to support an unqualified opinion on internal control over financial reporting.

Pervasive Deficiencies that Result in Material Weaknesses

The auditor's objective in an audit of internal control is to express an opinion on the effectiveness of the company's internal control over financial reporting. Because a company's internal control over financial reporting cannot be considered effective if one or more material weaknesses exist, to form a basis for expressing an opinion, the auditor must plan and perform the audit to obtain competent evidence that is sufficient to obtain reasonable assurance about whether material weaknesses exist as of the date specified in management's assessment.²

Ordinarily, the auditor's strategy should include tests of controls as necessary to support a conclusion that internal control over financial reporting is effective.³ However, the auditor's existing knowledge of the company or information obtained early in the audit process might lead an auditor to a preliminary judgment that internal control over financial reporting is likely to be ineffective because of the presence of pervasive control deficiencies that result in one or more material weaknesses. In those situations, the auditor's strategy for testing selected controls may depend on the effect of the pervasive deficiencies on other controls, as discussed in the following paragraphs.

Considering the Effect of Pervasive Control Deficiencies on Other Controls

When the auditor encounters pervasive control deficiencies, he or she might decide that those deficiencies also impair the effectiveness of other controls by rendering their design ineffective or by keeping them from operating effectively. For example, certain deficient entity-level controls, such as the following, might impair the effectiveness of other controls over relevant assertions:

- *Ineffective control environment (considering the risk profile of the company).* An ineffective control environment can increase the risk associated with a control by rendering its design ineffective or preventing it from operating effectively. Also, certain controls in the control environment, such as maintaining financial reporting competencies, might be necessary for the effective functioning of other controls.
- *Ineffective IT controls or information systems.* Ineffective information systems could impair the effectiveness of certain IT-dependent controls (e.g., monitoring controls that rely on the reports produced by an ineffective information system).
- *Pervasive lack of segregation of duties without appropriate alternative controls.* When a person performs two or more incompatible duties, the design of some controls might be ineffective without appropriate alternative controls.
- *Frequent management override of controls.* A control that is frequently overridden is less likely to operate effectively. The effectiveness of controls that depend on an overridden control also might be impaired.

The top-down audit approach can help the auditor identify pervasive control deficiencies earlier in the audit process and take them into account in determining the audit approach for testing other controls.

² See Auditing Standard No. 5, paragraph 3.

³ See Auditing Standard No. 5, paragraph 39.

The auditor's preliminary judgments regarding the effect of the pervasive control deficiencies can help determine the approach to gathering audit evidence. When the pervasive control deficiencies adversely affect other controls, the auditor may modify the planned testing of the other controls because less evidence generally is needed to support a conclusion that controls are not effective than a conclusion that controls are effective.⁴ For example, if a control is likely to be impaired because of another control's deficiency, the inquiries and observations during walkthroughs might provide enough evidence to conclude that the design of a control is deficient and thus could not prevent or detect misstatements. In some cases, limited testing of a control might be necessary (e.g., if a walkthrough has not been performed) to conclude that a control is not operating effectively. Also, detected misstatements from the audit of the financial statements could indicate that a control is not effective.

Some companies might have pervasive control deficiencies and still have effective controls over some relevant assertions. For the selected controls that are likely to be effective, the auditor should test those controls to obtain the evidence necessary to support a conclusion about their operating effectiveness.⁵ The pervasive control deficiencies may affect the risk associated with the controls selected for testing, and, in turn, the amount of audit evidence needed. Example 8-1 discusses the effect of pervasive control deficiencies on tests of controls.

Scope Limitation Due to Lack of Sufficient Audit Evidence

Pervasive deficiencies in a company's internal control over financial reporting do not necessarily prevent an auditor from obtaining sufficient audit evidence to express an opinion on internal control over financial reporting. If the auditor determines that sufficient evidence is available to express an opinion, the auditor should perform tests of those controls that are important to the auditor's conclusion about the effectiveness of the company's internal control over financial reporting and evaluate the severity of the identified control deficiencies.⁶

In some audits of companies with pervasive control deficiencies, the auditor could become aware that there is minimal available evidence about the design and operation of internal control over financial reporting. Such situations could lead the auditor to conclude that the lack of available evidence constitutes a scope limitation that will prevent him or her from obtaining reasonable assurance necessary to express an opinion on internal control over financial reporting, including identification of existing material weaknesses.

The auditor may issue a report disclaiming an opinion on internal control over financial reporting as soon as the auditor concludes that a scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion.⁷ The auditor is not required to perform any additional work before issuing a disclaimer when the auditor concludes that he or she will not be able to obtain sufficient evidence to express an opinion. The auditor's report should disclaim an opinion on internal control and disclose the substantive reasons for the disclaimer. The report also should disclose the material weaknesses of which the auditor is aware.⁸

⁴ See Auditing Standard No. 5, paragraphs 46 and 47.

⁵ See Auditing Standard No. 5, paragraph 39.

⁶ See Auditing Standard No. 5, paragraphs 22, 39, and 62.

⁷ See Auditing Standard No. 5, paragraph C6.

⁸ See Auditing Standard No. 5, paragraph C5, for the specific requirements regarding the disclosures of the material weaknesses.

Even if the auditor lacks sufficient evidence to express an opinion on internal control, the auditor might still be able to obtain sufficient evidence to perform an audit of the financial statements. The auditor should, however, take into account the control deficiencies and issues encountered in the audit of internal control in assessing control risk and determining the nature, timing, and extent of tests of accounts and disclosures in the audit of the financial statements.⁹

Example 8-2 illustrates a situation in which the auditor is unable to obtain sufficient evidence to express an opinion on internal control over financial reporting.

Example 8-1 – Pervasive Deficiencies and Testing of Controls

Scenario: A small company has a two-person staff that handles all of the accounting and financial reporting duties. The staff is competent in routine financial reporting matters but has difficulty with more complex accounting matters, such as valuation of stock-based compensation and income tax calculations and disclosures. The lack of competencies in these areas has resulted in adjustments based on the auditor's identification of material misstatements.¹⁰

Audit Approach: Based on the auditor's experience with the company, she expects that controls over the valuation/allocation and disclosures related to stock-based compensation and income taxes will not be effective. For those assertions, the auditor obtains evidence about the respective controls during a walkthrough of the related process. Also, misstatements in those assertions were detected in the financial statement audit, and she observes that the controls failed to prevent or detect those misstatements. Based on this evidence, she concludes that the controls over those assertions are not effective.

With respect to routine financial reporting processes, such as cash receipts and disbursements, the auditor plans to perform tests of the selected controls to obtain enough evidence to support a conclusion that the respective controls are effective.

⁹ See Auditing Standard No. 5, paragraph B5.

¹⁰ Chapter 6 discusses financial reporting competencies in more detail, including approaches that smaller, less complex companies might take to enhance their financial reporting competencies.

Example 8-2 – Lack of Sufficient Audit Evidence

Scenario: A development stage company is devoted exclusively to research and development for a new product and currently generates no revenue. The financial staff consists of a CFO and accounting clerk. The company's principal accounting records consist of a checkbook and payroll records, and the company has no documentation of policies and procedures. Most of its controls are undocumented supervisory checks by the CFO.

Late in the fourth quarter, a management dispute results in the resignation of the CFO and termination of the accounting clerk. Management hires an accountant on a temporary contract basis to prepare financial statements from the company's existing records and to help the company establish appropriate controls over its financial reporting functions. However, most of these controls were implemented near or shortly after year-end.

Audit Approach: As the auditor begins trying to obtain an understanding of the company's internal control over financial reporting and evaluate entity-level controls, she notes that there is minimal information available about the controls that existed at yearend. Because of the turnover in financial reporting personnel, the auditor is unable to perform inquiries, observations, or other procedures to understand the flow of transactions and related controls in significant processes. The auditor identifies some material weaknesses, but she determines that the lack of evidence results in a scope limitation because she cannot obtain reasonable assurance that all of the existing material weaknesses are identified.

Accordingly, the auditor ceases further audit procedures in the audit of internal control. The auditor's report on internal control over financial reporting contains a disclaimer of opinion and disclosure of the substantive reasons for the disclaimer and the material weaknesses that she identified.

Appendix A

The Integrated Audit Process

Auditing Standard No. 5 indicates that the audit of internal control should be integrated with the audit of the financial statements. This means that the auditor should plan and perform the work to achieve the objectives of both audits,¹ which are as follows:

- *Audit of the financial statements.* To express an opinion on the fairness with which the financial statements present, in all material respects, financial position, results of operations, and its cash flows in conformity with GAAP.²
- *Audit of internal control.* To express an opinion on the effectiveness of the company's internal control over financial reporting.³

This appendix illustrates one approach for integrating the audit of internal control with the audit of the financial statements and is not intended to present all of the procedures that are required for a particular audit. Auditors must plan and perform their integrated audits to achieve the objectives of the audits and to comply with standards of the PCAOB.⁴

Summary of the Illustrative Audit Approach

The integrated audit process can be summarized into the following major components:

- a. Preliminary engagement procedures
- b. Audit planning
- c. Risk assessment procedures
- d. Auditor response, including tests of accounts and controls
- e. Conclusion and wrap-up

Preliminary Engagement Procedures

Preliminary engagement procedures include the auditor's engagement acceptance process and reaching an understanding with the audit committee about the terms of the engagement, including pre-approval of audit and non-audit services.

During the engagement acceptance process, the auditor might identify matters that could affect the risk of material misstatement of the financial statements or the risk of material weakness in internal control over financial reporting and, thus, could inform the auditor's risk assessments during the audit.

Audit Planning

During audit planning, the auditor should make a preliminary judgment about materiality. The judgment about materiality is the same for both the audit of the financial statements and the audit of internal control.⁵

The auditor also can develop a preliminary audit strategy and audit plan based on his or her understanding of the company and its environment. The audit

¹ See Auditing Standard No. 5, paragraphs 6 and 7.

² See paragraph .01 of AU sec. 110, *Responsibilities and Functions of the Independent Auditor*.

³ See Auditing Standard No. 5, paragraph 3.

⁴ See Auditing Standard No. 5, paragraph 6.

⁵ See AU sec. 311.03, AU sec. 312.12–.33, and Auditing Standard No. 5, paragraph 20.

strategy could cover matters such as general scope and timing of the engagement. The audit strategy and plan could be refined further as the audit progresses.

Risk Assessment Procedures

Risk assessment procedures are intended to help the auditor identify risks of misstatement and the controls that are in place to address those risks. When performing risk assessment procedures, the auditor should obtain an understanding of the company and its environment, including its internal control.⁶ These procedures include walkthroughs, or other procedures, to understand the likely sources of misstatement.⁷ It also includes performing preliminary analytical procedures and procedures to assess the risk of material misstatement due to fraud.⁸ The auditor's risk identification and assessment should also take into account his or her knowledge about the company and its environment from other sources, such as prior audits.⁹

Based on the auditor's understanding gained through performing the risk assessment procedures and obtaining other evidence, the auditor should assess the identified risks.¹⁰

The auditor's risk assessments are the basis for the identification of significant accounts and disclosures and relevant assertions as well as the selection of controls to test. Relevant assertions and significant accounts and disclosures should be determined based on whether there is a reasonable possibility that they could contain misstatements that could cause the financial statements to be materially misstated.¹¹ The identification of relevant assertions and significant accounts¹² is the same for both the audit of internal control and the audit of the financial statements.

Auditing Standard No. 5 states that the auditor should use a top-down approach to the audit of internal control to select the controls to test. A top-down approach begins at the financial statement level and with the auditor's understanding of the overall risks to internal control over financial reporting.¹³ The auditor then focuses on entity-level controls and works down to significant accounts and disclosures and their relevant assertions. This approach directs the auditor's attention to accounts, disclosures, and assertions that present a reasonable possibility of material misstatement to the financial statements and related disclosures. The auditor then verifies his or her understanding of the risks in the company's processes and selects for testing those controls that sufficiently address the assessed risk of misstatement to each relevant assertion.

⁶ See AU sec. 319.25–.61, and Auditing Standard No. 5, paragraph 9.

⁷ See Auditing Standard No. 5, paragraphs 34–38, for discussion of the objectives of walkthroughs and direction on walkthrough procedures.

⁸ See AU sec. 329.06–.08, and AU sec. 316.35–.45.

⁹ See AU sec. 311.04 and .08, and AU sec. 319.59.

¹⁰ See AU sec. 312.16 and .26–.33.

¹¹ See Auditing Standard No. 5, paragraphs 28–33.

¹² In the financial statement audit, the auditor may perform substantive auditing procedures on financial statement accounts, disclosures, and assertions that are not determined to be significant accounts and disclosures and relevant assertions. This is because his or her assessment of the risk that undetected misstatement would cause the financial statements to be materially misstated is unacceptably high (see AU sec. 312.39 for further discussion about undetected misstatement) or as a means of introducing unpredictability in the procedures performed (see AU sec. 316.50 for further discussion about predictability of auditing procedures).

¹³ See Auditing Standard No. 5, paragraph 21.

Overall Response to Risks

Based on the auditor's risk assessment, the auditor should evaluate the need for an overall response to the risks.¹⁴ This evaluation is particularly important for pervasive risks of misstatement, which can affect many financial statement accounts, but it applies to every audit.

The overall responses could affect such aspects of the audit as –

- Assignment of staff
- Level of supervision
- Need for specialists
- Appropriateness of planned audit strategy and scope

Specific Responses – Substantive Procedures and Tests of Controls

Specific responses to risk relate to the tests of relevant assertions of significant accounts and disclosures (“substantive procedures”) and the controls over those assertions. Auditing Standard No. 5 requires the auditor to obtain evidence about the controls over relevant assertions, and it states that the auditor should perform substantive procedures for all relevant assertions, regardless of the assessed level of control risk.¹⁵ The auditor should determine an appropriate mix of the nature, timing, and extent of testing based on the associated risks and other factors.¹⁶ The determination of the nature, timing, and extent of testing includes decisions about using the work of others to test controls in the integrated audit. As the associated risk increases, the evidence that the auditor should obtain also increases.¹⁷

The relationship between tests of controls and substantive procedures is important to the integration of the audit of internal control with the audit of financial statements. Obtaining sufficient evidence to support control risk assessments of low for purposes of the financial statement audit ordinarily allows the auditor to reduce the amount of substantive procedures that otherwise would have been necessary to opine on the financial statements. On the other hand, deficiencies in the controls that the auditor planned to rely on could lead the auditor to expand his or her substantive procedures.

As discussed in Chapter 1, the results of substantive tests of accounts and disclosures do not provide sufficient evidence for the auditor to conclude on the operating effectiveness of controls. However, the results of substantive tests could affect the auditor's risk assessments associated with the controls. For example, if the results of substantive procedures indicate misstatements in an assertion, evaluating the nature, cause, and significance of the misstatements could lead the auditor to identify a deficiency in the related controls or to modify his or her risk assessments. When no misstatements are detected from substantive procedures for an assertion, the auditor should take that into account along with the factors discussed in paragraphs 46–49 of Auditing Standard No. 5 in considering the risk associated with the related controls, which affects the

¹⁴ See AU sec. 312.16.

¹⁵ See Auditing Standard No. 5, paragraph B7.

¹⁶ For example, in the audit of internal control, walkthroughs might provide sufficient evidence of operating effectiveness for some selected controls, depending on the risk associated with the control being tested, the specific procedures performed as part of the walkthrough, and the results of those procedures.

¹⁷ See Auditing Standard No. 5, paragraphs 46 and 49.

nature, timing, and extent of the testing necessary to conclude on the effectiveness of the controls.¹⁸

Conclusion and Wrap-up

In the conclusion and wrap-up phase, the auditor should evaluate the results of his or her testing, particularly for identified misstatements and control deficiencies. The auditor should evaluate the misstatements and control deficiencies, individually and in the aggregate. In evaluating the effects of misstatements, the auditor should include both quantitative and qualitative considerations.¹⁹

Based on the evaluation of the testing results, the auditor should form conclusions about whether—

- The financial statements are materially misstated,
- A material weakness in internal control exists, and
- He or she has obtained sufficient competent evidence to support those conclusions.²⁰

The results of each portion of the integrated audit inform the auditor's conclusions about the other portion. For example, the auditor's conclusions about the effectiveness of controls should be based on all of the pertinent information about control effectiveness,²¹ including—

- Tests of controls for the audit of internal control,
- Tests of controls for the audit of the financial statements,
- Use of the work of others in either audit, and
- Evidence about control deficiencies resulting from identified misstatements or other sources (e.g., control deficiencies identified by management).

This information could affect the conclusions about control effectiveness as of year-end as well as control risk assessments for the financial statement audit. In some situations, the evaluation of audit results also could lead the auditor to re-evaluate his or her assessments of risk and the sufficiency of the audit procedures performed.

The conclusion and wrap-up phase of the audit also includes completion of the review of the audit and resolution of reviewers' comments.

¹⁸ See Auditing Standard No. 5, paragraph B9. This does not mean that the auditor is required to perform substantive procedures for a relevant assertion before performing tests of controls.

¹⁹ See AU sec. 312.34, and Auditing Standard No. 5, paragraphs 62 and B8.

²⁰ See paragraphs .34–.41 of AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, paragraph .01 of AU sec. 326, *Evidential Matter*, and Auditing Standard No. 5, paragraph 3.

²¹ See Auditing Standard No. 5, paragraph 71.

Appendix B

Discussion of Comments Received on the Preliminary Staff Views

On October 17, 2007, the staff of the Board's Office of the Chief Auditor published for comment *Preliminary Staff Views – An Audit of Internal Control That Is Integrated with An Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies* (“the preliminary guidance”). During the public comment period, 23 comment letters were received from investors, auditors, issuers, and others.

The majority of commenters were supportive of the preliminary guidance. They noted that it appropriately considered the environment of smaller, less complex companies and provided useful examples that will help in designing and executing strategies for the audits of these companies in accordance with the provisions of Auditing Standard No. 5.

The commenters offered suggestions to improve the preliminary guidance. After a careful analysis, certain changes have been made to this publication to further clarify or enhance the guidance. This Appendix describes significant comments received on the preliminary guidance and the related changes that the staff made in this publication.

General Comments

The introduction to the preliminary guidance stated that it did not establish new requirements for auditors. However, some commenters suggested reinforcing this statement by providing references to the Board's standards that establish mandatory or presumptively mandatory responsibilities to which this publication refers. As suggested by commenters, this publication includes additional references to the Board's standards.

Several commenters suggested that some or all of the preliminary guidance could be applicable to audits of internal control of larger public companies. As noted in the introduction, this publication was developed specifically to describe how auditors may apply the provisions of Auditing Standard No. 5 to audits of smaller, less complex companies. If auditors of larger public companies find this guidance useful in applying the scalability principles of Auditing Standard No. 5, they may, of course, refer to it. As noted earlier, this guidance does not establish requirements for the audit of internal control. Rather, all audits of internal control—regardless of the size of the company—must comply with the requirements of Auditing Standard No. 5.

Chapter 1 – Scaling the Audit for Smaller, Less Complex Companies

The preliminary guidance said that “[i]f none of the controls that are designed to address a risk for a relevant assertion is likely to be effective, the auditor can take that into account in determining the testing of that control.” According to one commenter, this statement could suggest that, under such circumstances, the auditor still has an obligation to test a particular control. This sentence has been modified to say that, if none of the controls over an assertion “is likely to be effective, the auditor can take that into account in determining the evidence needed to support a conclusion about the effectiveness of controls for this assertion.” Paragraph 47 of Auditing Standard No. 5 indicates that less evidence generally is needed to support a conclusion that controls are not effective. Chapter 8 discusses how this principle may be applied when a company has pervasive control deficiencies.

Several commenters asked the staff to clarify the example in the section entitled Tests of Operating Effectiveness of Controls, in which the auditor was able to use the results of tests of controls to reduce the substantive work on accounts receivable but not revenue. In the commenters' view, it can be difficult to distinguish controls over accounts receivable—specifically, over billing and cash receipt processing—from controls over revenue recognition. In response, the reference to revenue recognition in this example has been replaced with a reference to the allowance for doubtful accounts, the controls over which are more easily distinguishable from controls over billing and cash receipt processing.

Additionally, as suggested by the commenters, the discussion leading to this example has been modified to emphasize that the auditor's decisions about relying on controls, which were illustrated by the example, were related to the audit of the financial statements rather than the audit of internal control. The example is not meant to suggest that the auditor should avoid testing controls in high-risk areas. Rather, the example assumes that the auditor is following the requirements and direction in AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*, in designing his or her audit strategy.

Another commenter asked for clarification about whether an auditor would be able to issue an unqualified opinion on the effectiveness of internal control over financial reporting when the auditor assessed control risk at the maximum for one or more relevant assertions in the audit of financial statements. A new paragraph that discusses the relationship between assessing control risk at the maximum and expressing an opinion on internal control over financial reporting has been added to the section entitled Tests of Operating Effectiveness of Controls.

In the last paragraph of Chapter 1, one commenter asked to clarify what impact the absence of misstatements detected by substantive procedures has on the testing of controls. In response, this publication explains that the absence of misstatements is only one of a number of factors that informs the auditor's risk assessment in determining the testing necessary to conclude on the effectiveness of a control. Additionally, as recommended by another commenter, the wording in this paragraph has been revised to better reflect paragraph B9 of Auditing Standard No. 5, to which it refers.

One commenter suggested adding guidance to address situations in which controls changed during the period. The purpose of Chapter 1 is to discuss the principles in Auditing Standard No. 5 for scaling the audit and integrating tests of controls in audits of smaller, less complex public companies. Auditing Standard No. 5 and AU sec. 319, address the auditor's responsibilities for situations in which controls change during the year.

Chapter 2 – Evaluating Entity-Level Controls

Comments on Chapter 2 related primarily to the guidance on the precision of entity-level controls.

Some commenters were concerned that the list of factors that the auditor might consider in judging the level of precision of an entity-level control, in the section entitled Assessing the Precision of Entity-Level Controls, will be used as a checklist by auditors. Other commenters suggested expanding the list. Consistent with the preliminary guidance, this publication uses the phrase “factors include” to indicate that the list of factors is not all-inclusive, and the list of factors is not a list of criteria that the auditor should determine are met for every entity-level control. Not all factors are necessarily applicable to every control (e.g., some are relevant only to detective controls), and some factors might be more important than others for a given control. Examples 2-1 and 2-2

have been modified to better explain which factors the auditor in those examples took into account in evaluating the precision of the company's entity-level controls.

One commenter suggested expanding the guidance in Chapter 2 by discussing auditing considerations related to evaluating design and operating effectiveness of company's entity-level risk assessment component. The risk assessment component of internal control involves identification and analysis of the risks of material misstatement²² and thus, by itself, would not necessarily prevent or detect misstatements. Chapter 2 focuses on those entity-level controls that are more likely to operate at a sufficient level of precision to result in a reduction of testing of processlevel controls in an audit of a smaller, less complex company.

Additionally, another commenter asked for clarification regarding when the auditor can obtain a substantial amount of evidence about the effectiveness of internal control over financial reporting through the evaluation of entity-level controls. In this publication, the discussion following the bullet points at the beginning of Chapter 2, to which the commenter referred, has been revised to state more clearly that the auditor can obtain such evidence if senior management performs many controls—including entity-level controls—that are important to effective internal control over financial reporting.

Chapter 3 – Assessing the Risk of Management Override and Evaluating Mitigating Actions

Some commenters on Chapter 3 were concerned that the introductory statement to a list of mitigating controls in the section entitled Evaluating Mitigating Controls constituted a requirement for management to implement these controls. As stated in the introduction to this publication, the discussions and examples of controls in this publication do not establish internal control requirements and are not intended as guidance to management regarding establishing or evaluating internal control over financial reporting. Nevertheless, the introductory statement has been revised to remove reference to management's implementation of controls. Additionally, as suggested by some commenters, the fourth item in the list of mitigating controls has been renamed "controls over certain journal entries" to more clearly refer to the related discussion in the subsection entitled Evaluating Controls over Journal Entries later in the chapter.

As recommended by one of the commenters, a statement about the importance of the auditor's exercise of professional skepticism when considering the risk of management override has been added to the section entitled Assessing the Risk of Management Override. Because of the important role that the audit committee may play in mitigating the risk of management override, several commenters suggested providing more details in Example 3-1 about procedures performed by the audit committee. Accordingly, Example 3-1 has been expanded to provide more details on the types of procedures performed by the audit committee to address the risk of management override.

Some commenters suggested adding clarification regarding situations in which a company does not have an audit committee. A footnote reference to COSO Small Companies Guidance has been added to the section entitled Evaluating Audit Committee Oversight for clarification, as suggested.

²² See COSO Small Companies Guidance, Volume II: Guidance, page 43.

Chapter 4 – Evaluating Segregation of Duties and Alternative Controls

Most comments on Chapter 4 related to perceived inconsistencies in Example 4-1, which illustrates some audit procedures for testing alternative controls over inventory. In response to these comments, the example has been revised to describe more clearly the access rights of both the company's employee who performs certain incompatible duties, and the manager who performs the alternative controls. The paragraph preceding the example has also been revised to clarify that entity-level controls should operate at a necessary level of precision to effectively address the risk of misstatement.

One commenter suggested using the term “compensating controls” instead of “alternative controls” to describe controls that address the same issues as segregation of duties. The term “compensating controls” is not used in this chapter because it is generally applied to situations in which control deficiencies have been identified and the auditor is evaluating whether other controls might compensate for the deficiencies. Chapter 4 of this publication, as well as paragraph 42 of Auditing Standard No. 5, use the term “alternative controls” to apply to situations in which management has designed and implemented controls that achieve the same objectives as segregation of duties.

Chapter 5 – Auditing Information Technology Controls in a Less Complex IT Environment

Some commenters cautioned against underestimating risks that are associated with pre-packaged software. They indicated that readers might mistakenly perceive prepackaged software to be risk-free. In response to these comments, a footnote has been added to the section entitled Characteristics of Less Complex IT Environments in Chapter 5 to indicate that significant user configuration of the pre-packaged software might create additional risks that require additional controls.

In response to other commenters' suggestions, the following sentence has been added to the discussion in the third bullet point in the section entitled Characteristics of Less Complex IT Environments. “Access to systems is typically managed by a limited number of personnel.” In the fourth bullet point, the phrase “in many instances” has been inserted to acknowledge that a smaller, less complex company might perform more complex calculations using spreadsheets and other user-developed applications. In the same bullet point, the phrase “to accumulate, summarize, process, and report” has been replaced with “to initiate, authorize, record, process and report” to more accurately describe tasks included in the end-user computing.

Some commenters asked to clarify how the lack of controls over backups might impact the financial reporting process. In response, the second to last paragraph in the section entitled IT-Related Risks Affecting Financial Reporting of this publication has been reworded to refer, more specifically, to the controls that address the financial reporting risk, i.e., the risk of loss of data necessary to prepare the financial statements, and to acknowledge that there may be different controls to address the potential loss of data.

Several commenters suggested modifying Example 5-1 in order to better illustrate the points made in this chapter. In response, the description of controls and software in the Scenario section of Example 5-1 has been clarified, and controls over authorization have been added to the first sub-bullet in the Audit Approach section.

In general, several commenters were concerned about the potential for auditors to use the lists of controls and audit procedures from Chapter 5 as checklists.

As previously mentioned, the discussions and examples of controls in this publication do not establish internal control requirements and are not intended as guidance to management regarding establishing or evaluating internal control over financial reporting. These examples of controls in Chapter 5 do not represent required controls for management.

One commenter suggested adding guidance relating to testing of controls over spreadsheets. The purpose of this chapter was to discuss general audit strategies that might be employed regarding the evaluation of IT controls in a less complex IT environment rather than to discuss testing of any particular control activities.

Chapter 6 – Considering Financial Reporting Competencies and Their Effects on Internal Control

Most of the comments on Chapter 6 related to controls over the work performed by outside professionals.

One commenter provided examples of the controls that a company might implement to test work performed by the outside professional. These examples have been added to the discussion of audit considerations in the section entitled Supplemented Competencies with Assistance from Outside Professionals. Additionally, as suggested by commenters, Example 6-1 has been modified to more clearly outline the responsibilities of management and the third-party service provider in a situation typical for a smaller, less complex company. The discussion in the example has also been expanded to provide further details of the procedures performed by the auditor.

Some commenters asked what controls the auditors should expect to see over the work of outside professionals in addition to those over the competence and the accuracy of the information. One commenter asked for specific examples of controls in the situations when the management uses outside professionals in the areas of stock compensation, derivatives and hedging activities, off-balance-sheet accounting, and financial statements preparation. Because of the variety of situations in which outside professionals could be used, including the ones mentioned by the commenters, and the diversity of potential controls that might be implemented by companies using outside professionals, the chapter focuses mainly on the control objectives that might be relevant to those situations rather than the individual controls. However, as noted in the preceding paragraph, some additional examples of controls have been included in this publication as suggested by commenters.

Chapter 7 – Obtaining Sufficient Competent Evidence When the Company Has Less Formal Documentation

Some commenters on this chapter asked the staff to clarify the differences between the terms “formal” and “less formal” documentation and the impact of the distinction on the audit. One commenter asked about the auditor’s course of action if there is no documentary evidence at all.

“Formal” and “less formal” documentation are relative terms used in this publication to illustrate differences that might exist in the documentation practices of larger and smaller companies. For instance, the section entitled Documentation of Processes and Controls provides examples of more formal documentation and less formal documentation of processes and controls. As stated in this chapter, when auditing a smaller, less complex company, it generally is helpful to obtain an understanding of the nature and availability of documentation as early in the audit process as practical, so that the auditor has sufficient time to explore alternatives if the company has less formal documentation. The section entitled Other Considerations discusses various

types of documentation that auditors might consider using as audit evidence relating to internal control, including the documentation of company processes and procedures and other documentation that the company uses to run the business. The chapter also addresses situations in which only limited documentation exists.

Additionally, in response to one commenter's concern, Example 7-2 has been clarified to explain that the CFO's review represents one control – rather than the only control – that management relies on with respect to the period-end financial reporting process.

Chapter 8 – Auditing Smaller, Less Complex Companies with Pervasive Control Deficiencies

Several commenters asked for clarification regarding when limited testing of a control that is unlikely to be effective might be necessary. Chapter 8 now includes an example indicating that limited testing of a control might be necessary if walkthrough procedures have not been performed. In response to another commenter's suggestion, the discussion in the section entitled *Considering the Effect of Pervasive Control Deficiencies on Other Controls* has been expanded to clarify how certain deficient entity-level controls might impair the effectiveness of other controls over relevant assertions.

Other commenters suggested changing the discussion of management override of controls to state that a control that has been “inappropriately overridden” instead of “frequently overridden” is either less likely to operate effectively or ineffective. The wording from the preliminary guidance has been retained in this publication because it best describes the risk associated with management override. Although management override might be appropriate in certain circumstances (e.g., manual override of the old credit limits until the new limits are posted in the IT system), frequent management override of a control could impair the effectiveness of the overridden control.

Appendix A – The Integrated Audit Process

Some commenters expressed concern that auditors might view the audit approach outlined in Appendix A as the preferred approach because this publication would “formalize” it. Others expressed concern that the audit approach described in the appendix does not cover all of the auditing procedures that might need to be performed. As noted in the Introduction to this publication, the guidance is not a rule of the Board and does not establish new requirements. Rather, it discusses how the auditors of smaller, less complex companies may address some (but not all) of the challenges that might arise in audits of those companies. Thus, this publication does not attempt to “formalize” or endorse any particular approach to the audit of internal control over financial reporting. Auditing Standard No. 5 provides direction on integrating the audit of internal control with the audit of financial statements. Appendix A to this publication has been developed to illustrate one approach for integrating the two audits, and it is not intended to present all of the procedures that are required for a particular audit. Auditors should plan and perform their integrated audits to achieve the objectives of the audits and to comply with standards of the PCAOB.

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Section 400

STAFF AUDIT PRACTICE ALERTS

.01 Staff Audit Practice Alert No. 1 Matters Related to Timing and Accounting for Option Grants

July 28, 2006

Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of PCAOB standards and relevant laws. Auditors should determine whether and how to respond to these circumstances based on the specific facts presented. The statements contained in Audit Practice Alerts are not rules of the Board and do not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person.

Recent reports and disclosures about issuer practices related to the granting of stock options, including the “backdating” of such grants, indicate that some issuers’ actual practices in granting options might not have been consistent with the manner in which these transactions were initially recorded and disclosed. Some issuers have announced restatements of previously issued financial statements as a result of these practices. In addition, some of these practices could result in legal and other contingencies that may require recognition of additional expense or disclosure in financial statements.

This practice alert advises auditors that these practices may have implications for audits of financial statements or of internal control over financial reporting (“ICFR”) and discusses factors that may be relevant in assessing the risks related to these matters.

Background

The recorded value of a stock option depends, in part, on the market price of the underlying stock on the date that the option is granted and the exercise price specified in the option. Some issuers may have granted options with exercise prices that are less than the market price of the underlying stock on the date of grant. These options are sometimes referred to as “discounted” or “in-the-money” options. Where discounted options were granted and an issuer failed to properly consider this condition in its original accounting for the option, errors in recording compensation cost, among other effects, may have resulted. These errors may cause an issuer’s financial statements, including related disclosures, to be materially misstated.¹

While this alert does not attempt to describe all of the variations in circumstances that may result in the issuance of discounted options, a range of practices appears to be involved, including—

¹ In addition, academic research has suggested the possibility that some issuers may have purposefully granted options immediately before the release of information that the issuer believed would be favorable to its share price. While these practices may not result in the granting of discounted options, they may create legal or reputational risks and raise concerns about the issuer’s control environment.

- The application of provisions in option plans that allow for:
 - the selection of exercise prices based on market prices on dates earlier than the grant date, or
 - the award of options that allow the option holder to obtain an exercise price equal to the lower of the market price of the stock at the grant date or during a specified period of time subsequent to the grant date.
- Preparation, or subsequent modification, of option documentation for purposes of indicating a lower exercise price than the market price at the actual grant date.
- Treating a date as the grant date when, in fact, all of the prerequisites to a grant had not yet occurred.

Available information suggests that the incidence of these and similar practices may have substantially decreased after the implementation of the shortened filing deadline for reports of option grants specified by Section 403 of the Sarbanes-Oxley Act of 2002. In August 2002, the Securities and Exchange Commission (“SEC”) implemented this requirement by requiring the reporting of an option grant on Form 4 within two days of the date of grant. However, periods subsequent to the grant of an option may also be affected by improper accounting for a grant because option cost is generally expensed over the period during which the issuer receives the related services, most commonly its vesting period.

Matters for Auditor Consideration

Auditors planning or performing an audit should be alert to the risk that the issuer may not have properly accounted for stock option grants and, as a result, may have materially misstated its financial statements or may have deficiencies in its ICFR. For audits currently underway or to be performed in the future, the auditor should acquire sufficient information to allow him or her to assess the nature and potential magnitude of these risks. An auditor must use professional judgment in making these assessments and in determining whether to apply additional procedures in response.

In making these judgments, auditors should be mindful of the following—

Applicable financial accounting standards. Financial Accounting Standards Board Statement of Financial Accounting Standards (“SFAS”) No. 123 R (revised 2004), *Share-Based Payment*, applies to issuer reporting periods beginning after June 15, 2005 (December 15, 2005 for small business issuers). Accounting for options was, however, previously governed by other accounting standards and related interpretations, specifically Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), and SFAS No. 123, *Accounting for Stock-Based Compensation*. If an auditor determines that it is necessary to consider the accounting for option grants and related disclosures in financial statements of a prior period, the auditor should take care to determine the applicable generally accepted accounting principles in effect in those periods and to consider the specific risks associated with these principles.

- *Accounting for discounted options.* For periods in which an issuer used the provisions of APB 25 to determine compensation cost related to stock options, the issuer may have been required to record additional compensation cost equal to the difference in the

exercise price and the market price at the measurement date (as defined in APB 25). In periods in which the issuer has recorded option compensation cost using the fair value method as allowed by SFAS No. 123, or as required by SFAS No. 123 R (revised 2004), the impact on the calculated fair value of options of using an incorrect date as the grant date would depend on the nature and magnitude of changes in conditions that affect option valuation between the incorrect date used and the actual grant date. In all cases, the compensation cost of options should be recognized over the period benefited by the services of the option holder.

- *Accounting for variable plans.* For periods in which an issuer used the provisions of APB 25 to determine compensation cost related to stock options, an option with terms allowing a modification of the exercise price, or whose exercise price was modified subsequent to the grant date may require variable plan accounting. Variable option accounting requires that compensation cost be recorded from period to period based on the variation in current market prices. In periods in which the issuer records option compensation cost using the fair value method as allowed by SFAS No. 123, or as required by SFAS No. 123 R, the right to a lower exercise price may constitute an additional component of value of the option that should be considered at the grant date. In all cases, the cost of options should be recognized over the period benefited by the services of the option holder.
- *Accounting for contingencies.* If the consequences of the issuer's practices for stock option grants or its accounting for, and disclosure of, option grants result in legal or other contingencies, the application of SFAS No. 5, *Accounting for Contingencies*, may require that the issuer record additional cost or make additional disclosures in financial statements.
- *Accounting for tax effects.* The grant of discounted stock options may affect the issuer's ability to deduct expenses related to these options for income tax purposes, thereby affecting the issuer's cash flows and the accuracy of the related accounting for the tax effects of options.

Consideration of materiality. In evaluating materiality, auditors should remember that paragraph .11 of AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, and SEC Staff Accounting Bulletin: No. 99—*Materiality* emphasize that both quantitative and qualitative considerations must be assessed. Quantitatively small misstatements may be material when they relate to unlawful acts or to actions by an issuer that could lead to a material contingent liability. In all cases, auditors should evaluate the adequacy of related issuer disclosures.

Possible illegal acts. Auditors who become aware that an illegal act may have occurred must comply with the applicable requirements of AU section ("AU sec.") 317, *Illegal Acts*, and Section 10A of the Securities Exchange Act of 1934. Section 10A, among other things, requires a registered public accounting firm to take certain actions if it "detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements of the issuer) has or may have occurred..." If it is likely that an illegal act has occurred, the registered public accounting firm must "determine and consider the possible effect of the illegal act on the financial statements of the issuer, including any contingent monetary effects, such as fines, penalties, and

damages.” The registered public accounting firm must also inform the appropriate level of management and assure that the audit committee is adequately informed “unless the illegal act is clearly inconsequential.” The auditor may, depending on the circumstances, also need to take additional steps required under Section 10A if the issuer does not take timely and appropriate remedial actions with respect to the illegal act.

A. Effects of options-related matters on planned or ongoing audits

In planning and performing an audit of financial statements and ICFR, the auditor should assess the nature and potential magnitude of risks associated with the granting of stock options and perform procedures to appropriately address those risks. The following factors are relevant to accomplishing these objectives—

- Assessment of the potential magnitude of risks of misstatement of financial statements and deficiencies in ICFR related to option granting practices. This assessment should include consideration of possible indicators of risk related to option grants, including, where appropriate:
 - The status and results of any investigations relating to the timing of options grants conducted by the issuer or by regulatory or legal authorities.
 - The results of direct inquiries of members of the issuer’s management and its board of directors that should have knowledge of matters related to the granting and accounting for stock options.
 - Public information related to the timing of options grants by the issuer.
 - 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. In these situations, auditors should also consider whether issuers have other policies that adequately control the related risks.
 - Patterns of transactions or conditions that may indicate higher levels of inherent risk in the period under audit. Such patterns or conditions may include levels of option grants that are very high 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 option grants, or high levels of stock-price volatility.
- In planning and performing audits, auditors should appropriately address the assessed level of risk, if any, related to option granting practices. Specifically:
 - In addition to the general planning considerations for financial statement audits identified in AU sec. 311, *Planning and Supervision*, the auditor should consider:
 - The implications of any identified or indicated fraudulent or illegal acts related to option grants to assessed risks of fraud (AU sec. 312.07 and AU sec. 316, *Consideration of Fraud in a*

Financial Statement Audit); the potential for illegal acts (AU sec. 317, *Illegal Acts by Clients*); or the assessment of an issuer's internal controls (AU sec. 319, *Internal Control in a Financial Statement Audit*).

- The scope of procedures applied to assess the potential for fraud (AU sec. 316) and illegal acts (AU sec. 317).
- The nature, timing, and extent of audit procedures applied to elements of the financial statements affected by the issuance of options. In particular, this assessment should include consideration of:
 - The need for specific management representations related to these matters (AU sec. 333, *Management Representations*) and the nature of matters included in inquiries of lawyers (AU sec. 337, *Inquiry of a Client's Lawyer*).
 - Where applicable, the result of tests of internal controls over the granting, recording, and reporting of option grants.
 - The need, based on the auditor's risk assessment, for additional specific auditing procedures related to the granting of stock options.

For integrated audits performed as described in PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements* ("AS No. 2"), the auditor should consider the implications of identified or potential accounting and legal risks related to options in planning, performing, and reporting on audits of ICFR. In addition, as discussed in paragraphs 145–158 of AS No. 2, the results of the audit of ICFR should be considered in connection with the related financial statement audit.

B. Auditor involvement in registration statements

In cases where an auditor is requested to consent to the inclusion of his or her report, including a report on ICFR, in a registration statement under the Securities Act of 1933, AU sec. 711, *Filings Under Federal Securities Statutes*, provides that the auditor should perform certain procedures prior to issuing such a consent.²

- Paragraph .10 of AU sec. 711 provides that an auditor should perform certain procedures with respect to events subsequent to the date of the audit opinion up to the effective date of the registration statement (or as close thereto as is reasonable and practical under the circumstances). These procedures include inquiry of responsible officials and employees of the issuer and obtaining written representations from them about whether events have occurred subsequent to the date of the auditor's report that have a material effect on the financial statements or that should be disclosed in order to keep the financial statements from being misleading. The auditor should consider performing inquiries and obtaining representations specifically related to the granting and recording of option grants.
- Paragraph .11 of AU sec. 711 provides that a predecessor auditor that has been requested to consent to the inclusion of his or her report on

² Under Paragraph 198 of AS No. 2, the auditor should apply AU sec. 711 when the auditor's report on management's assessment of ICFR is included in filings under federal securities statutes.

prior-period financial statements in a registration statement should obtain written representations from the successor auditor regarding whether the successor auditor's audit and procedures with respect to subsequent events revealed any matters that might have a material effect on the financial statements reported on by the predecessor auditor or that would require disclosure in the notes to those financial statements. If the successor auditor becomes aware of information that leads him or her to believe that financial statements reported on by the predecessor auditor may require revision, the successor auditor should apply paragraphs .21 and .22 of AU sec. 315.³

- If either the successor or predecessor auditor discovers subsequent events that require adjustment or disclosure in the financial statements or becomes aware of facts that may have existed at the date of his or her report and might have affected the report had he or she been aware of them, the auditor should take the actions described in paragraph .12 of AU sec. 711. In addition, where the auditor concludes that unaudited financial statements or unaudited interim financial information presented, or incorporated by reference, in a registration statement are not in conformity with generally accepted accounting principles, he or she should take the actions described in paragraph .13 of AU sec. 711.

C. Effects of option-related matters on previously issued opinions

If an auditor becomes aware of information that relates to financial statements previously reported on by the auditor, but which was not known to him or her at the date of the report, and which is of such a nature and from such a source that he or she would have investigated it had it come to his or her attention during the course of the audit, he or she should take the actions described in AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

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³ In cases in which a predecessor auditor reissues his or her report on financial statements included in a filing under the Securities Exchange Act of 1934, the predecessor auditor should follow the directives in paragraphs .71 through .73 of AU sec. 508.

.02 Staff Audit Practice Alert No. 2 Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists

December 10, 2007

Staff Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of PCAOB standards and relevant laws. Auditors should determine whether and how to respond to these circumstances based on the specific facts presented. The statements contained in Audit Practice Alerts are not rules of the Board and do not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person.

The purpose of this staff audit practice alert is to remind auditors of their responsibilities for auditing fair value measurements of financial instruments and when using the work of specialists under the existing standards of the PCAOB. This alert is focused on specific matters that are likely to increase audit risk related to the fair value of financial instruments in a rapidly changing economic environment.¹

This practice alert highlights certain requirements in the auditing standards related to fair value measurements and disclosures in the financial statements and certain aspects of generally accepted accounting principles (GAAP) that are particularly relevant to the current economic environment.

While this practice alert focuses on fair value in general, it also draws the auditor's attention to certain areas of the new fair value accounting standard, Statement of Financial Accounting Standard (SFAS) No. 157, *Fair Value Measurements*.² Auditing fair value measurements developed under the new accounting standard likely will provide new challenges during implementation. Therefore, the practice alert describes the applicable accounting pronouncements in these areas and provides direction, in accordance with the auditing standards, for evaluating the application of GAAP.³

The practice alert also discusses the auditor's responsibilities, under the existing auditing standards, when using the work of specialists. The alert

¹ A combination of factors in the housing and mortgage markets, including rising delinquency and default rates on subprime mortgages and declining home prices, has led to increases in actual and expected credit losses for residential mortgage-backed securities and mortgage loans. In early 2007, the credit markets began reacting to these changing factors and the prices of many securities backed by subprime mortgages began to decline. Lower volumes of transactions in certain types of collateralized securities might make it more difficult to obtain relevant market information to estimate the fair value of these financial instruments.

² In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS 157, which is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. This standard, which some companies early-adopted, defines fair value, establishes a framework for measuring fair value, and expands disclosures. On November 14, 2007, the FASB voted to expose for comment a one year deferral for the implementation of SFAS 157 for certain nonrecurring, nonfinancial assets and liabilities. See FASB web site at www.fasb.org.

³ In order to provide guidance to auditors on auditing fair value measurements, this practice alert necessarily describes GAAP used by public companies to measure fair value. The Board, however, has no authority to prescribe the form or content of an issuer's financial statements. That authority, and the authority to make binding determinations concerning an issuer's compliance with GAAP, rests with the Securities and Exchange Commission. Accordingly, while this staff audit practice alert describes applicable GAAP, it should not be understood as establishing or interpreting GAAP.

provides some considerations for the auditor in determining whether a specialist is needed and highlights the requirement that the auditor should evaluate assumptions used in fair value measurements developed by a company's specialist in accordance with the PCAOB standard on auditing fair value measurements. It also highlights the auditor's responsibility to evaluate the appropriateness of using the specialist's work for the purpose of financial statements prepared in conformity with GAAP.

The practice alert is organized into four sections—

- Auditing fair value measurements;
- Classification within the fair value hierarchy under SFAS 157;
- Using the work of specialists; and
- Use of a pricing service.

Auditing Fair Value Measurements

AU sec. 328, *Auditing Fair Value Measurements and Disclosures*, applies to auditing fair value measurements and disclosures in financial statements.⁴ Among other things, AU sec. 328 states that the auditor should evaluate whether the fair value measurements and disclosures in the financial statements are in conformity with GAAP. In general, for companies that had not adopted SFAS 157 before its mandatory effective date, GAAP in effect throughout 2007 provides that—

- Fair value is the amount at which an asset or liability could be bought or sold in a current transaction between willing parties, that is, other than a forced or liquidation sale;⁵
- Quoted market prices in active markets are the best evidence of fair value and should be used as the basis for the measurement, if available;⁶
- The estimate of fair value should consider prices for similar assets;⁷ and
- Valuation techniques should incorporate assumptions that market participants would use in their estimates of value.⁸

In addition, AICPA Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, requires certain disclosures, in addition to those required by other accounting standards, about estimates when certain information is known prior to the issuance of financial statements.⁹

⁴ AU secs. 342, *Auditing Accounting Estimates*, and 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, also are related to auditing fair value.

⁵ See SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities*, paragraph 137; SFAS 133, *Accounting for Derivatives and Hedging Activities*, paragraph 540; and SFAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, paragraph 69.

⁶ *Ibid.* Also, in paragraph 58 of SFAS 107, *Disclosures about Fair Value of Financial Assets* the FASB Board reiterated its belief that quoted prices, even from thin markets, provide useful information because investors and creditors regularly rely on those prices to make their decisions.

⁷ See SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities*, paragraph 137; SFAS 133, *Accounting for Derivatives and Hedging Activities*, paragraph 540; and paragraph 69 of SFAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

⁸ *Ibid.*

⁹ See SOP 94-6, paragraph .13.

SFAS 157 incorporates concepts similar to those in SFASs 115, *Accounting for Certain Investments in Debt and Equity Securities*, 133, *Accounting for Derivatives and Hedging Activities*, and 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. SFAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. However, it also introduces concepts such as the principal and most advantageous markets and the fair value hierarchy of inputs (further discussed in this alert).¹⁰

In planning and performing procedures in response to the risk associated with fair value measurements, the auditor should obtain an understanding of the company's process for determining fair value measurements and disclosures, including relevant controls.¹¹ In addition, the auditor should, among other things—

- Evaluate whether management's assumptions are reasonable and reflect, or are not inconsistent with, market information.¹² For example, the fact that transaction volume in a particular market is lower than in previous periods may not necessarily support an assumption that transactions in that market constituted forced or distressed sales.
- If management relies on historical financial information in the development of an assumption, consider the extent to which such reliance is justified. However, historical information might not be representative of future conditions or events.¹³ For example, an auditor should evaluate whether a company's use of historical default rates, in an environment in which default rates are increasing, is justified.
- Evaluate whether the company's method for determining fair value measurements is applied consistently and if so, whether the consistency is appropriate considering possible changes in the environment or circumstances affecting the company.¹⁴ For example, the relative weightings in a company's model may not be reasonable in situations where there has been a change in market conditions. In such cases, auditors should consider whether compliance with applicable accounting standards might require a change in the model.

Inputs based on a company's own data may be more susceptible to preparer bias because they may not be based on observable market inputs.¹⁵ In such cases, the auditor should be aware of the increased risk of management bias and address the related risk of material misstatement.¹⁶

¹⁰ See SFAS 157, paragraphs 8, 22, and 23.

¹¹ See AU sec. 328.09.

¹² See AU sec. 328.26.

¹³ See AU sec. 328.37.

¹⁴ See AU sec. 328.19. Also, under SFAS 157, paragraph 20, a change in valuation technique or its application, is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances.

¹⁵ See AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*. Paragraph .39 notes that certain accounts, classes of transactions, and assertions may have high inherent risk due to a high degree of management judgment and subjectivity. They also may represent fraud risks because they are susceptible to management manipulation.

¹⁶ AU sec 312, *Audit Risk and Materiality in Conducting an Audit*, paragraph .36, provides that the risk of material misstatement is generally greater when account balances include estimates because of the inherent subjectivity in estimating future events.

Classification Within the Fair Value Hierarchy Under SFAS 157

Under SFAS 157, a company must determine the appropriate level in the fair value hierarchy for each fair value measurement. The fair value hierarchy in SFAS 157 prioritizes the inputs, which refer broadly to assumptions market participants would use in pricing an asset or liability, into three levels. It gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities and the lowest priority to unobservable inputs.¹⁷ The level in the fair value hierarchy within which a fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement in its entirety.

- 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 within Level 1 that are observable for the asset or liability, either directly or indirectly. A significant adjustment to a Level 2 input could result in the Level 2 measurement becoming a Level 3 measurement.
- Level 3 inputs are unobservable inputs for the asset or liability.¹⁸

Because there are different consequences associated with each of the three levels of the hierarchy, the auditor should be alert for circumstances in which the company may have an incentive to inappropriately classify fair value measurements within the hierarchy. For example, an asset or liability with Level 1 inputs generally must be measured using unadjusted quoted prices in an active market, while an asset or liability with Level 2 inputs is measured using observable market inputs other than quoted prices included in Level 1. Accordingly, a Level 2 measurement might allow for more discretion or judgment on the part of management than a Level 1 measurement. As another example, the required disclosures associated with Level 3 measurements are more extensive than those associated with Level 1 and Level 2 measurements.

The auditor's opinion is based on, among other things, his or her judgment as to whether the financial statements and related notes are informative of matters that may affect their use, understanding, and interpretation.¹⁹ In evaluating whether a company's disclosures are complete, accurate, and in conformity with SFAS 157, the auditor should be aware that a financial statement disclosure that is not in accordance with GAAP could be a misstatement of the financial statements.²⁰

¹⁷ See SFAS 157, paragraph 21. Observable inputs are inputs that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the reporting entity. Unobservable inputs are those that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances.

¹⁸ See SFAS 157, paragraphs 22–32.

¹⁹ See AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, paragraph .04.

²⁰ See AU sec. 9312, *Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312*, paragraphs .01 and .02.

Using the Work of Specialists

Management and auditors frequently use the work of a specialist in preparing and auditing financial statements containing complex fair value measurements.

AU sec. 328 states that the auditor should consider whether to engage a specialist and use the work of that specialist as evidential matter in performing substantive tests to evaluate material financial statement assertions.²¹ As part of the consideration, the auditor should evaluate whether he or she has the necessary skill and knowledge to plan and perform audit procedures related to the fair value measurement. Factors to consider include—

- Significant use of unobservable inputs;
- Complexity of the valuation technique; and
- Materiality of the fair value measurement.

AU sec. 336, *Using the Work of a Specialist*, provides direction that applies when the auditor uses the work of a specialist, whether the specialist is engaged by the company or the auditor. It states that the auditor should (a) obtain an understanding of the methods and assumptions used by the specialist, (b) make appropriate tests of data provided to the specialist, and (c) evaluate whether the specialist's findings support the related assertions in the financial statements.²² In obtaining an understanding of the specialist's methods, the auditor should consider whether the method will result in a measurement that is in conformity with the applicable accounting standards.²³ In addition, the auditor should evaluate, in accordance with AU sec. 328, the assumptions developed by a specialist engaged or employed by management.²⁴

Additionally, the auditor should evaluate the specialist's qualifications, including the specialist's experience in the type of work under consideration, and obtain an understanding of the work performed by the specialist, including the appropriateness of using the specialist's work for the intended purpose.²⁵ In the context of this practice alert, the intended purpose of the specialist's work is the valuation of assets and liabilities for use in financial statements prepared in conformity with GAAP.

Use of a Pricing Service

If a company uses a pricing service for its fair value measurements, the auditor should determine the nature of the information provided by the pricing service. For example, the auditor should understand whether the fair value measurement was determined using quoted prices from an active market, observable inputs (such as prices for similar assets), or fair value measurements based on a model, and adjust his or her audit procedures based on the nature of the information provided by the pricing service.²⁶ In addition, if the price is not based on quoted prices from an active market or observable inputs (such as

²¹ See AU sec. 328.20.

²² See AU sec. 336.12.

²³ See AU secs. 328.03 and 336.09.

²⁴ AU sec. 328 provides that management's assumptions used in fair value measurements or disclosures include assumptions developed by a specialist engaged or employed by management. See AU sec. 328.05, footnote 2.

²⁵ See AU sec. 336.08–.09.

²⁶ The evaluation of pricing information also is applicable to fair value measurements that a company obtains from other third parties.

prices for similar assets), the auditor should obtain an understanding of the model and evaluate whether the assumptions are reasonable.²⁷

There are additional factors for the auditor to consider under SFAS 157. For example, under SFAS 157, a fair value measurement assumes that the transaction occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market. The principal market is one in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity. If there is a principal market, under SFAS 157, the fair value measurement represents the price in that market even if the price in a different market is potentially more advantageous.²⁸

Under SFAS 157, when a company uses a pricing service, the auditor should evaluate whether the assumptions used by the pricing service reflect the price to sell the asset or paid to transfer the liability in the principal market (or most advantageous market if the company has no principal market) of the company. If the pricing service valuation is based on actual trades or quotes, the auditor should evaluate whether those traded or quoted prices would be available to the company in the company's principal market (or most advantageous market, if the company has no principal market). For example, a pricing service might provide an amount for which a large financial institution could sell the financial instrument. However, a company that owns that financial instrument might not be able to transact in the same market as a large financial institution. If the price available to a large financial institution would not be available to the company, then that price may not be an appropriate measure of fair value under SFAS 157.

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²⁷ See AU secs. 328.05 and 336.12. In addition, see AU sec. 332.39.

²⁸ See FASB Statement 157, paragraph 8.

.03 Staff Audit Practice Alert No. 3 Audit Considerations in the Current Economic Environment

December 5, 2008

Staff Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of PCAOB standards and relevant laws. Auditors should determine whether and how to respond to these circumstances based on the specific facts presented. The statements contained in Audit Practice Alerts are not rules of the Board and do not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person.

Recent events in the financial markets and the current economic environment may affect companies' operations and financial reporting and, in turn, may have implications for audits of financial statements and internal control over financial reporting. Audit risks that may have been identified previously may become more significant or new risks may exist due to current events (e.g. those affecting the economy, credit and liquidity). Among other things, the current uncertainties in the market and economy may create questions about the valuation, impairment, or recoverability of certain assets and the completeness or valuation of certain liabilities reflected in financial statements.

The purpose of this staff audit practice alert is to assist auditors in identifying matters related to the current economic environment that might affect audit risk and require additional emphasis. While the alert highlights certain areas, it is not intended to identify all areas that might affect audit risk in the current economic environment or serve as a substitute for the relevant auditing standards. All audits of issuers must be conducted in accordance with the standards of the PCAOB.

The practice alert is organized into six sections—

- Overall audit considerations;
- Auditing fair value measurements;
- Auditing accounting estimates;
- Auditing the adequacy of disclosures;
- Auditor's consideration of a company's ability to continue as a going concern; and
- Additional audit considerations for selected financial reporting areas.

In order to provide guidance to auditors on audit considerations in the current economic environment, this practice alert necessarily describes generally accepted accounting principles ("GAAP") used by public companies in various areas. The Board, however, has no authority to prescribe the form or content of an issuer's financial statements. That authority, and the authority to make binding determinations concerning an issuer's compliance with GAAP, rests with the U.S. Securities and Exchange Commission ("SEC"). Accordingly, while this staff audit practice alert describes applicable GAAP, it should not be understood as establishing or interpreting GAAP.

Overall Audit Considerations

The following section describes overall audit considerations related to planning, fraud, internal controls, substantive procedures, and communications with audit committees that may be affected by recent events in the financial markets and current economic conditions.

Planning considerations

The effects of current economic conditions on a company's operations and financial reporting may affect audit planning. In planning the audit, the auditor should consider, among other things, matters affecting the industry in which the company operates, including the economic conditions.¹

As the audit progresses, changed conditions may make it necessary to modify planned audit procedures.² Accordingly, the auditor may need to reassess audit risks and update his or her understanding of how current economic conditions may affect the company's financial reporting. Knowledge of these effects helps the auditor in—

- Identifying areas that may need special consideration;
- Assessing conditions under which accounting data are produced, processed, reviewed, and accumulated within the company;
- Evaluating the reasonableness of estimates, such as valuation of inventories, depreciation, allowances for doubtful accounts, and percentage of completion of long-term contracts;
- Evaluating the reasonableness of management representations;
- Making judgments about the appropriateness of the accounting principles applied and the adequacy of disclosures.³

Whenever the auditor has concluded that there is significant risk of material misstatement of the financial statements, the auditor should consider this conclusion in determining the nature, timing, or extent of procedures; assigning staff; or requiring appropriate levels of supervision.⁴ Higher risk may cause the auditor to expand the extent of procedures applied, apply procedures closer to or as of year end, particularly in critical audit areas, or modify the nature of procedures to obtain more persuasive evidence.⁵

In an audit of internal control over financial reporting, a direct relationship exists between the degree of risk that a material weakness could exist in a particular area of the company's internal control over financial reporting and the amount of audit attention that should be devoted to that area.⁶

Fraud risk considerations

The current economic environment may also trigger certain risk factors that may affect the risk of misstatement due to fraudulent financial reporting. Examples of risk factors include—

- Incentives and pressures

¹ Paragraphs .03 and .07 of AU sec. 311, *Planning and Supervision*, and paragraph 9 of PCAOB Auditing Standard No. 5 ("AS No. 5"), *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

² AU sec. 311.05.

³ AU sec. 311.06.

⁴ Paragraph .17 of AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*.

⁵ Ibid.

⁶ AS No. 5, paragraph 11.

- Financial stability or profitability is threatened by economic, industry, or company operating conditions;
- Excessive pressure exists for management to meet the requirements or expectations of third parties;
- Information available indicates management or the board of directors' personal financial situation is threatened by the company's financial performance;
- Excessive pressure is placed on management or operating personnel to meet financial targets set up by the board of directors or management, including sales or profitability incentive goals;
- Opportunities
 - The nature of the industry or the company's operations provides opportunities to engage in fraudulent financial reporting;
 - There is ineffective monitoring of management;
 - There is a complex or unstable organizational structure;
 - Internal control components are deficient.⁷

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.⁸ As part of the understanding of internal control sufficient to plan the audit, 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.⁹ Also, the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition.¹⁰ The auditor responds to risks of material misstatement due to fraud in the following three ways—

- 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.¹¹ For example, the knowledge, skill, and ability of personnel assigned significant engagement responsibilities should be commensurate with the auditor's assessment of the risks of material misstatement due to fraud for the engagement.¹² The auditor also should consider management's selection and application of significant accounting principles, particularly those related to subjective measurements and complex transactions.¹³ Further, the auditor should incorporate an element of unpredictability in the selection from year to year of auditing procedures to be performed.¹⁴
- A response to identified risks involving the nature, timing, and extent of the auditing procedures to be performed.¹⁵ For example, the auditing

⁷ Paragraph .85A.2 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

⁸ Paragraph .02 of AU sec. 110, *Responsibilities and Functions of the Independent Auditor*.

⁹ AU sec. 316.44.

¹⁰ AU sec. 316.41.

¹¹ AU sec. 316.48.

¹² AU sec. 316.50.

¹³ Ibid.

¹⁴ Ibid.

¹⁵ AU sec. 316.48.

procedures performed in response to identified risks of material misstatement due to fraud should vary depending upon the types of risks identified and the account balances, classes of transactions, and related assertions that may be affected.¹⁶ Such procedures may involve both substantive tests and tests of the operating effectiveness of the company's programs and controls.¹⁷

- 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 Audit Considerations in the such override could occur.¹⁸ For example, the auditor should examine journal entries and other adjustments for evidence of possible material misstatement due to fraud.¹⁹ The auditor also should review accounting estimates for biases that could result in material misstatement due to fraud,²⁰ and evaluate the business rationale for significant unusual transactions.²¹

The auditor's assessment of the risks of material misstatement due to fraud should be ongoing throughout the audit.²²

In an audit of internal control over financial reporting, the risk that a company's internal control over financial reporting will fail to prevent or detect misstatement caused by fraud usually is higher than the risk of failure to prevent or detect error.²³

Internal control considerations

The current environment may increase audit risk and thus require additional auditor attention regarding the effective operation of internal controls. Areas in which additional attention may be required include the company's entity-level controls, such as, among other things, controls related to the control environment, and the company's risk assessment process. Additional attention also may be warranted on the controls related to certain significant accounts and disclosures and their relevant assertions, such as controls over the development of inputs and assumptions for the valuation of significant assets and liabilities; controls over the identification and review of assets for recoverability or impairment; and controls over the company's use of external specialists (for example, valuation or actuarial specialists) who assist in the determination of recorded amounts of certain assets or liabilities. In addition, some companies are responding to the current economic conditions by eliminating jobs. The loss of employees integral to the operation of internal controls may increase the risk of deficiencies in internal control over financial reporting because of, for example, lack of segregation of duties or lack of effective monitoring controls.

In an audit of internal control over financial reporting, the auditor also should evaluate whether the company's controls sufficiently address the identified risks of material misstatement due to fraud²⁴ and controls intended to address

¹⁶ AU sec. 316.51.

¹⁷ Ibid.

¹⁸ AU sec. 316.48.

¹⁹ AU sec. 316.58.

²⁰ AU sec. 316.63.

²¹ AU sec. 316.66.

²² AU sec. 316.68.

²³ AS No. 5, paragraph 11.

²⁴ AS No. 5, paragraph 14.

the risk of management override of controls.²⁵ Controls that might address these risks include—

- Controls over significant, unusual transactions, particularly those that result in late or unusual journal entries;
- Controls over journal entries and adjustments made in the period-end financial reporting process;
- Controls over related party transactions;
- Controls related to significant management estimates; and
- Controls that mitigate incentives for, and pressures on, management to falsify or inappropriately manage financial results.²⁶

Effect on substantive procedures

Because the current environment may increase inherent and control risks, the auditor might need to modify his or her planned substantive procedures or perform additional substantive procedures in order to reduce the level of detection risk to an acceptable level to support his or her opinion on the financial statements. Examples of modifications of planned substantive procedure include the following—

- Changing the nature of substantive tests from a less effective to a more effective procedure, such as using tests directed toward independent parties outside the company rather than tests directed toward parties or documentation within the company;
- Changing the timing of substantive tests, such as performing them at year end rather than at an interim date; and
- Changing the extent of substantive tests, such as using a larger sample size.²⁷

Communications with audit committees

The auditor has a responsibility to communicate certain matters related to the conduct of the audit to the audit committee.²⁸ Some of the required communications that may be affected by current economic conditions include discussions about accounting estimates as well as the company's accounting principles.

With respect to accounting estimates, the auditor should determine that the audit committee is informed about the process used by management in formulating particularly sensitive accounting estimates and about the basis for the auditor's conclusions regarding the reasonableness of those estimates.²⁹ The auditor should discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles as applied in its financial reporting.³⁰ The discussion should include such matters as the consistency of the company's accounting policies and their application, and the clarity and completeness of the company's financial statements, which

²⁵ AS No. 5, paragraph 14. AU secs. 316.57 to .67 describe procedures that should be performed to address the risk of management override of controls.

²⁶ AS No. 5, paragraph 14.

²⁷ Paragraph .82 of AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*.

²⁸ Paragraph .01 of AU sec. 380, *Communication With Audit Committees*.

²⁹ AU sec. 380.08.

³⁰ AU sec. 380.11.

include related disclosures.³¹ The discussion also should include items that have a significant impact on the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements.³² Examples of items that may have such an effect include the following—

- Selection of new or changes to accounting policies;
- Estimates, judgments, and uncertainties;
- Unusual transactions; and
- Accounting policies relating to significant financial statement items, including the timing of transactions and the period in which they are recorded.³³

While these and other communications are directed to the audit committee, the auditor is not precluded from communicating with management or other individuals within the company, who may, in the auditor's judgment, benefit from the communications.³⁴

Auditing Fair Value Measurements

Certain kinds of investments such as auction rate securities, commercial paper, mortgage-backed or other asset-backed securities, alternative investments (such as hedge funds, private equity investments, funds of funds, etc.), collateralized debt obligations and other investments may present complexities in valuation because of the current conditions in the financial markets. Accordingly, difficulties surrounding the measurement of fair value and the adequacy of related disclosures have come under increased focus over the past year.

Statement of Financial Accounting Standard (“SFAS”) No. 157, *Fair Value Measurements*,³⁵ establishes a framework for measuring fair values for financial reporting purposes and expands disclosures about those measurements. On September 30, 2008, the SEC’s Office of the Chief Accountant and the Financial Accounting Standards Board (“FASB”) staff issued *Clarifications on Fair Value Accounting* acknowledging that “the current environment has made questions surrounding the determination of fair value particularly challenging for preparers, auditors and users of financial information.”³⁶ On October 10, 2008, the FASB issued Staff Position (“FSP”) No. FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*, which provides application guidance regarding—

- How the company’s own assumptions (that is, expected cash flows and appropriately risk-adjusted discount rates) should be considered when measuring fair value when relevant observable inputs do not exist;
- How available observable inputs in a market that is not active should be considered when measuring fair value; and

³¹ Ibid.

³² Ibid.

³³ Ibid.

³⁴ AU sec. 380.02.

³⁵ In September 2006, the Financial Accounting Standards Board (“FASB”) issued Statement of Financial Accounting Standard (“SFAS”) No. 157, *Fair Value Measurements*, which is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The FASB deferred the implementation of SFAS No. 157 for certain nonrecurring, nonfinancial assets and liabilities for financial statements issued for fiscal years beginning after November 15, 2008 and interim periods within those fiscal years.

³⁶ See <http://www.sec.gov/news/press/2008/2008-234.htm>.

- How the use of market quotes (for example, broker quotes or pricing services for the same or similar financial assets) should be considered when assessing the relevance of observable and unobservable inputs available to measure fair value.³⁷

The following matters may be particularly important for auditors in considering fair value accounting estimates—

- The extent to which fair value accounting applies to various accounts;
- The choice and complexity of valuation techniques and models;
- Judgments concerning significant assumptions that may be used by others such as specialists employed or engaged by the company or the auditor;
- The availability, or lack thereof, of information or evidence and its reliability; and
- The extent of disclosure in the financial statements about measurement methods and uncertainty.

PCAOB Staff Audit Practice Alert No. 2 (“Practice Alert No. 2”), *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists*, remains relevant in the current environment and reminds auditors of their responsibilities with regard to—

- Auditing fair value measurements,
- Classification within the fair value hierarchy under SFAS 157,
- Using the work of specialists, and
- Use of a pricing service.³⁸

In discussing the auditor’s responsibilities for auditing fair value measurements, Practice Alert No. 2 refers the auditor to AU sec. 328, *Auditing Fair Value Measurements and Disclosures*, AU sec. 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, AU sec. 336, *Using the Work of a Specialist*, and AU sec. 342, *Auditing Accounting Estimates*.

Auditing Accounting Estimates

Accounting estimates measure the effects of past business transactions or events, or the present status of an asset or liability.³⁹ Examples of accounting estimates include net realizable value of inventories, allowance for uncollectible accounts receivable, valuation allowance for deferred tax assets, actuarial assumptions in pension and other postretirement benefit costs, the impairment analysis and estimated useful lives of long-lived assets, restructuring accruals, and assumptions used in option pricing models for share-based payments.⁴⁰ In auditing accounting estimates, the auditor normally should consider, among other things, the company’s historical experience in making past estimates as well as the auditor’s experience in the industry.⁴¹ However, changes in facts, circumstances, or a company’s procedures may cause factors different from

³⁷ Paragraph 5 of FASB Staff Position (“FSP”) No. FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*.

³⁸ PCAOB Staff Audit Practice Alert No. 2, *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists* (December 10, 2007).

³⁹ Paragraph .02 of AU sec. 342, *Auditing Accounting Estimates*.

⁴⁰ See AU sec. 342.16 for other examples of accounting estimates.

⁴¹ AU sec. 342.09.

those considered in the past to become significant to the accounting estimate.⁴² The significance of the recent changes in the economy and the financial markets increases the likelihood that this will be the case.

The auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements taken as a whole.⁴³ In evaluating the reasonableness of accounting estimates, the auditor should obtain an understanding of how management developed the estimate.⁴⁴ Based on that understanding, the auditor should use one or a combination of the following approaches—

- Review and test the process used by management to develop the estimate;
- Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate;
- Review subsequent events or transactions occurring prior to the date of the auditor's report.⁴⁵

The work that the auditor performs as part of the audit of internal control over financial reporting should necessarily inform the auditor's decisions about the approach he or she takes to auditing an estimate because, as part of the audit of internal control over financial reporting, the auditor would be required to obtain an understanding of the process management used to develop the estimate and to test controls over all relevant assertions related to the estimate.⁴⁶

In evaluating the reasonableness of an estimate, the auditor normally concentrates on key factors and assumptions that are—

- Significant to the accounting estimate;
- Sensitive to variations;
- Deviations from historical patterns;
- Subjective and susceptible to misstatement and bias.⁴⁷

When assessing audit differences between estimates best supported by the audit evidence and the estimates included in the financial statements, the auditor should consider whether such differences, even if they are individually reasonable, indicate a possible bias on the part of the company's management, in which case the audit or should reconsider the estimates taken as a whole.⁴⁸

As part of the audit, the auditor also should perform a retrospective review of significant accounting estimates reflected in the financial statements of the prior year to determine whether management judgments and assumptions relating to the estimates indicate a possible bias on the part of management.⁴⁹ With the benefit of hindsight, a retrospective review should provide the auditor with additional information about whether there may be a possible bias on the part of management in making the current year estimates.⁵⁰

⁴² Ibid.

⁴³ AU sec. 342.04.

⁴⁴ AU sec. 342.10.

⁴⁵ Ibid.

⁴⁶ Ibid.

⁴⁷ AU sec. 342.09.

⁴⁸ AU sec. 316.63.

⁴⁹ AU sec. 316.64.

⁵⁰ Ibid.

Auditing the Adequacy of Disclosures

The current economic environment may increase the risks regarding the adequacy of disclosures, including the disclosures surrounding a company's risks and uncertainties, which in turn may warrant additional auditor attention.

The American Institute of Certified Public Accountants' Statement of Position 94-6 ("SOP 94-6"), *Disclosure of Certain Significant Risks and Uncertainties*, focuses on disclosures about risks and uncertainties, that in the near term (considered to be within one year from the date of the financial statements), could affect the amounts reported in the financial statements or the functioning of the reporting company.⁵¹ SOP 94-6 provides that companies should make disclosures in their financial statements about the risks and uncertainties in the following areas—

- Nature of operations;
- Use of estimates in the preparation of financial statements;
- Certain significant estimates;
- Current vulnerability due to certain concentrations.⁵²

The presentation of financial statements in conformity with GAAP includes adequate disclosure of material matters, related to the form, arrangement, and content of the financial statements and their appended notes.⁵³ The auditor considers whether a particular matter should be disclosed in light of the circumstances and facts of which he or she is aware at the time.⁵⁴ If management omits from the financial statements, including the accompanying notes, information that is required by GAAP, the auditor should express a qualified or adverse opinion and should provide the information in his or her report, if practicable, unless its omission from the auditor's report is recognized as appropriate by a specific PCAOB auditing standard.⁵⁵

With respect to other information included in documents containing the financial statements, the auditor should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements.⁵⁶ For instance, the section on management's discussion and analysis of financial condition and results of operations in Form 10-K requires discussion of liquidity, capital resources, results of operations, off-balance sheet arrangements and contractual obligations.⁵⁷ In addition, the section on controls and procedures of the Form 10-K requires discussion of management's responsibility for internal control over financial reporting and changes in internal control over financial reporting.⁵⁸ If the information in these disclosures is materially inconsistent with the financial statements, the

⁵¹ Paragraph .02 of American Institute of Certified Public Accountants' Statement of Position 94-6 ("SOP 94-6"), *Disclosure of Certain Significant Risks and Uncertainties*. Paragraph .07 of SOP 94-6 defines near term as a period of time not to exceed one year from the date of the financial statements.

⁵² SOP 94-6, paragraph .08.

⁵³ Paragraph .02 of AU sec. 431, *Adequacy of Disclosure in Financial Statements*.

⁵⁴ *Ibid.*

⁵⁵ AU sec. 431.03.

⁵⁶ Paragraph .04 of AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*.

⁵⁷ Regulation S-K, Item 303, *Management's Discussion and Analysis of Financial Condition and Results of Operations*.

⁵⁸ Regulation S-K, Items 308 and 308T, *Internal Control Over Financial Reporting*.

auditor should determine whether the financial statements, the audit report, or both require revision.⁵⁹

Auditor's Consideration of a Company's Ability to Continue as a Going Concern

In the current economic environment, some companies may face challenges in their ability to continue operating as a going concern. For instance, sources of liquidity may be strained because of reduced availability of lines/letters of credit from financial institutions or because of a violation of a debt covenant or other covenant. Additionally, companies may encounter limited access to the commercial paper markets, a decrease in valuation of collateral, difficulty restructuring loans, and delays in payment from customers.

The auditor has a responsibility to evaluate whether there is a substantial doubt about the company's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited.⁶⁰ The auditor's evaluation is based on his or her knowledge of relevant conditions and events that exist at or have occurred prior to the date of the auditor's report.⁶¹

The auditor's evaluation includes considering whether the results obtained in planning, performing, and completing the audit identify conditions and events that, when considered in the aggregate, indicate there could be a substantial doubt about the company's ability to continue as a going concern for a reasonable period of time.⁶² It may be necessary to obtain additional information about such conditions and events, as well as the appropriate evidential matter to support information that mitigates the auditor's doubt.⁶³ Conditions or events that, when considered in the aggregate, indicate there could be substantial doubt about the company's ability to continue as a going concern for a reasonable period of time include—

- *Negative trends*—for example, recurring operating losses, working capital deficiencies, negative cash flows from operating activities, adverse key financial ratios;
- *Other indications of possible financial difficulties*—for example, default on loan or similar agreements, arrearages in dividends, denial of usual trade credit from suppliers, restructuring of debt, noncompliance with statutory capital requirements, need to seek new sources or methods of financing or to dispose of substantial assets;
- *Internal matters*—for example, work stoppages or other labor difficulties, substantial dependence on the success of a particular project, uneconomic long-term commitments, need to significantly revise operations;
- *External matters that have occurred*—for example, legal proceedings, legislation, or similar matters that might jeopardize a company's ability to operate; loss of a key franchise, license, or patent; loss of a

⁵⁹ AU sec. 550.04.

⁶⁰ Paragraph .02 of AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.

⁶¹ Ibid.

⁶² AU sec. 341.03a.

⁶³ Ibid.

principal customer or supplier; uninsured or underinsured catastrophe such as a drought, earthquake, or flood.⁶⁴

If the auditor believes there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time, the auditor should obtain information about management's plans that are intended to mitigate the effect of such conditions or events, and assess the likelihood that such plans can be effectively implemented.⁶⁵ The auditor's considerations relating to management plans may include the following—

- Plans to dispose of assets;
- Plans to borrow money or restructure debt;
- Plans to reduce or delay expenditures;
- Plans to increase ownership equity.⁶⁶

Such considerations also may include the effect of federal assistance or participation in a federal program.

If, after considering identified conditions and events and management's plans, the auditor concludes there is substantial doubt, he or she should consider the possible effects on the financial statements and the adequacy of disclosure about the company's inability to continue as a going concern for a reasonable period of time, and include an explanatory paragraph in the audit report to reflect this conclusion.⁶⁷ If the auditor concludes that substantial doubt is alleviated, the auditor should consider the need for disclosure of the principal conditions and events that initially caused the auditor to believe there was substantial doubt.⁶⁸

Additional Audit Considerations for Selected Financial Reporting Areas

The following discussion provides auditors with information on selected financial reporting areas that may be affected by the current economic environment. The auditor should give consideration to elevated risks related to the current economic environment and adjust his or her audit procedures as appropriate. This list is not intended to be all inclusive.

- Consolidation
- Contingencies and guarantees
- Credit derivatives
- Debt obligations
- Deferred tax assets
- Derivatives (other than credit derivatives)
- Goodwill, intangible assets and other long-lived assets
- Inventory
- Other-than-temporary impairment
- Pension and other postretirement benefits

⁶⁴ AU sec. 341.06.

⁶⁵ AU sec. 341.03b.

⁶⁶ AU sec. 341.07.

⁶⁷ AU secs. 341.10 and 341.12.

⁶⁸ AU sec. 341.11.

- Receivables
- Restructuring
- Revenue recognition
- Share-based payments

Consolidation

As a result of the economic environment, some companies have provided financial support or guarantees, or have taken other actions that may cause them to have a variable interest in an entity or to have increased their exposure to the entity, and, therefore, cause them to consider or reconsider whether the entity is a variable interest entity and if so whether they are its primary beneficiary.⁶⁹ Such commitments to provide financial support or guarantees might be found in various contractual arrangements, such as leasing arrangements, supply contracts, service contracts or derivative contracts.

FASB Interpretation (“FIN”) No. 46(R) (as amended), *Consolidation of Variable Interest Entities—an interpretation of ARB No. 51*, addresses consolidation by the primary beneficiary of variable interest entities. On November 21, 2008, the FASB announced plans to issue final FSP FAS 140-4 and FIN 46(R)-8, *Disclosures about Transfers of Financial Assets and Interests in Variable Interest Entities*, by December 15, 2008, which will increase disclosure requirements for public companies for reporting periods that end after December 15, 2008.⁷⁰

Contingencies and guarantees

Recent events in the credit markets may expose companies to additional contingencies and guarantees, which could increase the risk of unidentified or undisclosed contingencies related to, for example—

- Pending or threatened litigation;
- Asserted or unasserted claims and assessments;
- Guarantees of indebtedness of others;
- Guarantees to repurchase receivables or property previously sold or otherwise assigned;
- Violations of laws and regulations;
- Guarantees of contractual performance of others; and
- Outstanding purchase commitments at prices in excess of market values.

The audit normally includes procedures that might identify litigation, claims, and assessments, among other things.⁷¹ Examples of such procedures include the following—

- Reading minutes of meetings of stockholders, directors, and appropriate committees held during and subsequent to the period being audited;

⁶⁹ Paragraphs 7 and 15 of FASB Interpretation (“FIN”) No. 46(R) (as amended), *Consolidation of Variable Interest Entities – an interpretation of ARB No. 51*.

⁷⁰ See <http://www.fasb.org/news/nr112108.shtml>.

⁷¹ Paragraph .07 of AU sec. 337, *Inquiry of a Client’s Lawyer Concerning Litigation, Claims and Assessments*. AU sec. 337.08 indicates that a letter of audit inquiry to the client’s lawyer is the auditor’s primary means of obtaining corroboration of the information furnished by management concerning litigation, claims, and assessments.

- Reading contracts, loan agreements, leases, and correspondence from taxing or other governmental agencies, and similar documents;
- Obtaining information concerning guarantees from bank confirmation forms;
- Inspecting other documents for possible guarantees by the client.⁷²

Credit derivatives

The downturn in the credit markets can have a significant effect on the fair value of a company's credit derivatives. A credit derivative is a derivative instrument whose value derives from the credit risk on an underlying bond, loan or financial asset. The credit risk is on an entity other than the counterparty to the transaction.⁷³ This entity is known as a reference entity, which incurred the debt.⁷⁴

Credit derivatives are bilateral contracts between the buyer and seller under which the seller sells to the buyer protection against the credit risk of the reference entity.⁷⁵ Credit derivatives may be valued through the use of internally developed models or by pricing services. The assumptions used in models can be highly subjective, sensitive, and complex. A slight difference in assumptions could result in a significant change in the valuation of the derivative.

One factor that affects the fair value of credit derivatives is a decline in the credit quality of the reference entity. As a result of the deterioration in credit derivative positions insured by sellers of credit derivatives, some sellers have been required to post significant amounts of additional collateral. A seller also may be required to post additional collateral based on the deterioration of its own credit standing (regardless of changes in value of the written credit derivatives) to protect the buyer from default by the seller. In addition, the fair value of the asset included in the buyer's financial statements is affected by both the credit rating of the seller of the credit derivative (the counterparty) and the credit rating of the reference entity. The credit risk of the seller may affect the fair value of the liability in the seller's financial statements. In response to concerns from financial statement users and others that the current disclosure requirements for derivative instruments and certain guarantees did not adequately address the potential adverse effects of changes in the credit risk on the financial position, financial performance, and cash flows of the sellers of credit derivatives and certain guarantees, the FASB issued a staff position aimed at improving such disclosures.⁷⁶

The auditor should obtain evidence supporting management's assertions about the fair value of derivatives measured or disclosed at fair value.⁷⁷ In addition,

⁷² AU sec. 337.07.

⁷³ Satyajit Das, *Credit Derivatives: CDOs and Structured Credit Products*, (Singapore: John Wiley and Sons (Asia) Pte Ltd, 2005, Third Edition).

⁷⁴ Edmund Parker, "Credit Derivatives," *PLC Finance* (<http://www.mayerbrown.com/london/article.asp?id=4234&nid=1575>).

⁷⁵ *Ibid.*

⁷⁶ Paragraph 1 of FSP No. FAS 133-1 and FIN 45-4, *Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161* (September 12, 2008).

⁷⁷ Paragraph .35 of AU sec. 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*. AU secs. 332.35 to .48 provide further direction on auditing valuations based on fair value.

the auditor should evaluate whether the presentation and disclosure of derivatives are in conformity with GAAP.⁷⁸

In addition to valuation and presentation and disclosure, other considerations relate to existence and completeness. In March 2008, the President's Working Group on Financial Markets noted "[w]hile the infrastructure of the financial markets generally has coped quite well with heightened price volatility and surging trading volumes, there have been issues with the accuracy and timeliness of trade data transmissions, the timeliness of resolutions of trade matching errors, documentation and cash settlement, electronic post-trade processing, backlogs, integrated processing, and reconciliation and valuation."⁷⁹ Sellers and buyers of credit derivatives may have made trades which may not be properly reflected in the financial statements. AU sec. 332 provides examples of substantive procedures auditors may perform to obtain evidence about whether all derivatives have been properly identified and appropriately included in the financial statements.⁸⁰

Debt obligations

Companies may find it more difficult to refinance debt or it may take longer to arrange new financing in the current business environment, and compliance with debt covenants may be more challenging. Circumstances such as the following can affect the risks of material misstatement and the necessary audit procedures regarding debt obligations—

- Violations of existing debt covenants;
- Proper classification between short-term and long-term debt;
- The existence of cross default provisions, such that a violation of a covenant on one loan affects compliance with covenants for another loan;
- Exchange of debt or modifications to the terms of outstanding debt agreements;
- Concessions granted by lenders, including those that constitute a troubled debt restructuring;
- Subjective acceleration clauses;
- Embedded derivatives.

Deferred tax assets

Under current economic conditions, companies may need to record valuation allowances for their deferred tax assets. Deferred tax assets are required to be reduced "by a valuation allowance if, based on the weight of available evidence,

⁷⁸ AU sec. 332.49. AU secs. 332.49 to .51 provide further direction on auditing presentation and disclosure of derivatives.

⁷⁹ See pages 18 to 19 of the Policy Statement on Financial Market Developments by The President's Working Group on Financial Markets (March 2008) (http://www.treas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf). In June 2008, the Federal Reserve Bank of New York noted that "[s]tarting in September 2005, industry participants implemented a number of initiatives to improve the operational performance and infrastructure of the over-the-counter markets" and that market participants and regulators agreed on an "agenda for bringing about further improvements in the OTC derivatives market infrastructure." Federal Reserve Bank of New York, "Statement Regarding June 9 Meeting on Over-the-Counter Derivatives" (June 9, 2008), (<http://www.newyorkfed.org/newsevents/news/markets/2008/ma080609.html>).

⁸⁰ AU secs. 332.21 to .24.

it is *more likely than not* (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized.”⁸¹

Evaluating the need for and amount of a valuation allowance for deferred tax assets requires consideration of “all available evidence, both positive and negative”⁸² to determine whether all or some portion of the deferred tax assets will not be realized. SFAS No. 109, *Accounting for Income Taxes*, provides that the more negative evidence that exists (a) the more positive evidence is necessary and (b) the more difficult it is to support a conclusion that a valuation allowance is not needed for some portion or all of the deferred tax asset.⁸³

In addition, SFAS No. 109 states that “information about an enterprise’s current financial position and its results of operations for the current and preceding years ordinarily is readily available. That historical information is supplemented by all currently available information about future years. Sometimes, however, historical information may not be available (for example, start-up operations) or it may not be as relevant (for example, if there has been a significant, recent change in circumstances) and special attention is required.”⁸⁴

Future realization of a deferred tax asset “ultimately depends on the existence of sufficient taxable income of the appropriate character (for example, ordinary income or capital gain) within the carryback, carryforward period available under the tax law.”⁸⁵ SFAS No. 109 states that “the weight given to the potential effect of negative and positive evidence should be commensurate with the extent to which it can be objectively verified.”⁸⁶

In addition, FIN No. 48 (as amended), *Accounting for Uncertainty in Income Taxes – an Interpretation of FASB Statement No. 109*, defines a criterion that an individual tax position must meet for any part of the benefit of that position to be recognized in a company’s financial statements.⁸⁷ The interpretation also provides guidance on measurement, derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.⁸⁸

Derivatives (other than credit derivatives)

The current environment may have a significant effect on the fair value of a company’s derivative contracts. In addition, the ability for a company to use hedge accounting, including its ability to apply the short-cut method, may be affected because of the company’s or the counterparty’s creditworthiness.⁸⁹ Hedge accounting also may be affected because changes in the fair value of the

⁸¹ Paragraph 17e of SFAS No. 109 (as amended), *Accounting for Income Taxes*.

⁸² SFAS No. 109, paragraph 20.

⁸³ SFAS No. 109, paragraph 25.

⁸⁴ SFAS No. 109, paragraph 20.

⁸⁵ SFAS No. 109, paragraph 21.

⁸⁶ SFAS No. 109, paragraph 25.

⁸⁷ Paragraph 2 of FIN No. 48 (as amended), *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109*.

⁸⁸ *Ibid.*

⁸⁹ FASB Staff Implementation Guidance: Guide to Implementation of Statement 133 on Accounting for Derivative Instruments and Hedging Activities, Issue G10 (“DIG Issue G10”), *Cash Flow Hedges: Need to Consider Possibility of Default by the Counterparty to the Hedging Derivative*.

derivative may be attributable to a risk other than the risk that is being hedged, such as company or counterparty creditworthiness.⁹⁰

Auditors should obtain evidence supporting management's assertion about the fair value of derivatives measured or disclosed at fair value.⁹¹ External factors, such as credit and market risk, may affect the valuation of derivatives. Credit or default risk exposes the company to the risk of loss as a result of the counterparty to a derivative failing to meet its obligation. Alternatively, the credit risk of the company may affect the fair value of the derivative when the derivative is in a liability position. Market risk exposes the company to the risk of loss from adverse changes in market factors that affect the fair value of a derivative, such as interest rates and foreign exchange rates. In order for a company to use hedge accounting, GAAP requires that management have an expectation that the hedging relationship will be highly effective at inception and on an ongoing basis.⁹² Counterparty default risk may affect hedge accounting as GAAP requires that consideration be given to the likelihood that the counterparty will comply with the contractual terms of the derivative contract.⁹³ If the likelihood that the counterparty will not default ceases to be probable, the company would be unable to conclude that a cash flow hedging relationship is expected to be highly effective in achieving offsetting cash flows.⁹⁴ Additionally, a change in the creditworthiness of the derivative's counterparty in a fair value hedge would affect the assessment of whether the relationship qualifies for hedge accounting and amount of ineffectiveness recognized in earnings under fair value hedge accounting.⁹⁵ Under SFAS No. 133, hedge accounting ceases when a hedge is no longer highly effective on an ongoing basis.⁹⁶

When assessing hedge accounting, auditors should gather evidential matter—

- To determine whether management complied with the hedge accounting requirements of GAAP, including designation and documentation requirements.⁹⁷
- To support management's expectation at the inception of the hedge that the hedging relationship will be highly effective and its periodic assessment of the ongoing effectiveness of the hedging relationship as required by GAAP.⁹⁸
- Supporting the recorded change, for a fair value hedge, in the hedged item's fair value that is attributable to the hedged risk.⁹⁹

In addition, for a cash flow hedge of a forecasted transaction, the auditor should evaluate management's determination of whether a forecasted transaction is probable.¹⁰⁰

⁹⁰ Paragraphs 20 and 28 of SFAS No. 133 (as amended), *Accounting for Derivative Instruments and Hedging Activities*, discuss the risks that are being hedged for a fair value and a cash flow hedge, respectively. Paragraphs 25 and 29 of SFAS No. 133 indicate when to discontinue hedge accounting for a fair value and cash flow hedge, respectively.

⁹¹ AU sec. 332.35.

⁹² SFAS No. 133, paragraphs 20b and 28b.

⁹³ DIG Issue G10.

⁹⁴ *Ibid.*

⁹⁵ *Ibid.*

⁹⁶ SFAS No. 133, paragraph 67.

⁹⁷ AU sec. 332.53.

⁹⁸ *Ibid.*

⁹⁹ AU sec. 332.54.

¹⁰⁰ AU sec. 332.55.

Goodwill, intangible assets and other long-lived assets

Market conditions during an economic downturn may result in an impairment of goodwill, other indefinite-lived intangible assets and other long-lived assets. Goodwill and indefinite-lived intangible assets “shall be tested for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired.”¹⁰¹ Similarly, SFAS No. 144 (as amended), *Accounting for the Impairment or Disposal of Long-Lived Assets*, states that “A long-lived asset (asset group) shall be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable.”¹⁰² The following are examples of such events and changes in circumstances—

- A significant decrease in the market price of a long-lived asset (asset group);
- A significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition;
- A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator;
- An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (asset group);
- A current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (asset group);
- A current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life. The term more likely than not refers to a level of likelihood that is more than 50 percent.¹⁰³

Goodwill of a reporting unit shall be tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount.¹⁰⁴ Examples of such events or circumstances include—

- A significant adverse change in legal factors or in the business climate;
- An adverse action or assessment by a regulator;
- Unanticipated competition;
- A loss of key personnel;
- A more-likely-than-not expectation that a reporting unit or a significant portion of a reporting unit will be sold or otherwise disposed of;
- The testing for recoverability under SFAS No. 144 of a significant asset group within a reporting unit;

¹⁰¹ Paragraph 17 of SFAS No. 142 (as amended), *Goodwill and Other Intangible Assets*.

¹⁰² Paragraph 8 of SFAS No. 144 (as amended), *Accounting for the Impairment or Disposal of Long-Lived Assets*.

¹⁰³ Ibid.

¹⁰⁴ SFAS No. 142, paragraph 28.

- Recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit.¹⁰⁵

In addition to valuation, companies may need to reassess the useful life of indefinite-lived intangible assets and other long-lived assets. SFAS No. 142 (as amended), *Goodwill and Other Intangible Assets*, requires companies to “evaluate the remaining useful life of an intangible asset that is not being amortized each reporting period to determine whether events and circumstances continue to support an indefinite useful life.”¹⁰⁶ In addition, when other long-lived assets (asset group) are tested for recoverability, companies also may need to review depreciation estimates and methods.¹⁰⁷ Under SFAS No. 144, any revision to the remaining useful life of a long-lived asset resulting from that review also shall be considered in developing estimates of future cash flows used to test the asset (asset group) for recoverability.¹⁰⁸

Inventory

Current market conditions and the effect on consumer spending may result in excess or obsolete inventory or inventory with carrying amounts in excess of market values. Inventory is required to be stated at the lower of cost or market.¹⁰⁹ The following are examples of conditions related to the current environment that might affect the risk of material misstatement of inventory valuation and the necessary audit procedures—

- An increase in inventory balances in relation to sales levels, a reduction in inventory turnover, and the aging of inventory may indicate excess or obsolete inventory balances that are not recoverable.
- Declining prices may indicate the carrying amount of inventory is in excess of market value. Accounting Research Bulletin (“ARB”) No. 43 (as amended), *Inventory Pricing* (chapter 4), requires that a loss be recognized in the current period “whenever the utility of goods is impaired by damage, deterioration, obsolescence, changes in price levels, or other causes.”¹¹⁰

In addition, losses on firm, uncancelable, and unhedged commitments to purchase inventory should be measured in the same way as are inventory losses and, if material, should be recognized in the accounts in the current period and separately disclosed in the income statement.¹¹¹

Other-than-temporary impairment

Many debt and equity securities have experienced significant declines in fair value. These declines in fair value may raise questions about whether such declines are other than temporary. The auditor should evaluate management’s conclusion about the need to recognize in earnings an impairment loss for a decline in fair value that is other than temporary.¹¹²

In accordance with SFAS No. 115 (as amended), *Accounting for Certain Investments in Debt and Equity Securities*, a charge to earnings should be made for

¹⁰⁵ Ibid.

¹⁰⁶ SFAS No. 142, paragraph 16.

¹⁰⁷ SFAS No. 144, paragraph 9.

¹⁰⁸ Ibid.

¹⁰⁹ Accounting Research Bulletin (“ARB”) No. 43 (as amended), *Inventory Pricing*, chapter 4.

¹¹⁰ ARB No. 43, chapter 4, paragraph 8.

¹¹¹ ARB No. 43, chapter 4, paragraph 17.

¹¹² AU sec. 332.46.

impairment that is “other than temporary” in held-to-maturity and available-for-sale securities.¹¹³ SEC Staff Accounting Bulletin (“SAB”) No. 59, *Accounting for Noncurrent Marketable Equity Securities*, also provides the SEC staff’s view and indicates that “other than temporary” should not be interpreted to mean “permanent.” SAB No. 59 provides examples of factors which, individually or in combinations, may indicate that a decline is other than temporary and that a write-down of the carrying value is required, including—

- The length of the time and the extent to which the market value has been less than cost;
- The financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer such as changes in technology that may impair the earnings potential of the investment or the discontinuance of a segment of the business that may affect the future earnings potential; or
- 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.

SAB No. 59 further provides that “[u]nless evidence exists to support a realizable value equal to or greater than the carrying value of the investment, a write-down accounted for as a realized loss should be recorded.”

Additionally, under FASB Emerging Issues Task Force No. 99-20, *Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets*, certain beneficial interests should be written down to fair value through earnings if the security has declined below its cost and there has been an adverse change in the estimated cash flows based on a holder’s best estimate of cash flows that a market participant would use in determining the fair value of the beneficial interest.¹¹⁴

Pension and other postretirement benefits (“OPEB”)

Increased credit risk and reduced liquidity in the current economic environment can have a significant effect on the fair value of plan assets as well as the assumptions used to measure the pension and OPEB obligation. Companies that sponsor pension and OPEB plans are required to recognize the funded status of these plans in the statement of financial position.¹¹⁵ The funded status is measured as the difference between the fair value of plan assets and the benefit obligation.¹¹⁶ SFAS No. 87 (as amended), *Employers’ Accounting for Pensions*, and SFAS No. 106 (as amended), *Employers’ Accounting for Postretirement Benefits Other Than Pensions*, generally require that plan investments, whether equity or debt securities, real estate or other, be measured at fair value as of the measurement date.¹¹⁷ Therefore, the measurement requirements of SFAS No. 157 apply to defined-benefit postretirement plan assets.

¹¹³ Paragraph 16 of SFAS No. 115 (as amended), *Accounting for Certain Investments in Debt and Equity Securities*.

¹¹⁴ Paragraph 12b of FASB Emerging Issues Task Force No. 99-20, *Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets*.

¹¹⁵ Paragraph 1 of SFAS No. 158, *Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R)*.

¹¹⁶ SFAS No. 158, paragraph 4a.

¹¹⁷ Paragraph 49 of SFAS No. 87 (as amended), *Employers’ Accounting for Pensions* and paragraph 65 of SFAS No. 106 (as amended), *Employers’ Accounting for Postretirement Benefits Other Than Pensions*.

Several assumptions are relevant to determining a company's pension and OPEB obligation, such as discount rate, expected rate of return on plan assets, and rate of compensation increase. Significant declines in the stock market may adversely affect the fair value of the plan assets, and companies may need to consider recent shifts in the market when developing the expected rate of return on plan assets. Changes in fair value of plan assets affect the funded status of the plan.¹¹⁸ Deviations from the expected rate of return on plan assets affect a company's pension or OPEB expenses in future periods,¹¹⁹ unless gains and losses are recognized immediately.¹²⁰

Receivables

In the current economic environment, companies may face a heightened risk of non-collection of receivables. Evidence of this risk might be noted in an increase in days sales outstanding, the aging of receivables, or the amount of delinquent receivables.¹²¹

In addition for loans receivable, evidence of this risk might be rising loan delinquency and defaults and decreasing secondary market liquidity.¹²² These situations can affect the risk of material misstatement in the valuation of a company's receivables and the auditor's evaluation of management's estimate of the allowance.

Restructuring

Market events and their effect on liquidity have caused many companies to take actions such as restructuring to reduce costs. SFAS No. 146 (as amended), *Accounting for Costs Associated with Exit or Disposal Activities*, addresses financial accounting and reporting for costs associated with exit or disposal activities.¹²³ The risks of material misstatement may relate to recording costs in the improper period, incorrect measurement or presentation of restructuring liabilities and costs, or inadequate disclosures. Misstatements could result in understatement or overstatement of restructuring liabilities and costs.

¹¹⁸ SFAS No. 87, paragraph 35 and SFAS No. 106, paragraph 44A.

¹¹⁹ SFAS No. 87, paragraph 34 and SFAS No. 106, paragraph 62.

¹²⁰ SFAS No. 87, paragraph 32 and SFAS No. 106, paragraph 59.

¹²¹ Scott Malone, "Corporate America Taking Longer to Collect: Study" (August 24, 2008), (<http://www.reuters.com/article/reutersEdge/idUSN2745047620080827>), noted that it is taking companies longer to collect from their customers.

¹²² SFAS No. 114 (as amended), *Accounting by Creditors for Impairment of a Loan- an amendment of FASB Statements no. 5 and 15*, addresses the accounting by creditors for impairment of a loan by specifying how allowances for credit losses related to certain loans should be determined.

¹²³ As described in paragraph 2a of SFAS No. 146 (as amended), *Accounting for Costs Associated with Exit or Disposal Activities*, SFAS No. 146 does not change the accounting for termination benefits, including one-time termination benefits granted in the form of an enhancement to an ongoing benefit arrangement, covered by SFAS No. 87, SFAS No. 88 (as amended), *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, SFAS No. 106, and SFAS No. 112 (as amended), *Employers' Accounting for Postemployment Benefits - an amendment of FASB Statements No. 5 and 43*. FSP No. FAS 146-1 (as amended), *Determining Whether a One-Time Termination Benefit Offered in Connection with an Exit or Disposal Activity Is, in Substance, an Enhancement to an Ongoing Benefit Arrangement*, provides guidance on when additional termination benefits offered in connection with an exit or disposal activity are considered, in substance, enhancements to an ongoing benefit arrangement and, therefore, subject to the provisions SFAS Nos. 87, 88, 106 and 112. In addition, SFAS No. 144 addresses accounting for long-lived assets and disposal groups to be disposed of, including components of a company that are discontinued operations.

Revenue recognition

In the current economic environment, companies may be faced with increased pressure to meet revenue targets and analysts' expectations. These pressures may cause companies to change business practices, which could affect the amount and timing of revenue recognition. Examples of business practices that could affect revenue recognition and the necessary audit procedures include, among other things, rights of return, bill-and-hold arrangements, change in payment terms, side agreements, and consignment arrangements. Also, the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition.¹²⁴

Share-based payments

Current market conditions have resulted in volatile stock prices for many companies. As a result, some companies may consider modifying share-based payment awards. In addition, the changing economic environment may affect the assumptions used when valuing such awards.

The valuation of share-based payment awards under an option-pricing model includes significant estimates, such as expected term, pre-vesting forfeiture rate and the expected volatility of the underlying stock price. For new grants of awards, companies may need to revise these and other inputs to reflect current expectations. For example, expected volatility in an option-pricing model may be affected by recent volatility in the markets. Assumptions used in the option pricing model affect the value of the award and, consequently, the compensation expense that is recognized in the financial statements.

Modifications of share-based payment awards may result in the recognition of incremental compensation cost. Incremental compensation cost is measured as the excess, if any, of the fair value of the modified award over the fair value of the original award immediately before its terms are modified.¹²⁵

PCAOB Staff Questions and Answers ("Q&A"), *Auditing the Fair Value of Share Options Granted to Employees*, remains relevant in the current environment and reminds auditors of their responsibilities for auditing share-based payments including consideration of—

- The company's process,
- Risk factors,
- Model selection,
- Assumptions used in option-pricing models,
- Validation of data and the option-pricing model,
- Role of specialists.¹²⁶

In discussing the auditor's responsibilities for auditing the fair value of share options granted to employees, the Q&A refers the auditor to AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, AU sec. 328, *Auditing Fair Value Measurements and Disclosures*, AU sec. 336, *Using the Work of a Specialist*, and AU sec. 342, *Auditing Accounting Estimates*.

¹²⁴ AU 316.41.

¹²⁵ Paragraph 51 of SFAS No. 123(R) (as amended), *Share-Based Payment*.

¹²⁶ PCAOB Staff Questions and Answers, *Auditing the Fair Value of Share Options Granted to Employees* (October 17, 2006).

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.04 Staff Audit Practice Alert No. 4 Auditor Considerations Regarding Fair Value Measurements, Disclosures, and Other-Than-Temporary Impairments

April 21, 2009

Staff Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of PCAOB standards and relevant laws. Auditors should determine whether and how to respond to these circumstances based on the specific facts presented. The statements contained in Staff Audit Practice Alerts are not rules of the Board and do not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person.

On April 9, 2009, the Financial Accounting Standards Board (“FASB”) issued three FASB Staff Positions (“FSP” or, collectively, “the FSPs”):

- FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* (“FSP FAS 157-4”)
- FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* (“FSP FAS 115-2”)
- FSP FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments* (“FSP FAS 107-1”)¹

The objectives of these FSPs are to: (1) provide “additional guidance for estimating fair value in accordance with FASB Statement No. 157, *Fair Value Measurements*, when the volume and level of activity for the asset or liability have significantly decreased” including “guidance on identifying circumstances that indicate a transaction is not orderly,”² (2) amend “the other-than-temporary impairment guidance in U.S. GAAP for debt securities to make the guidance more operational and to improve the presentation and disclosure of other-than-temporary impairments on debt and equity securities in the financial statements,”³ and (3) “require disclosures about fair value of financial instruments for interim reporting periods for publicly traded companies as well as in annual financial statements.”⁴

The purpose of this staff audit practice alert is to inform auditors about potential implications of the FSPs on reviews of interim financial information and annual audits. This alert addresses the following topics: (1) reviews of interim financial information (“reviews”); (2) audits of financial statements,

¹ The respective FSPs are available at:

- http://www.fasb.org/pdf/fsp_fas157-4.pdf
- http://www.fasb.org/pdf/fsp_fas115-2andfas124-2.pdf
- http://www.fasb.org/pdf/fsp_fas107-1andapb28-1.pdf

² FSP FAS 157-4, paragraph 1.

³ FSP FAS 115-2, paragraph 2. This FSP does not amend existing recognition and measurement guidance related to other-than-temporary impairment of equity securities. On April 14, 2009, the SEC’s staff released Staff Accounting Bulletin (“SAB”) No. 111, *Other Than Temporary Impairment of Certain Investments in Equity Securities*, which amends SAB Topic 5.M. SAB Topic 5.M. now excludes debt securities from its scope while maintaining the SEC staff’s views related to equity securities.

⁴ FSP FAS 107-1, paragraph 1.

including integrated audits; (3) disclosures; and (4) auditor reporting considerations. While this alert highlights certain areas, it is not intended to serve as a substitute for the relevant auditing standards.

In considering the effects of the FSPs on their audits and reviews, auditors should be aware that some PCAOB standards include descriptions of accounting requirements that are no longer current. The accounting standards set by the FASB are recognized by the U.S. Securities and Exchange Commission (“SEC”) as generally accepted.⁵ Auditors should look to those standards and to the requirements of the SEC,⁶ rather than the standards of the PCAOB, for current accounting requirements and disregard descriptions of accounting requirements in PCAOB standards that are inconsistent with the FSPs. The PCAOB has a project on its standards-setting agenda to address the auditing standards related to auditing accounting estimates and auditing fair value measurements. In connection with this project, the PCAOB is planning to remove descriptions of accounting requirements from these standards. In general, as the PCAOB replaces or substantively revises its interim standards, it will continue to remove descriptions of accounting requirements from those auditing standards.

Reviews of Interim Financial Information

The objective of a review is to provide the auditor with a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information for it to conform with generally accepted accounting principles (“GAAP”). A review differs significantly from an audit and consists principally of performing analytical procedures and making inquiries of persons responsible for financial and accounting matters.⁷ A review does not provide a basis for expressing an opinion about whether the financial statements are presented fairly, in all material respects, in conformity with GAAP.⁸ For an audit, PCAOB standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.⁹

As part of the review, the auditor should, among other things, make inquiries of members of management who have responsibility for financial and accounting matters. If relevant to the company, the auditor should include in these inquiries questions about the implementation of the FSPs.¹⁰

The auditor also should determine whether any matters described in AU sec. 380, *Communication With Audit Committees* (“AU sec. 380”), as they relate to the interim financial information, have been identified.¹¹ If such matters have been identified, the auditor should communicate those matters to the audit

⁵ SEC, *Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter*, Exchange Act Release No. 34-47743 (April 25, 2003). The PCAOB has no authority to prescribe the form or content of an issuer’s financial statements. Accordingly, while this staff audit practice alert describes applicable generally accepted accounting principles (“GAAP”), it does not establish or interpret GAAP.

⁶ Auditors should look to the requirements of the SEC for the company under audit with respect to the accounting principles applicable to that company. See AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*.

⁷ Paragraph .07 of AU sec. 722, *Interim Financial Information* (“AU sec. 722”).

⁸ Ibid.

⁹ Paragraph .08 of AU sec. 508, *Reports on Audited Financial Statements*. An audit includes, among other things, examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements.

¹⁰ AU sec. 722.18(c).

¹¹ AU sec. 722.34.

committee or be satisfied, through discussion with the audit committee, that management has communicated such matters to the audit committee.¹² Matters to be communicated include: a change in a significant accounting policy affecting the interim financial information; accounting estimates and management's judgments about those accounting estimates; processes management uses to formulate sensitive accounting estimates; and the auditor's judgment about the quality, not just the acceptability, of the company's accounting policies.¹³ Depending upon the circumstances, the implementation of the FSPs may present matters that should be communicated to the audit committee.

Audits of Financial Statements, Including Integrated Audits

FSP FAS 157-4 provides additional guidance for estimating fair value when the volume and level of activity for an asset or liability have significantly decreased.¹⁴ In performing procedures under AU sec. 328, *Auditing Fair Value Measurements and Disclosures* ("AU sec. 328"), the auditor is required to, among other things, obtain an understanding of the company's process for determining fair value measurements and disclosures and of the relevant controls sufficient to assess the risk of material misstatement, and to plan the nature, timing, and extent of the audit procedures.¹⁵ Based on the auditor's assessment of the risk of material misstatement, the auditor should test the entity's fair value measurements and disclosures.¹⁶ Because of the wide range of possible fair value measurements, from relatively simple to complex, and the varying levels of risk of material misstatement associated with the process for determining fair values, the auditor's planned audit procedures can vary significantly in nature, timing, and extent.¹⁷ The auditor's 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.¹⁸

FSP FAS 115-2 amends the guidance for recognizing an other-than-temporary impairment ("OTTI") for a debt security.¹⁹ The auditor is required to evaluate a company's conclusions about the need to recognize an impairment loss.²⁰ When a company has recognized an impairment loss, the auditor should gather evidence supporting the amount of the impairment adjustment recorded and determine whether the company has appropriately followed GAAP.²¹ In certain circumstances, a company is required to separate the amount of the OTTI representing credit losses (as defined by FSP FAS 115-2) and the amount representing all other factors.²² In those situations, the auditor's objective is to obtain sufficient competent evidential matter to provide reasonable assurance that these estimates are reasonable in the circumstances and that they are

¹² Ibid.

¹³ AU secs. 380.07-08, AU sec. 380.11, and AU sec. 722.34.

¹⁴ FSP FAS 157-4, paragraphs 12-16.

¹⁵ AU secs. 328.09 and 328.13.

¹⁶ AU sec. 328.23.

¹⁷ Ibid.

¹⁸ Ibid.

¹⁹ FSP FAS 115-2, paragraph 7.

²⁰ Paragraph .48 of AU sec. 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*.

²¹ Ibid.

²² FSP FAS 115-2, paragraphs 29-30.

presented and disclosed in conformity with GAAP.²³ In evaluating reasonableness, the auditor should obtain an understanding of how the company developed the estimates.²⁴ In addition, the auditor should discuss an accounting change due to FSP FAS 115-2 and other related topics (as described in the previous section related to interim financial information), with the audit committee in connection with the audit of the financial statements, including integrated audits.²⁵

Disclosures

The FSPs require additional disclosures regarding fair value measurements and OTTI. For example (1) FSP FAS 157-4 requires a company to disclose changes in valuation techniques and related inputs for fair value measurements in interim and annual periods and to provide additional disclosures under Statement No. 157, *Fair Value Measurements*²⁶ and (2) FSP FAS 115-2 requires a company to disclose information that enables users to understand the reasons that a portion of OTTI was not recognized in earnings and the methodology and significant inputs used to calculate the portion of OTTI that was recognized in earnings.²⁷ The auditor should evaluate whether the financial statement disclosures are in conformity with the FSPs.²⁸

In addition, the auditor should read the other information accompanying the interim and annual financial statements contained in reports filed with the SEC.²⁹ For example, the Management's Discussion and Analysis of Financial Condition and Results of Operations section of annual reports and other filings might include discussions regarding fair value measurements and OTTI.³⁰ The auditor should consider whether that information or the manner of its presentation is materially inconsistent with the financial statements. If the auditor concludes that there is a material inconsistency, or becomes aware of information that he or she believes is a material misstatement of fact, the auditor should determine if the financial statements, the audit report, or both require revision. If the auditor concludes that the financial statements or audit report do not require revision, the auditor should request the company to revise the other information.³¹

Auditor Reporting Considerations

FSP FAS 157-4 states that revisions resulting from a change in the valuation technique or its application are to be accounted for as a change in accounting estimate. In the period of adoption, entities are required to disclose a change,

²³ Paragraph .07 of AU sec. 342, *Auditing Accounting Estimates*.

²⁴ AU sec. 342.10.

²⁵ AU secs. 380.07 and 380.11. Also, Section 10A(k) of the Securities and Exchange Act of 1934 requires the auditor to communicate certain matters to the audit committee.

²⁶ FSP FAS 157-4, paragraph 20.

²⁷ FSP FAS 115-2, paragraph 38.

²⁸ The auditor considers whether a particular matter should be disclosed in light of the circumstances and facts of which the auditor is aware at the time. See paragraph .02 of AU sec. 431, *Adequacy of Disclosure in Financial Statements*.

²⁹ AU sec. 722.18(f) and paragraph .04 of AU sec. 550, *Other Information in Documents Containing Audited Financial Statements* ("AU sec. 550").

³⁰ For example, see the discussion of critical accounting policies and critical accounting estimates, respectively, in SEC Release Nos. 33-8040, *Cautionary Advice Regarding Disclosure About Critical Accounting Policies* (December 12, 2001) and 33-8350, *Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations* (December 29, 2003).

³¹ AU secs. 550.04-.05.

if any, in valuation technique and related inputs and quantify the total effect, if practicable, by major category.³² In addition, FSP FAS 115-2 requires the company to recognize the cumulative effect of initially applying the FSP as an adjustment to the opening balance of retained earnings, as of the beginning of the period in which FSP FAS 115-2 is adopted, with a corresponding adjustment to accumulated other comprehensive income.³³

The auditor should evaluate whether the company's accounting for and disclosure of the changes are in accordance with the FSPs. To identify consistency matters that might affect the auditor's report, the auditor should evaluate whether the comparability of the financial statements between periods has been materially affected by changes in accounting principles. A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report through the addition of an explanatory paragraph following the opinion paragraph.³⁴

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³² FSP FAS 157-4, paragraph 22.

³³ FSP FAS 115-2, paragraph 45.

³⁴ Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*.

.05 Staff Audit Practice Alert No. 5 Auditor Considerations Regarding Significant Unusual Transactions

April 7, 2010

Staff Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of PCAOB standards and relevant laws. Auditors should determine whether and how to respond to these circumstances based on the specific facts presented. The statements contained in Staff Audit Practice Alerts are not rules of the Board and do not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person.

During the course of an audit, the auditor may become aware of significant transactions that are outside the normal course of business for the company, or that otherwise appear to be unusual given the auditor's understanding of the company and its environment ("significant unusual transactions").¹ Significant unusual transactions, especially those close to period end that pose difficult "substance over form" questions, can provide opportunities for companies to engage in fraudulent financial reporting.² Further, the auditor's evaluation of whether the company's financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework, includes the consideration of the financial statement presentation and disclosure of significant unusual transactions.³

The auditor should gain an understanding of the business rationale or such transactions and whether that rationale (or the lack thereof) suggests that the transactions may have been entered into to engage in fraudulent financial reporting or conceal a misappropriation of assets.⁴ The audit engagement team might consult with individuals having appropriate levels of knowledge, competence, and judgment regarding significant unusual transactions.⁵ Such consultations regarding significant unusual transactions should occur in accordance with the firm's policies and procedures. The auditor should determine that the audit committee is informed about the methods used to account for significant unusual transactions.⁶ In addition, the engagement quality reviewer cannot provide concurring approval of issuance if he or she is aware of a significant engagement deficiency, including those regarding significant unusual transactions.⁷

¹ Paragraph .66 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

² AU sec. 316.85.

³ Paragraph .04 of AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, notes financial statements are materially misstated when they contain misstatements whose effect, individually or in the aggregate, is important enough to cause them not to be presented fairly, in all material respects, in conformity with generally accepted accounting principles.

⁴ AU sec. 316.66.

⁵ Paragraph .19 of QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*.

⁶ Paragraph .07 of AU sec. 380, *Communication With Audit Committees*.

⁷ Paragraphs 12 and 17 of Auditing Standard No. 7, *Engagement Quality Review*. AS No. 7 is effective for audits of financial statements and reviews of interim financial information for fiscal years beginning on or after December 15, 2009.

Introduction

Staff Audit Practice Alert No. 3, *Audit Considerations in the Current Economic Environment* (“Practice Alert No. 3”), was issued in December 2008 to assist auditors in identifying matters related to the current economic environment that might affect audit risk and require additional emphasis.⁸ Practice Alert No. 3 reminds auditors that the auditors’ response to the risks of material misstatement due to fraud includes evaluating the business rationale for significant unusual transactions. In the staff’s view, although the economic conditions have changed since December 2008, the risk factors, including the risks of significant unusual transactions, that existed in December 2008 continue to exist today and may affect the risk of material misstatement.

The existing standards of the PCAOB contain a variety of requirements related to significant, unusual, or complex transactions, or a combination thereof. The purpose of this staff audit practice alert is to complement Practice Alert No. 3 by compiling selected, relevant requirements from existing PCAOB auditing standards regarding significant unusual transactions into one document. While this alert summarizes certain areas with respect to significant unusual transactions, it is not intended to, and does not, serve as a substitute for the relevant standards of the PCAOB. Nor does this alert change the auditor’s responsibilities regarding significant, unusual, or complex transactions. This alert reminds auditors of certain responsibilities with respect to significant unusual transactions and assists auditors in assessing and responding to the risks of material misstatement associated with these transactions during reviews of interim financial information and audits of financial statements, including integrated audits.

This alert groups the existing requirements for significant unusual transactions into the following categories: (1) identifying and assessing risks of material misstatement, (2) responding to risks of material misstatement, (3) consulting others, (4) evaluating financial statement presentation and disclosure,⁹ (5) communicating with audit committees, and (6) reviewing interim financial information.

Identifying and Assessing Risks of Material Misstatement

The auditor’s identification of significant unusual transactions is informed by the performance of audit procedures and the auditor’s knowledge of the company’s business and industry. The auditor should obtain knowledge of matters that relate to the nature of the company’s business, its organization, and its operating characteristics.¹⁰ Such matters include, for example, the type of business, types of products and services, and related parties.¹¹ The auditor also should consider matters affecting the industry in which the company operates, such as accounting practices common to the industry, competitive conditions, and financial trends and ratios.¹²

⁸ Staff Audit Practice Alert No. 3 is available at http://pcaobus.org/Standards/QandA/12-05-2008_APA_3.pdf.

⁹ The PCAOB has no authority to prescribe the form or content of an issuer’s financial statements. Accordingly, while this staff audit practice alert describes authoritative accounting guidance, it does not establish or interpret that accounting guidance. See Staff Questions and Answers, References to Authoritative Accounting Guidance in PCAOB Standards, available at http://pcaobus.org/Standards/QandA/2009-09-02_FASB_Codification.pdf.

¹⁰ Paragraph .07 of AU sec. 311, *Planning and Supervision*.

¹¹ *Ibid.*

¹² *Ibid.*

The auditor should consider whether the information obtained about the company and its environment indicates that one or more fraud risk factors are present, including significant unusual transactions.¹³ The auditor also should consider identified fraud risk factors in identifying and assessing risks of material misstatement due to fraud.¹⁴ In obtaining the information needed to identify risks of material misstatement due to fraud, the auditor, among other things, should inquire of others within the company about the existence or suspicion of fraud, including, for example, employees involved in initiating, recording, or processing significant unusual transactions.¹⁵ The auditor also should perform analytical procedures when planning the audit with one objective being the identification of significant unusual transactions.¹⁶ The auditor's assessment of the risks of material misstatement due to fraud, including those regarding significant unusual transactions, should be ongoing throughout the audit.¹⁷

The auditor should take into account the results of the fraud risk assessment when planning and performing an audit of internal control over financial reporting.¹⁸ The auditor should evaluate whether the company's controls (including controls over significant unusual transactions, particularly those that result in late or unusual journal entries) sufficiently address the identified risks of material misstatement due to fraud and controls intended to address the risk of management override of other controls.¹⁹

Responding to Risks of Material Misstatement

When the auditor has concluded that there is a significant risk of material misstatement of the financial statements, the auditor should consider this conclusion in determining the nature, timing, or extent of procedures; assigning staff; or requiring appropriate levels of supervision.²⁰ The auditor's response to the assessment of the risks of material misstatement of the financial statements due to fraud is influenced by the nature and significance of the risks identified as being present and the company's programs and controls that address these identified risks.²¹

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.²² 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 associated with significant unusual transactions.²³

As part of the overall responses to the risks of material misstatement due to fraud, the auditor should consider management's selection and application of

¹³ AU sec. 316.32.

¹⁴ *Ibid.*

¹⁵ AU sec. 316.24-.25.

¹⁶ AU sec. 316.28.

¹⁷ AU sec. 316.68.

¹⁸ Paragraph 14 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

¹⁹ *Ibid.*

²⁰ AU secs. 312.17 and 316.50.

²¹ AU sec. 316.47.

²² AU sec. 316.13. In addition, paragraphs .07-.09 of AU sec. 230, *Due Professional Care in the Performance of Work*, notes that due professional care requires the auditor to exercise professional skepticism.

²³ *Ibid.*

significant accounting principles, including those related to significant unusual transactions.²⁴ In this respect, the auditor may have a greater concern about whether the accounting principles selected and policies adopted are being applied in an inappropriate manner to create a material misstatement of the financial statements.²⁵ The auditor should consider whether their collective application indicates a bias that might create a material misstatement of the financial statements.²⁶ In examining journal entries and other adjustments for evidence of possible material misstatement due to fraud, the auditor should consider that inappropriate entries or adjustments may be applied to accounts that contain significant unusual transactions.²⁷ The auditor also should evaluate whether analytical procedures that were performed in the overall review stage of the audit indicate a previously unrecognized risk of material misstatement resulting from significant unusual transactions.²⁸

In evaluating whether the business rationale (or the lack thereof) for significant unusual transactions suggests that the transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets, the auditor should consider:

- Whether the form of such transactions is overly complex;
- Whether management has discussed the nature of and accounting for such transactions with the audit committee or board of directors;
- Whether management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction;
- Whether transactions that involve unconsolidated related parties, including special purpose entities, have been properly reviewed and approved by the audit committee or board of directors; and
- Whether the transactions involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transaction without assistance from the company under audit.²⁹

If the company has entered into a significant unusual transaction and the combined assessed level of inherent and control risk is high, in addition to examining documentation held by the company, the auditor should consider confirming the terms and amounts of the transaction with the other parties.³⁰ The auditor also should obtain an understanding of the substance of the transaction to determine the appropriate information to include on the confirmation request.³¹

The auditor must identify all significant findings or issues (including significant unusual transactions) in an engagement completion document.³² The auditor must document actions taken to address significant unusual transactions (including additional evidence obtained), and the basis for the conclusions

²⁴ AU sec. 316.50.

²⁵ Ibid.

²⁶ Ibid.

²⁷ AU secs. 316.58 and .61.

²⁸ AU sec. 316.69.

²⁹ AU secs. 316.66-67.

³⁰ Paragraph .08 of AU sec. 330, *The Confirmation Process*.

³¹ AU sec. 330.25.

³² Paragraphs 12 and 13 of Auditing Standard No. 3, *Audit Documentation*.

reached.³³ In addition, a principal auditor that decides not to make reference to the audit of another auditor, among other things, must obtain, review, and retain an engagement completion document from that auditor.³⁴

Engagement Quality Review

The engagement quality reviewer should review the engagement completion document and confirm with the engagement partner that there are no significant unresolved matters, including unresolved matters related to significant unusual transactions.³⁵ The engagement quality reviewer also should, among other things, evaluate whether (1) appropriate consultations have taken place on difficult or contentious matters, and review the documentation, including conclusions, of such consultations and (2) appropriate matters have been communicated, or identified for communication, to the audit committee, management, and other parties, such as regulatory bodies.³⁶

Consulting Others

A firm's policies and procedures should 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 significant unusual transactions).³⁷ Individuals consulted should have appropriate levels of knowledge, competence, judgment, and authority.³⁸ 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.³⁹ In addition, procedures performed by filing reviewers for U.S. Securities and Exchange Commission ("SEC") filings by SEC registrants audited by foreign associated firms of registered firms that were members of the American Institute of Certified Public Accountants' SEC Practice Section should generally include discussing with the engagement partner any significant auditing, accounting, financial reporting, and independence matters that come to the attention of the filing reviewer, including how such matters were addressed and resolved.⁴⁰

Evaluating Financial Statement Presentation and Disclosure

The auditor's opinion that the financial statements are presented fairly in conformity with the applicable financial reporting framework should be based on whether:

- a. The accounting principles selected and applied have general acceptance,⁴¹
- b. The accounting principles are appropriate in the circumstances;

³³ Paragraph 12 of Auditing Standard No. 3.

³⁴ Paragraph .12 of AU sec. 543, *Part of Audit Performed by Other Independent Auditors*.

³⁵ Paragraph 10.e of Auditing Standard No. 7.

³⁶ Paragraphs 10.h and 10.i of Auditing Standard No. 7.

³⁷ QC sec. 20.19.

³⁸ *Ibid.*

³⁹ *Ibid.*

⁴⁰ PCAOB Rule 3400T, *Interim Quality Control Standards*.

⁴¹ The auditor should look to the requirements of the SEC for the company under audit with respect to accounting principles applicable to that company. See Rule 4-01 of Regulation S-X.

- c. The financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation;
- d. The information presented in the financial statements is classified and summarized in a reasonable manner, that is, neither too detailed nor too condensed; and
- e. The financial statements reflect the underlying transactions and events in a manner that presents the financial position, results of operations, and cash flows stated within a range of acceptable limits, that is, limits that are reasonable and practicable to attain in financial statements.⁴²

The auditor's judgment concerning the "fairness" of the overall presentation of financial statements should be applied within the framework of generally accepted accounting principles.⁴³ Generally accepted accounting principles recognize the importance of reporting transactions and events in accordance with their substance.⁴⁴ The auditor should consider whether the substance of transactions or events, including significant unusual transactions, differs materially from their form.⁴⁵

The presentation of financial statements in conformity with generally accepted accounting principles includes adequate disclosure of material matters.⁴⁶ An auditor considers whether a particular matter should be disclosed by management in light of the circumstances and facts of which he or she is aware at the time.⁴⁷ A basic tenet of the auditing standards of reporting states, "[i]nformative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report."⁴⁸ If management omits from the financial statements, including the accompanying notes, information that is required by generally accepted accounting principles, the auditor should determine the effect on his or her audit report.⁴⁹ The auditor also may emphasize a matter regarding the financial statements in a separate paragraph of the auditor's report.⁵⁰

In addition, the auditor should read the other information accompanying the interim and annual financial statements contained in reports filed with the SEC.⁵¹ For example, the Management's Discussion and Analysis of Financial Condition and Results of Operations section of annual reports and other filings

⁴² Paragraph .04 of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*.

⁴³ AU sec. 411.03.

⁴⁴ AU sec. 411.06.

⁴⁵ *Ibid.*

⁴⁶ Paragraph .02 of AU sec. 431, *Adequacy of Disclosure in Financial Statements*.

⁴⁷ *Ibid.* When an auditor becomes aware of information that relates to financial statements previously reported on by the auditor, but which was not known to the auditor at the date of the report, and which is of such a nature and from such a source that the auditor would have investigated it had it come to the auditor's attention during the course of the audit, the auditor should take the actions described in AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

⁴⁸ Paragraph .02 of AU sec. 150, *Generally Accepted Auditing Standards*, and AU sec. 431.01.

⁴⁹ AU sec. 431.03.

⁵⁰ Paragraph .19 of AU sec. 508, *Reports on Audited Financial Statements*.

⁵¹ Paragraph 18(f) of AU sec. 722, *Interim Financial Information*, and paragraph .04 of AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*.

might include discussions regarding significant unusual transactions.⁵² The auditor should consider whether that information or the manner of its presentation is materially inconsistent with the financial statements. If the auditor concludes that there is a material inconsistency, or becomes aware of information that he or she believes is a material misstatement of fact, the auditor should determine if the financial statements, the audit report, or both require revision. If the auditor concludes that the financial statements or audit report do not require revision, the auditor should request the company to revise the other information.⁵³

Communicating With Audit Committees

The auditor should determine that the company's audit committee is informed about the methods used to account for significant unusual transactions.⁵⁴ The auditor also should discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles as applied in its financial reporting.⁵⁵ The discussion should be open and frank and generally should include such matters as the clarity and completeness of the company's financial statements, which include related disclosures.⁵⁶ In addition, the discussion should include items that have a significant impact on the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements.⁵⁷ Items that may have such an impact include significant unusual transactions.⁵⁸

Reviewing Interim Financial Information

The objective of a review of interim financial information is to provide the auditor with a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information for it to conform with generally accepted accounting principles.⁵⁹ The objective of a review differs significantly from that of an audit of annual financial statements and consists principally of performing analytical procedures and making inquiries of persons responsible for financial and accounting matters.⁶⁰ Certain auditing procedures may be performed concurrently with the review of interim financial information.⁶¹ For example, there may be significant unusual transactions occurring during the interim period under review for which the auditing procedures needed for purposes of the audit of the annual financial statements could be performed, to the extent practicable, at the time of the interim review.⁶²

During a review of interim financial information, the auditor should make inquiries of members of management who have responsibility for financial and

⁵² For example, Item 303(a)(3)(i) of Regulation S-K instructs management to “[d]escribe any unusual or infrequent events or transactions or any significant economic changes that materially affected the amount of reported income from continuing operations and, in each case, indicate the extent to which income was so affected.”

⁵³ AU secs. 550.04-05.

⁵⁴ AU sec. 380.07.

⁵⁵ AU sec. 380.11.

⁵⁶ *Ibid.*

⁵⁷ *Ibid.*

⁵⁸ *Ibid.*

⁵⁹ AU sec. 722.07.

⁶⁰ *Ibid.*

⁶¹ AU sec. 722.23.

⁶² *Ibid.*

accounting matters.⁶³ Specifically, the auditor should inquire about, among other things (a) significant unusual transactions that may have an effect on the interim financial information, and (b) significant unusual transactions occurring or recognized in the last several days of the interim period.⁶⁴ If the auditor becomes aware of information that leads him or her to believe that the interim financial information may not be in conformity with generally accepted accounting principles in all material respects, the auditor should make additional inquiries or perform other procedures that he or she considers appropriate to provide a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information.⁶⁵

When conducting a review of interim financial information, the auditor also should determine whether significant unusual transactions have been identified.⁶⁶ If such transactions have been identified, the auditor should communicate them to the audit committee, or be satisfied, through discussion with the audit committee, that such matters have been communicated to them by management.⁶⁷

Standards-Setting Activities

The PCAOB has a project on its standards-setting agenda to address the auditing standards regarding related parties. In connection with that project, the PCAOB is evaluating its auditing standards regarding the consideration of significant unusual transactions. In addition, the PCAOB also has on its standards-setting agenda projects to address other standards referenced in this practice alert. Updates on these activities are available on the PCAOB's website. Relevant links are provided below:

- Release No. 2009-007, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards*, available at: http://pcaobus.org/Rules/Rulemaking/Docket%20026/2009-12-16_Release_No_2009-007.pdf
- Release No. 2010-001, *Proposed Auditing Standard Related to Communications With Audit Committees and Related Amendments to Certain PCAOB Auditing Standards*, available at: http://pcaobus.org/Rules/Rulemaking/Docket030/Release_No_2010-001.pdf
- Release No. 2009-002, *Concept Release on Possible Revisions to the PCAOB's Standard on Audit Confirmations*, available at: <http://pcaobus.org/Rules/Rulemaking/Pages/Docket028.aspx>.
- Standing Advisory Group Meeting briefing paper, *Responsibilities of the Principal Auditor*, available at: http://pcaobus.org/News/Events/Documents/04072010_SAGMeeting/Principal_Auditor_Briefing_Paper.pdf.

⁶³ AU sec. 722.18c.

⁶⁴ Ibid. AU sec. 722.55 contains examples of situations about which the auditor ordinarily inquires of management during a review of interim financial information.

⁶⁵ AU sec. 722.22.

⁶⁶ AU secs. 722.33-.34.

⁶⁷ Ibid.

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.06 Staff Audit Practice Alert No. 6 Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants From Outside the Firm

July 12, 2010

Staff Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of PCAOB standards and relevant laws. Auditors should determine whether and how to respond to these circumstances based on the specific facts presented. The statements contained in Staff Audit Practice Alerts are not rules of the Board and do not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person.

Introduction

The PCAOB staff has observed that a number of registered public accounting firms located in the United States (“U.S.”) have been issuing audit reports on financial statements filed by issuers that have substantially all of their operations outside of the U.S. Although there is nothing inherently inappropriate about this, observations from the Board’s inspection process suggest that some firms may not be conducting those audits in accordance with PCAOB standards. Specifically, some firms may be issuing audit reports based on the work of another firm, or by using the work of assistants engaged from outside of the firm, without complying with relevant PCAOB standards.

The circumstances in which such conduct occurs often involve issuers that are incorporated in the U.S. (and that file their annual reports with the Securities and Exchange Commission (“SEC”) on Form 10-K), even though substantially all of their operations are in another country. In this context, a number of issuers have come to be incorporated in the U.S., and to have securities trading in the U.S., following a transaction in which an operating company in another country merges with a U.S. shell company that had previously registered its securities under the Securities Exchange Act of 1934.

The number of issuers that file financial statements audited by U.S. auditors, while having substantially all of their operations in another country, has increased in recent years. The demand for those audit services is met by U.S. registered public accounting firms of various sizes, including small firms.¹ The Board’s inspection staff has observed some situations in which it appeared that U.S. registered public accounting firms that provided those auditing services did so by having all or most of the audit performed by another firm or by assistants engaged from outside the firm (including firms and assistants

¹ For example, in a 27-month period ending March 31, 2010, at least 40 U.S. registered public accounting firms with fewer than five partners and fewer than ten professional staff issued audit reports on financial statements filed with the SEC by companies whose operations were substantially all in the China region. (As used in this Staff Audit Practice Alert, the term “China region” includes the People’s Republic of China, Hong Kong Special Administrative Region, and Taiwan.) This trend has also attracted attention, and was a subject of discussion at a recent meeting of the Board’s Standing Advisory Group (available beginning at minute 43:15 of the archived Webcast at <http://pcaobus.org/News/Webcasts/Documents/2010/pcaob-040710-p2.mp3>). This trend is not necessarily limited to the China region, and the discussion in this Staff Audit Practice Alert of issues associated with the U.S. registered public accounting firms’ audits of companies whose operations were substantially all in the China region also is relevant to audits of companies located in other jurisdictions.

located in another country) without complying with PCAOB standards applicable to using the work and reports of another auditor and supervising assistants.² Prompted by those observations, this Alert is intended as a reminder to registered firms concerning a firm's obligations when using the work of other firms or using assistants engaged from outside the firm.

Using the Work of Other Auditors

AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, establishes requirements that apply when an auditor of an issuer's financial statements "use[s] the work and reports of other independent auditors who have audited the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in [that issuer's] financial statements."³

The Board's inspection staff has identified indications that some U.S. firms auditing issuers with substantially all of their operations in another country are not properly applying AU sec. 543. For example, in one situation, a U.S. firm engaged to audit such an issuer retained an accounting firm in the China region to perform audit procedures. In the year preceding the audit, the U.S. firm's managing partner and engagement partner traveled to the China region to meet with the issuer's board of directors, the issuer's management, and the other firm in order to gain an understanding of the issuer's business and processes and review with the other firm its audit process. The U.S. firm's personnel did not travel to the China region during the audit, and the audit procedures performed by the other firm constituted substantially all of the audit procedures on the issuer's financial statements. The firm in the China region did not issue a report, and substantially all of the audit documentation was maintained by the firm in the China region. Based on its view that AU sec. 543 applied and permitted it to do so, the U.S. firm issued an audit report stating that it had audited the financial statements and expressing an unqualified opinion on the financial statements. The inspection staff, however, concluded that it was inappropriate for the firm to serve as principal auditor and use the work of the other auditor pursuant to AU sec. 543.

Identifying Circumstances in Which AU sec. 543 Applies

AU sec. 543 applies only to circumstances in which a firm would use the "work and reports of other independent auditors who have audited the financial statements of one or more subsidiaries, divisions, branches, components, or investments" of an issuer.⁴ AU sec. 543 does not provide a way for an auditor to take responsibility for the work of another auditor that has essentially audited an issuer's financial statements in their entirety, even if the firm complies with the other requirements in AU sec. 543. AU sec. 543 does not apply to the use of another auditor's work if that work is anything other than an audit of the financial statements of one or more subsidiaries, divisions, branches, components, or investments of the issuer.

² Where appropriate, the Board follows up on indications of such misconduct with enforcement investigations, disciplinary proceedings, and sanctions. By law, these Board processes are nonpublic unless and until they result in a final disciplinary sanction taking effect. In one completed matter, the Board imposed sanctions in a case in which a U.S. firm used a significant amount of audit work performed by a Hong Kong firm without adequately coordinating its work with that of the Hong Kong firm. See *In the Matter of Clancy and Co., P.L.L.C., Jennifer C. Nipp, CPA, and Judith J. Clancy, CPA*, PCAOB Release No. 105-2009-001 (March 31, 2009). Referrals from the Board's inspection program to the Board's enforcement program relating to situations in which firms are using work of other firms or using assistants from outside the firm in connection with audits of foreign-based issuers have been on the rise.

³ AU sec. 543.01.

⁴ *Ibid.*

Determining Whether to Serve as Principal Auditor

Even in circumstances where a firm has access to the work and reports of another auditor that has audited the financial statements of a subsidiary, division, branch, component, or investment, the firm cannot serve as principal auditor (and, accordingly, may not sign the audit report on the issuer's financial statements) unless the firm's own participation in the audit is sufficient.⁵ In determining whether its participation is sufficient to serve as principal auditor, the firm "should consider, among other things, the materiality of the portion of the financial statements [the firm] audited in comparison with the portion audited by other auditors, the extent of [the auditor's] knowledge of the overall financial statements, and the importance of the components [the firm] audited in relation to the enterprise as a whole."⁶ If an issuer has no significant operations other than those in another country, a registered public accounting firm that plays no significant part in the audit of the foreign operations is highly unlikely to have sufficient participation in the audit to serve as the issuer's principal auditor. A lack of sufficient participation cannot be overcome by using the work of the other auditor, even if the firm assumes responsibility for that work.

Responsibilities of the Principal Auditor

In circumstances in which AU sec. 543 applies and in which the firm's own participation is sufficient to serve as principal auditor, the principal auditor must comply with the other requirements in AU sec. 543 relative to the firm's use of the work and reports of the other auditor,⁷ including:

- *Determining the Method of Reporting* – The principal auditor must decide, taking certain factors into account, whether to express an opinion on the financial statements taken as a whole without making reference to the audit of the other auditor (thereby assuming responsibility for the work of the other auditor) or to make reference to the audit of the other auditor.⁸
- *Procedures Applicable to Both Methods of Reporting* – The principal auditor "should make inquiries concerning the professional reputation and independence of the other auditor [and] adopt appropriate measures to assure the coordination of [the principal auditor's] activities with those of the other auditor in order to achieve a proper review of matters affecting the consolidating or combining of accounts in the financial statements."⁹

⁵ See AU sec. 543.02.

⁶ AU sec. 543.02. In an integrated audit, the auditor who serves as the principal auditor of the financial statements should also be the principal auditor of internal control over financial reporting ("ICFR") and so must participate sufficiently in the audit of ICFR to provide a basis for serving as the principal auditor of ICFR. See Paragraph C8 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

⁷ AU sec. 543.03-.17.

⁸ See AU sec. 543.03-.06.

⁹ AU sec. 543.10. In connection with this point, both the principal auditor and auditors whose work and reports the principal auditor uses should be cognizant of PCAOB registration requirements. Under section 102(a) of the Sarbanes-Oxley Act of 2002 and PCAOB Rule 2100, *Registration Requirements for Public Accounting Firms*, an auditor whose work and report the principal auditor uses must be registered with the PCAOB if that auditor's work constitutes a substantial role in the preparation or furnishing of the audit report on the issuer's financial statements, as defined in PCAOB Rule 1001(p)(ii), *Definitions of Terms Employed in Rules / Play a Substantial Role in the Preparation or Furnishing of an Audit Report*.

- *Procedures Applicable When Assuming Responsibility* – If the principal auditor assumes responsibility for the work of the other auditor, the principal auditor “must obtain, and review and retain ... prior to the report release date”, certain specific information from the other auditor, and should also consider “[visiting] the other auditor and [discussing] the audit procedures followed and results thereof; [reviewing] the audit programs of the other auditor [and, if appropriate, issuing] instructions to the other auditor as to the scope of the audit work; [and/or reviewing] additional audit documentation of the other auditor relating to significant findings or issues in the engagement completion document.”¹⁰

If the principal auditor assumes responsibility for the work of other auditors, the principal auditor should determine whether the results of the principal auditor’s own work, combined with the results of the work of other auditors, provide sufficient competent evidential matter to afford a reasonable basis for an audit opinion on the issuer’s financial statements.¹¹ In developing an opinion, the principal auditor “should consider relevant evidential matter regardless of whether it appears to corroborate or to contradict the assertions in the financial statements.”¹²

The principal auditor must exercise due professional care in the performance of the audit.¹³ When the principal auditor assumes responsibility for the other auditor’s work, the principal auditor’s review of the audit documentation obtained from the other auditor¹⁴ and performance of other required procedures may identify issues requiring additional consideration by the principal auditor, such as the following issues observed in some audits by the Board’s inspection staff:

- The other auditor did not comply with instructions issued by the principal auditor.
- The other auditor identified an accounting or auditing issue that the other auditor did not resolve.
- The other auditor performed an audit in accordance with auditing standards other than the standards of the PCAOB.
- The other auditor reported on the financial statements of a component that prepares its financial statements in accordance with a financial reporting framework¹⁵ other than the framework used to prepare the financial statements of the issuer as a whole.

To the extent the principal auditor has substantial doubt about any financial statement assertion of material significance, the principal auditor “must refrain from forming an opinion until [the principal auditor] has obtained sufficient competent evidential matter to remove such substantial doubt, or ... must express a qualified opinion or a disclaimer of opinion.”¹⁶ For example, if the

¹⁰ AU sec. 543.12.

¹¹ See paragraph .02 of AU sec. 150, *Generally Accepted Auditing Standards*, and paragraph .08 of AU sec. 230, *Due Professional Care in the Performance of Work*.

¹² Paragraph .25 of AU sec. 326, *Evidential Matter*.

¹³ See AU sec. 230.01.

¹⁴ AU sec. 543.12 describes certain specific information that the principal auditor must obtain from the other auditor.

¹⁵ U.S. generally accepted accounting principles and International Financial Reporting Standards are examples of a financial reporting framework. Auditors should look to the requirements of the SEC for the issuer under audit with respect to the accounting framework applicable to the issuer.

¹⁶ AU sec. 326.25.

principal auditor determines that the work of the other auditor does not provide the necessary audit evidence, the principal auditor should take appropriate actions to obtain sufficient competent evidence, including “[participating] in discussions regarding the accounts with management personnel of the component whose financial statements are being audited by other auditors and/or [making] supplemental tests of such accounts.”¹⁷

Language Considerations

Appropriately satisfying the requirements described above necessarily entails overcoming any language barriers. If the appropriate supervisory personnel of the principal auditor are not sufficiently fluent in the language in which the audit documentation of the other auditor is prepared, the principal auditor must take the necessary actions to enable the principal auditor to fulfill its responsibilities in accordance with PCAOB standards. The principal auditor can neither omit the procedures described in AU sec. 543 because of language differences, nor satisfy those requirements by reference to documents that the principal auditor does not understand.

Engaging Assistants from Outside the Firm

The previous section describes certain requirements in PCAOB standards that apply when a principal auditor uses the work and reports of other auditors who have audited the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the financial statements presented. In other situations, the auditor might engage assistants from outside the firm in performing the audit. The auditor’s responsibilities related to the work of assistants engaged from outside the firm are governed by the same standards as the auditor’s responsibilities related to the work of assistants who are associated with the auditor’s firm as a partner, shareholder, or employee.

The Board’s inspection staff has identified situations in which U.S. firms auditing companies with substantially all of their operations in another country appeared not to have appropriately executed their responsibilities with respect to the work of assistants engaged from outside of the firm. For example, in one situation, a U.S. firm retained the services of a consulting firm that had personnel who could read, write, and speak the language of the area, in the China region, in which the issuer’s operations were located. Those consultants planned the audit, communicated with the issuer’s management, and traveled to the China region to complete a substantial portion of the audit. None of the U.S. firm’s partners or employees traveled to the China region or planned, performed, supervised, or meaningfully reviewed the audit work. Procedures performed by the U.S. firm’s engagement partner consisted primarily of reviewing certain work papers prepared by the consultants as well as issuer-prepared draft financial statements and lead schedules that had been translated into English. The inspection staff concluded that the level of the firm’s involvement in the audit work performed by the consultants was not sufficient for the firm to assert that an audit had been performed by the firm and that the audit provided a reasonable basis for the firm to have an opinion on the financial statements.

As described further in this Alert, some key considerations in determining the appropriate level of the firm’s involvement in audit work performed by assistants engaged from outside the firm (including planning, performing, and supervising the audit work) include, but are not limited to, the following:

¹⁷ AU sec. 543.13.

- Whether the auditor would be able to obtain information about the knowledge, skill, and ability of the assistants engaged from outside the firm (including their knowledge of PCAOB standards and the relevant financial reporting requirements), and to evaluate the independence of the assistants engaged from outside the firm.
- Whether the auditor would be able to properly plan and supervise the work of the assistants engaged from outside the firm and whether the auditing procedures performed by such assistants, in combination with the work performed by individuals from within the firm, would provide sufficient competent evidential matter to afford a reasonable basis for an audit opinion.
- Whether the assistants engaged from outside the firm are located in the same country or speak the same language as the auditor or the auditor's client.
- Whether the auditor would be able to comply with the documentation requirements, including the preparation, assembly, and retention of documentation, with respect to the work performed by the assistants engaged from outside the firm.

Knowledge, Skill, Ability, and Independence

As is the case when a registered public accounting firm deploys its own partners, shareholders, or employees on an audit, when a registered public accounting firm engages assistants from outside of the firm, the firm's engagement partner "is responsible for the assignment of tasks to, and supervision of, [those] assistants."¹⁸ Those assistants, like all assistants, should be "assigned to tasks and supervised commensurate with their level of knowledge, skill, and ability",¹⁹ which necessarily requires the person who assigns and supervises the assistants to have an understanding of the level of knowledge, skill, and ability possessed by those assistants. The knowledge, skill, and ability of personnel assigned significant engagement responsibilities also should be commensurate with the auditor's assessment of the level of risk for the engagement, including the risk of material misstatement due to fraud.²⁰ Ordinarily, higher risk requires the assignment of more experienced personnel or additional persons with specialized skills and knowledge, e.g., information technology or forensic specialists.²¹

As for independence, the registered public accounting firm must approach independence considerations concerning the assistants engaged from outside the firm as if they were employees of the firm.²²

¹⁸ AU sec. 230.06.

¹⁹ *Ibid.* A registered public accounting firm has a responsibility to ensure that all individuals who perform audit procedures for which the firm is responsible, including assistants engaged from outside the firm, comply with the professional standards applicable to the firm's auditing practice (see QC sec. 20.03) and that work is assigned to individuals who have the degree of technical training and proficiency required in the circumstances (see QC sec. 20.13).

²⁰ See paragraph .17 of AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, and paragraph .50 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

²¹ *Ibid.*

²² PCAOB standards require that policies and procedures be established to provide the firm with reasonable assurance that individuals who perform the audit maintain independence (in fact and in appearance) in all required circumstances, perform all professional responsibilities with integrity, and maintain objectivity in discharging professional responsibilities. (See QC sec. 20.09.)

Planning and Supervision

The registered public accounting firm is responsible for planning the audit, and for ensuring that the work of assistants is supervised and reviewed in accordance with PCAOB standards.

As the “auditor with final responsibility for the audit”, as that term is used in paragraph .02 of AU sec. 311, *Planning and Supervision*, the registered public accounting firm’s engagement partner is responsible for audit planning, which involves developing an overall strategy for the expected conduct and scope of the audit.²³ Procedures that an auditor may consider in planning the audit usually involve review of records relating to the company and discussions with assistants, including assistants engaged from outside the firm, and management of the company, the board of directors, or its audit committee.²⁴ “In planning the audit, the auditor should consider the nature, extent, and timing of work to be performed and should prepare a written audit program (or set of written audit programs).”²⁵

“The auditor should obtain a level of knowledge of the [issuer’s] business that will enable [the auditor] to plan and perform [the] audit in accordance with [PCAOB standards].”²⁶ “Knowledge of an [issuer’s] business is ordinarily obtained through experience with the [issuer] or its industry and inquiry of personnel of the [issuer].”²⁷ Prior to, or in conjunction with, gathering information about the issuer’s business, the engagement partner and key members of the audit team, including any engaged from outside the firm, should discuss the potential for material misstatement due to fraud.²⁸ The discussion should include, among other things, “an exchange of ideas or “brainstorming” ... about how and where [the auditor] believe[s] the [issuer’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 [issuer] could be misappropriated.”²⁹

Appropriate supervision and review necessarily entails overcoming any language barriers. The engagement partner is responsible for the supervision of assistants, including any engaged from outside the firm.³⁰ “Elements of supervision include instructing assistants, keeping informed of significant problems encountered, reviewing the work performed, and dealing with differences of opinion ... 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.”³¹ “Ordinarily, higher risk requires ... more extensive supervision by the [engagement partner] during both the planning and the conduct of the engagement.”³² Also, “the extent of supervision should reflect the risks of material misstatement due to fraud.”³³ “The work performed by each assistant should be reviewed to determine whether it was

²³ See AU sec. 311.03, and paragraph 9 of Auditing Standard No. 5.

²⁴ See AU sec. 311.04 (including examples of such procedures).

²⁵ AU sec. 311.05.

²⁶ AU sec. 311.06.

²⁷ AU sec. 311.08.

²⁸ See AU sec. 316.14 and AU sec. 316.17.

²⁹ AU sec. 316.14.

³⁰ See AU sec. 230.06.

³¹ AU sec. 311.11.

³² AU sec. 312.17.

³³ AU sec. 316.50.

adequately performed and to evaluate whether the results are consistent with the conclusions to be presented in the auditor's report."³⁴

Audit Documentation

The registered public accounting firm is responsible for ensuring that all audit documentation – including the documentation of the work of the assistants – necessary to meet the PCAOB's documentation requirements is prepared and retained.³⁵ Auditing Standard No. 3, *Audit Documentation*, "establishes general requirements for documentation the auditor should prepare and retain in connection with engagements conducted pursuant to the standards of the PCAOB."³⁶ Among other things, Auditing Standard No. 3 requires that the auditor "identify all significant findings or issues in an engagement completion document."³⁷ These requirements are applicable in situations in which the auditor engages, as assistants, individuals from outside the firm.

Engagement Quality Review

"[T]he engagement quality reviewer should evaluate the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the engagement and in preparing the [audit] report"³⁸ including "[reviewing] the engagement completion document and [confirming] with the engagement partner that there are no significant unresolved matters."³⁹ "[T]he firm may grant permission to the client to use the [audit] report only after the engagement quality reviewer provides concurring approval of issuance."⁴⁰

Standard-setting Activities

The Board has a project on its standard-setting agenda regarding the responsibilities of the principal auditor. The Board's Standing Advisory Group discussed this topic at its April 7-8, 2010 meeting.⁴¹

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³⁴ AU sec. 311.13.

³⁵ See paragraph 18 of Auditing Standard No. 3, *Audit Documentation*.

³⁶ Paragraph 1 of Auditing Standard No. 3.

³⁷ Paragraph 13 of Auditing Standard No. 3.

³⁸ Paragraph 9 of Auditing Standard No. 7, *Engagement Quality Review*.

³⁹ Paragraph 10.e of Auditing Standard No. 7, *Engagement Quality Review*.

⁴⁰ Paragraph 13 of Auditing Standard No. 7.

⁴¹ See briefing paper available at http://pcaobus.org/News/Events/Documents/04072010_SAGMeeting/Principal_Auditor_Briefing_Paper.pdf.

.07 Staff Audit Practice Alert No. 7 Auditor Considerations of Litigation and Other Contingencies Arising From Mortgage and Other Loan Activities

December 20, 2010

Staff Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of PCAOB standards and relevant laws. Auditors should determine whether and how to respond to these circumstances based on the specific facts presented. The statements contained in Staff Audit Practice Alerts are not rules of the Board and do not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person.

Background

In the fall of 2010, allegations surfaced that banks may have misrepresented the quality of mortgages sold and that those banks could be required to repurchase the affected mortgages.¹ Additional allegations have been made that companies servicing \$6.4 trillion in American mortgages may have bypassed legally required steps to foreclose on homes.² Some of these practices could result in loss contingencies for certain financial institutions that may require recognition of liabilities or disclosure in financial statements.³

The situation remains fluid, with estimates of potential costs associated with foreclosure irregularities and mortgage repurchases ranging from “manageable” to an exposure for the industry of up to \$52 billion.⁴ Some experts have acknowledged scenarios in which the title and legal documentation problems related to foreclosures could lead to significant effects on banks’ balance sheets.⁵

Numerous federal and state agencies are coordinating their efforts to review practices that may not comply with state foreclosure laws or applicable federal laws⁶ and to provide for better disclosures and improve transparency in the securitization market.

As part of the efforts to provide for better disclosures, in October 2010, the United States Securities and Exchange Commission’s (“SEC”) Division of Corporation Finance sent letters to certain public companies as a reminder of their disclosure obligations with respect to their forthcoming quarterly reports on Form 10-Q and subsequent filings. The letters highlighted continued concerns about potential risks and costs associated with mortgage and foreclosure-related activities or exposures. The sample letter posted to the SEC Web site stated that companies should consider certain items for disclosure, including, without limitation, “the impact of various representations and warranties

¹ Congressional Oversight Panel, *November Oversight Report* (November 16, 2010), available at: <http://cop.senate.gov/reports/library/report-111610-cop.cfm>.

² *Ibid.*

³ Loss contingencies may include, among others, accruals for liabilities relating to representations and warranties made at the time loans were sold or for litigation costs.

⁴ *November Oversight Report*, p. 52.

⁵ *Ibid.*

⁶ White House, Office of the Press Secretary, *Fact Sheet: Federal Government Efforts to Support Accountability, Stability and Clarity in the Housing Market*, dated October 20, 2010.

regarding mortgages made to purchasers of the mortgages (or to purchasers of mortgage-backed securities) including to the government-sponsored entities (GSEs), private-label mortgage-backed security (MBS) investors, financial guarantors and other whole loan purchasers.”⁷

The letters further reminded companies of the requirements for disclosures in Management’s Discussion and Analysis for Forms 10-Q and 10-K under Item 303 of Regulation S-K and for accruing and disclosing loss contingencies in the financial statements under the Financial Accounting Standards Board’s (“FASB”) Accounting Standards Codification (“ASC”) Topic 450, Contingencies, Subtopic 450-20. Companies were reminded that, as appropriate, they should consider the need to accrue loss contingencies and to provide clear and transparent disclosure regarding obligations relating to the various representations and warranties that were made in connection with securitization activities and whole loan sales, and to discuss any implications of any foreclosure reviews, including potential delays in completing foreclosures. If applicable, these disclosures would address the company’s role as an originator, securitizer, servicer, and investor.

The letters cautioned companies to consider a number of matters when preparing their quarterly and subsequent filings (e.g., litigation risks and uncertainties related to any known or alleged defects in the securitization process, including any potential defects in mortgage documentation or in the assignment of the mortgages). The letter also cautioned that some of these issues are not limited to financial institutions.

This practice alert advises auditors that the potential risks and costs associated with mortgage and foreclosure-related activities or exposures, such as those discussed in the SEC staff letters, could have implications for audits of financial statements or of internal control over financial reporting. These implications might include accounting for litigation or other loss contingencies and the related disclosures. Auditors should consider the effect of these matters during their reviews of interim financial information, year-end audits, and attestation engagements on assessments of compliance with servicing criteria.

Staff Audit Practice Alert No. 3, *Audit Considerations in the Current Economic Environment* (“Practice Alert No. 3”), was issued in December 2008 to assist auditors in identifying matters related to the current economic environment that might affect audit risk and require additional emphasis.⁸ Among other things, Practice Alert No. 3 provides auditors with information on selected financial reporting areas, including contingencies and guarantees that may be affected by the economic environment, and reminds auditors of the requirements regarding accounting estimates.

Audit risks that existed in December 2008 with respect to contingencies and guarantees, as well as potential other issues, continue to exist today. These audit risks potentially affect the risk of material misstatement, as evidenced by recent concerns regarding problematic foreclosures and asserted claims or potential litigation relating to representations and warranties made in connection with securitizations or whole loan sales. Auditors may need to consider

⁷ Neither companies nor public accounting firms should rely on the summary of the SEC staff letter in this practice alert, but should review the letter in its entirety. The SEC staff sample letter is available at: <http://www.sec.gov/divisions/corpfin/guidance/cfeforeclosure1010.htm>.

⁸ Staff Audit Practice Alert No. 3 is available at: http://pcaobus.org/Standards/QandA/12052008_APA_3.pdf.

the possible effects that these issues might have on the nature, timing, and extent of planned audit procedures.⁹

Matters for the auditor's consideration

In light of continued concerns about potential risks and costs associated with mortgage and foreclosure-related activities or exposures, this practice alert reminds auditors of their responsibilities with respect to auditing loss contingencies, disclosures, and other related topics.

Auditing Litigation, Claims, and Assessments

Companies that may be affected by mortgage and foreclosure-related activities or exposures may need to accrue for or provide disclosures relating to legal contingencies.¹⁰

AU sec. 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, establishes requirements with respect to litigation, claims, and assessments.¹¹ This standard states that in order to identify litigation, claims, and assessments, and to become satisfied with the accounting and reporting of such matters, the auditor should gather sufficient and appropriate audit evidence relevant to the following factors:

- The existence of a condition, situation, or set of circumstances indicating an uncertainty as to the possible loss to an entity arising from litigation, claims, and assessments;
- The period in which the underlying cause for legal action occurred;¹²
- The degree of probability of an unfavorable outcome; and
- The amount or range of potential loss.¹³

AU sec. 337 discusses the procedures the auditor should perform regarding litigation, claims, and assessments¹⁴ and also states that although certain audit procedures may be undertaken for other purposes, they might also disclose litigation, claims, and assessments (e.g., reading minutes of meetings of stockholders, directors, and appropriate committees held during and subsequent to the period being audited; reading contracts, loan agreements, leases, and correspondence from taxing or other governmental agencies; or inspecting similar documents).¹⁵ Further, the auditor should obtain a letter from the

⁹ Paragraph .33 of AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*.

¹⁰ FASB ASC Subtopic 45020 requires companies to establish accruals for litigation and other contingencies when it is probable that a loss has been incurred and the amount of the loss can be reasonably estimated. In an audit of a foreign private issuer ("FPI") whose financial statements are prepared in conformity with International Financial Reporting Standards ("IFRS"), the auditor should refer to applicable accounting and disclosure requirements of the International Accounting Standards Board ("IASB"). PCAOB standards apply regardless of the applicable financial reporting framework.

¹¹ AU sec. 337.01.

¹² According to paragraphs .01 and .04 of AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, when an auditor becomes aware of information that relates to financial statements previously reported on by the auditor, but which was not known to the auditor at the date of the report, and which is of such a nature and from such a source that the auditor would have investigated it had it come to the auditor's attention during the course of the audit, the auditor should take the actions described in AU sec. 561.

¹³ AU sec. 337.04.

¹⁴ AU sec. 337.05.

¹⁵ AU sec. 337.07.

client's lawyer to assist the auditor in corroborating the information furnished by management concerning litigation, claims, and assessments.¹⁶

Auditing Accounting Estimates

Companies involved in mortgage and foreclosure-related activities may need to estimate and accrue amounts for other potential loss contingencies including those related to various representations and warranties. AU sec. 342, *Auditing Accounting Estimates*, establishes requirements regarding obtaining and evaluating sufficient appropriate audit evidence for accounting estimates. In auditing accounting estimates, the auditor normally should consider the company's historical experience in making past estimates as well as the auditor's experience in auditing companies in the same industry.¹⁷ However, changes in facts, circumstances, or a company's procedures may cause factors different from those considered in the past to become significant to the accounting estimate.¹⁸ For example, a company's historical experience relating to repurchasing loans sold into securitization structures may not be indicative of future trends in that area.

According to AU sec. 342, when planning and performing procedures to evaluate the reasonableness of the company's accounting estimates, the auditor should consider, with an attitude of professional skepticism, the subjective and objective factors included in the estimate.¹⁹ When evaluating accounting estimates relating to mortgage loan repurchase losses, such factors may include, among others, estimated levels of defects based on the company's review or experience, default expectations, investor repurchase demand, or appeal success rates.

Evaluating Financial Statement Presentation and Disclosure

Information essential for a fair presentation in conformity with generally accepted accounting principles should be set forth in the financial statements (which include the related notes).²⁰ When such information is set forth elsewhere in a report to shareholders "it should be referred to in the financial statements."²¹ If management omits from the financial statements, including the accompanying notes, information that is required by generally accepted accounting principles, the auditor should express a qualified or adverse opinion and should provide the information in the audit report, if practicable.²²

In addition, the auditor should read the other information accompanying the interim and annual financial statements contained in reports filed with the SEC,²³ including the Management's Discussion and Analysis of Financial Condition and Results of Operations sections of annual reports and other filings.²⁴ The auditor should consider whether that information or the manner of its presentation is materially inconsistent with the financial statements. If

¹⁶ AU sec. 337.08.

¹⁷ AU sec. 342.09.

¹⁸ Ibid.

¹⁹ AU sec. 342.04.

²⁰ Paragraph .41 of AU sec. 508, *Reports on Audited Financial Statements*.

²¹ Ibid.

²² Paragraph .03 of AU sec. 431, *Adequacy of Disclosure in Financial Statements*.

²³ Paragraph .18(f) of AU sec. 722, *Interim Financial Information*, and paragraph .04 of AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*.

²⁴ For example, Item 303(a)(1) of Regulation S-K instructs management to "[i]dentify any known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way."

the auditor concludes that there is a material inconsistency or becomes aware of information that he or she believes is a material misstatement of fact, the auditor should determine if the financial statements, the audit report, or both, require revision. If the auditor concludes that the financial statements or audit report do not require revision, the auditor should request the company to revise the other information.²⁵

FASB ASC Topic 450, Contingencies, Subtopic 450-20 requires that when a loss is not both probable and estimable, an accrual is not recorded, but disclosure of the contingency is required to be made when there is at least a reasonable possibility that a loss or an additional loss has been incurred.²⁶ Companies involved in mortgage and foreclosure-related activities or exposures may need to establish new disclosures or enhance existing disclosures regarding litigation and other contingencies or estimates. For example, companies that sold or securitized loans but may not have complied with representations and warranties may be at risk of being forced to repurchase such loans. These companies may need to disclose or enhance their existing disclosures regarding the nature, timing, and uncertainty of their potential exposures as additional claims arise and are resolved.

Communication with Audit Committees

To the extent potential risks and costs associated with mortgage and foreclosure-related activities or exposures are identified, auditors are reminded of their responsibility to communicate with the audit committee. AU sec. 380, *Communication With Audit Committees*, includes requirements regarding communications relating to management judgments and accounting estimates.²⁷ Other communication with the audit committee includes such matters as the clarity and completeness of the company's financial statements, which include related disclosures²⁸ and a discussion of items that have a significant impact on the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements.²⁹ For example, in appropriate circumstances, this discussion would include the auditor's view on disclosures relating to representations and warranties that were made in connection with securitization activities.

Reviewing Interim Financial Information

The objective of a review of interim financial information is to provide the auditor with a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information for it to conform with generally accepted accounting principles.³⁰ AU sec. 722, *Interim Financial Information*, requires the auditor to make inquiries regarding unusual or complex situations that may have an effect on the interim information.³¹ These situations may include changes in estimated loss contingencies as well as trends and developments affecting accounting estimates.³²

²⁵ AU secs. 550.04–05.

²⁶ In an audit of a FPI whose financial statements are prepared in conformity with IFRS, the auditor should refer to applicable accounting and disclosure requirements of the IASB. PCAOB standards apply regardless of the applicable financial reporting framework.

²⁷ AU sec. 380.08.

²⁸ AU sec. 380.11.

²⁹ Ibid.

³⁰ AU sec. 722.07.

³¹ AU sec. 722.18c.

³² AU sec. 722.55B1.

If information obtained from performing review procedures leads the auditor to believe that the interim financial information may not be in conformity with generally accepted accounting principles in all material respects, the auditor should make additional inquiries or perform other procedures considered appropriate to provide a basis for communicating whether any material modifications should be made to the interim financial information.³³ AU sec. 722 provides additional requirements in cases where the auditor believes that a material modification should be made to the interim financial information.³⁴

Ongoing Audit Considerations

As additional information is determined in future periods regarding the potential risks and costs associated with mortgage and foreclosure-related activities or exposures, auditors planning or performing an audit should acquire a sufficient understanding to assess how the additional information affects the nature and potential magnitude of the associated risks. Auditors should modify the overall audit strategy and the audit plan as necessary if circumstances change significantly during the course of the audit, including changes due to a revised assessment of the risks of material misstatement or the discovery of a previously unidentified risk of material misstatement.³⁵ Accordingly, auditors may need to consider, e.g., how documentation issues in the loan origination process at a bank affect the auditors' initial risk assessment, overall audit strategy and the audit plan.

Risks of material misstatement can arise from a variety of sources, including external factors, including conditions in the company's industry and environment and company-specific factors, such as the nature of the company, its activities, and internal control over financial reporting which can affect the judgments involved in determining accounting estimates or create pressures to manipulate the financial statements to achieve certain financial targets.³⁶

In an integrated audit, many factors can affect the risk associated with a control including the design of the control,³⁷ nature of the control and the frequency with which it operates as well as the competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance.³⁸ Accordingly, an increase in the volume of foreclosures or loan repurchases could affect the risks associated with related controls.

³³ AU sec. 722.22.

³⁴ AU sec. 722.29–722.31.

³⁵ Paragraph 15 of Auditing Standard No. 9, *Audit Planning*. On August 5, the Board adopted Auditing Standards No. 8 through No. 15 related to the auditor's assessment of and response to risk ("the Risk Assessment Standards"), which, if approved by the SEC, would become effective for audits of fiscal periods beginning on or after December 15, 2010. For audits of fiscal periods before the Risk Assessment Standards are effective, auditors should refer to the relevant requirements of AU sec. 311, *Planning and Supervision*, AU sec. 312, AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*, and Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

³⁶ Paragraph 5 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

³⁷ Paragraph .42 of Auditing Standard No. 5.

³⁸ Paragraph .47, Auditing Standard No. 5.

Attestation Reports on Assessments of Compliance With Servicing Criteria

Section 1122 of the SEC's Regulation AB requires an attestation report by a registered public accounting firm on a servicer's assessment of compliance with servicing criteria.³⁹ These criteria include, among other things, maintaining collateral or security on pool assets as required by the transaction agreements or related pool asset documents; and initiating, conducting, and concluding loss mitigation or recovery actions in accordance with the timeframes or other requirements established by the transaction agreements.⁴⁰

In adopting Regulation AB, the SEC provided that AT sec. 601, *Compliance Attestation*, applies to the preparation of these attest reports⁴¹ and generally requires that, in assessing whether the servicer has complied with the criteria, an auditor should consider risk factors similar to those an auditor would consider when planning an audit of financial statements,⁴² as well as factors relevant⁴³ to the compliance engagement.⁴⁴ For example, in assessing risk, the auditor considers whether the servicer or its parent has identified noncompliance as part of an internal investigation, internal audit, or other compliance review.

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³⁹ Item 1122, *Compliance with applicable servicing criteria*, under Regulation AB.

⁴⁰ *Ibid.*

⁴¹ See SEC Release No. 338518, *Asset-Backed Securities* (December 22, 2004), which states in part: "On April 25, 2003, the Commission approved the PCAOB's adoption of the auditing and attestation standards in existence as of April 16, 2003 as interim auditing and attestation standards. The Attestation Standard for Compliance Attestation (AT sec. 601) in those interim auditing and attestation standards should be used in performing this examination engagement."

⁴² AT sec. 601.33.

⁴³ *Ibid.*

⁴⁴ Rules 13a18(c) and 15d18(c) under the Exchange Act require that the attestation report on the assessment of compliance with servicing criteria for assetbacked securities be made in accordance with standards for attestation engagements issued or adopted by the PCAOB.

.08 Staff Audit Practice Alert No. 8 Audit Risks in Certain Emerging Markets

October 3, 2011

Staff Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of the standards and rules of the PCAOB and relevant laws. Auditors should determine whether and how to respond to these circumstances based on the specific facts presented. The statements contained in Staff Audit Practice Alerts do not establish rules of the Board and do not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person.

Executive Summary

Emerging markets play an increasingly important role in the global economy given their high economic growth outlook and significant market size.¹ Recent disclosures of possible improprieties in financial reporting by companies based in certain large emerging markets in Asia and observations from the Board's oversight activities highlight the need for heightened awareness of risks when performing audits of companies with operations in emerging markets.

This practice alert focuses on risks of misstatement due to fraud ("fraud risks") that auditors might encounter in audits of companies with operations in emerging markets, auditors' responsibilities for addressing those risks, and certain other auditor responsibilities under PCAOB auditing standards. Local business practices and cultural norms in emerging markets may differ from those in more developed markets, and auditors should be alert to the effect of these differences on the risks of material misstatement. Auditors should focus on the audit procedures required to respond to those risks.

Fraud risks may be encountered in audits of companies in any region, whether the region is an emerging or developed market. Auditors have a responsibility to assess fraud risks in the financial statements that they audit and to perform audit procedures that respond to those risks, regardless of the regulatory environment.² The specific nature and characteristics of fraud risks, however, can vary depending upon, among other things, the environment in which the company operates, including the maturity and the robustness of the regulatory environments in the countries in which the company conducts its business activities.

Authorities in many emerging market countries are taking steps to improve investor protection. The PCAOB, however, has observed from its oversight activities some conditions in audits of certain companies in emerging markets that indicate heightened fraud risk. Other situations have come to light in recent corporate filings with the Securities and Exchange Commission ("SEC") and in SEC orders suspending trading in securities of certain companies in emerging markets. In just two months in 2011, more than 24 companies with their principal place of business in the People's Republic of China ("PRC") filed

¹ According to information in the Statistical Appendix of International Monetary Fund *World Economic Outlook: Slowing Growth Rising Risks* (September 2011), emerging market countries accounted for over 40 percent of global gross domestic product in 2010.

² See paragraph 4 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement* and paragraphs 3-4 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

Forms 8-K with the SEC reporting auditor resignations, accounting irregularities, or both.³ In some instances, the auditor's letter of resignation stated that the auditor resigned because of circumstances that could constitute illegal acts for purposes of Section 10A of the Securities Exchange Act of 1934 ("Exchange Act").⁴ Since then the SEC's actions have expanded, including instituting stop order proceedings against two PRC-based companies.⁵ Further, additional auditor resignations have occurred.⁶

Examples of conditions and situations indicating heightened fraud risk in certain companies in emerging markets that have been observed by PCAOB staff or reported in an SEC filing include:

- Existence of two separate and different sets of financial books and records;
- Discrepancies between the company's financial books and records and audit evidence obtained with respect to the existence and accuracy of cash balances, accounts receivable, and revenues;
- Auditor difficulties in confirming cash balances, including when requesting to visit the offices of the company's bank, or questions about the authenticity of bank statements provided to the auditor;
- Auditors' follow-up visits to bank offices indicating serious discrepancies between bank confirmations provided to the auditor and the bank's actual records, such as previously undisclosed material borrowings and no record of or significant differences regarding certain transactions;
- Attempts by management to intercept or alter confirmation requests or responses;
- Irregularities in sales contracts, such as a company-specific seal affixed on the sales contract that does not belong to the purported customer named in the contract;
- Recognizing revenue from contracts or customers whose existence could not be corroborated;
- Recording sales of products shipped to warehouses or freight forwarders where no customer is identified;
- Undisclosed material facts surrounding acquisition transactions, sales transactions, and off-balance-sheet transactions with related parties;
- Recording of assets for which evidence of control, ownership, or title is either unclear or difficult to corroborate;
- Potential double counting of fixed assets;
- Recording of uncorroborated operating expenses for which the business purpose is unclear;

³ See letter from SEC Chairman Mary Schapiro, dated April 27, 2011, to the Chairman of the House Subcommittee on TARP, Financial Services, and Bailouts of Public and Private Programs, Congressman Patrick McHenry, at <http://s.wsj.net/public/resources/documents/BARRONS-SEC-050411.pdf>.

⁴ See the discussion in the section on illegal acts below.

⁵ See SEC Press Release, Stop Order Proceedings Instituted Against China Intelligent Lightning and Electronics, Inc., and China Century Dragon Media, Inc. (June 13, 2011) at: <http://www.sec.gov/news/press/2011/2011-127.htm>.

⁶ See, e.g., Longtop Financial Technologies Limited, Form 6-K (May 23, 2011), Exhibit 2 at: <http://www.sec.gov/Archives/edgar/data/1412494/000095012311052882/d82501exv99w2.htm>.

- Manipulation of the accounting records to mischaracterize or conceal payment of bribes or other improper payments;
- Significant unexplained discrepancies between amounts included in the financial statements in SEC filings and amounts included in financial reports to other regulators, such as local authorities;
- Use of personal-type bank accounts held in the name of corporate officers or employees instead of corporate-type bank accounts for company business; and
- Unusual delays by management in the production of routine documents requested by the auditor.⁷

PCAOB standards require auditors to perform their audits to respond to fraud risks and other risks of material misstatement, and to obtain relevant and reliable evidence that is sufficient to support the auditor's opinion.⁸ This practice alert discusses certain considerations that may be relevant when performing audits in emerging markets.

Although the conditions, situations, and fraud risks described in this alert have been observed in audits of companies in certain emerging markets, they might also be present at companies in other markets. The matters discussed in this alert are relevant whenever such conditions, situations, or fraud risks are present in audits of companies located in emerging or developed markets.

Consideration of Fraud is an Integral Part of the Audit

The consideration of fraud is an integral part of the audit under PCAOB standards. PCAOB standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to error or fraud.⁹ The auditor should exercise professional skepticism, and "conduct the audit engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present."¹⁰ PCAOB auditing standards related to the auditor's assessment of and response to risk¹¹ and AU sec. 316, collectively, describe the auditor's responsibilities for identification, assessment, and response to fraud risks.

⁷ In addition to indicating a heightened fraud risk, in some circumstances, the conditions and situations in this list also may be indications of illegal acts which are discussed in the section on illegal acts below.

⁸ See, generally, AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*; Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, Auditing Standard No. 13 and Auditing Standard No. 15, *Audit Evidence*.

⁹ See paragraph 3 of Auditing Standard No. 8, *Audit Risk*.

¹⁰ AU sec. 316.13.

¹¹ Auditing Standard No. 8, Auditing Standard No. 9, *Audit Planning*, Auditing Standard No. 10, *Supervision of the Audit Engagement*, Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*, Auditing Standard No. 12, Auditing Standard No. 13, Auditing Standard No. 14, *Evaluating Audit Results*, and Auditing Standard No. 15.

Identifying and Assessing Fraud Risk Factors¹²

Fraud risks may arise from a variety of sources, including external factors and internal factors. The auditor should perform risk assessment procedures¹³ and evaluate whether the information gathered from those procedures indicates that one or more fraud risk factors are present and should be taken into account in identifying and assessing fraud risks.¹⁴

As part of risk assessment procedures, the auditor “should obtain an understanding of the company and its environment”¹⁵ in order to “understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement.”¹⁶ This includes, for example, understanding:¹⁷

- The relevant industry and regulatory factors, including the legal, and political environment, which may include matters such as:
 - The company’s significance in the regional or local economy and its level of influence over its industry, and regional or local government, and
 - Cultural norms in the business and regulatory environments;
- The company’s objectives, strategies, and related business risks; its organizational structure; and sources of funding of the company’s operations;
- The company’s significant investments, including equity method investments, joint ventures, and variable interest entities (“VIEs”),¹⁸
- The sources of the company’s earnings, including the relative profitability of key products and services; and
- The company’s key supplier and customer relationships.

Significant differences can exist between the business environments faced by companies with operations in emerging markets and those in developed markets, which may affect the risk of misstatement in the financial statements. For example, companies in emerging markets may be subject to rapidly changing or less consistent regulatory oversight and reporting requirements, whereas companies in developed markets may not.¹⁹ These and other aspects of the business environment in emerging markets can create incentives, pressures, and opportunities that may lead to a heightened risk of fraud.

¹² According to paragraph 65 of Auditing Standards 12, “[f]raud risk factors are events or conditions that indicate (1) an incentive or pressure to perpetrate fraud, (2) an opportunity to carry out the fraud, or (3) an attitude or rationalization that justifies the fraudulent action. Fraud risk factors do not necessarily indicate the existence of fraud; however, they often are present in circumstances in which fraud exists.” See, generally, AU sec. 316.85.

¹³ See paragraphs 4-58 of Auditing Standard No. 12, which describe risk assessment procedures the auditor should perform.

¹⁴ See paragraphs 59-73 of Auditing Standard No. 12, which discuss identifying and assessing the risks of material misstatement, due to error or fraud, using information obtained from performing risk assessment procedures.

¹⁵ Paragraph 7 of Auditing Standard No. 12.

¹⁶ *Ibid.*

¹⁷ See paragraphs 9-17 of Auditing Standard No. 12.

¹⁸ See Subtopic 810-10 of the Financial Accounting Standards Board’s Accounting Standards Codification for a definition of a variable interest entity.

¹⁹ See, generally, Silvia Iorgova and Li Lian Ong *The Capital Markets of Emerging Europe: Institutions, Instruments and Investors*, IMF Working Paper WP/08/103 (April 2008), at: www.imf.org/external/pubs/ft/wp/2008/wp08103.pdf.

Incentives and Pressures

As with public companies in developed countries, emerging market companies seeking to raise capital in international markets may wish to present a strong financial position and robust growth in revenue and earnings. In turn, this may create incentives or pressures to manipulate the financial statements rather than report poor results or bad news to the investing public. For example, if a company failed to consummate a previously announced acquisition, there is a risk that management might manipulate the financial statements to make them appear as though the acquisition has occurred. As another example, management at remotely located operating units of large multinational companies locations may feel pressure to report inflated results.

In addition to the incentives and pressures routinely considered in audits of public companies, auditors should consider any unique characteristics of the emerging market company or its environment that might result in specific fraud risks. For example, a company might engage in a significant business partnership with a state-owned entity or VIE. In that situation, the company might be motivated to consolidate the partnership or VIE to strengthen its reported financial position, even if significant legal restrictions prevent the company from obtaining a controlling interest in the partnership or assets. For instance, a company might enter into contractual arrangements with a VIE that are designed to enable the company to consolidate the VIE, even though there might be significant uncertainties regarding the economic substance of those arrangements.²⁰ As another example, legal restrictions on the movement of company assets might lead companies to maintain substantial amounts of cash or other liquid assets in business units in certain jurisdictions, which can create incentives for misappropriation of assets.

Opportunities

Some fraud risks arise when internal or external conditions and weak internal controls provide opportunities for management or employees of the company to engage in fraudulent activities. Certain aspects of the business environment in emerging markets can create opportunities to perpetrate fraud, as discussed in the examples below.

For example, a company in an emerging market might have a dominant presence in the geographic region in which it is located because it is the single largest employer in the region, or it may exercise control over raw materials on which other companies in the region depend. The company's management might have strong ties with the local or state government. In such circumstances:

- Management might be able to dictate terms or conditions to local suppliers or customers, which might result in non-arm's length transactions.
- Management might be able to pressure personnel of a local bank or other third parties to provide fraudulent information to the auditor.
- Company employees might not be willing to report instances of fraud for cultural reasons or fear of retribution from management. While whistleblower protections have been introduced in many emerging

²⁰ Additionally, such VIE structures can result in increased risks related to omitted, incomplete, or inaccurate disclosures. See paragraphs 12-13 of Auditing Standard No. 12.

market countries, observers have said that there is still a need to improve the effectiveness of the whistleblower programs.²¹

Additionally, weak internal controls and lack of robust governance mechanisms have been observed in companies in certain emerging market countries. This may stem from a lack of familiarity in local cultures with certain governance concepts, such as prohibition of self-dealing, even where similar legal concepts exist.²² For example, such a culture might provide opportunities for management to influence other senior company officials or various third parties to provide false or misleading information to the company's auditors.

If criticizing or questioning a figure of authority is contrary to the local culture, the company's employees may be hesitant to express any concerns about management's actions to an auditor. Such an environment can provide additional opportunities for management to override controls or intentionally misstate the financial statements.²³

As another example, a company in an emerging market might be created as a spin-off from a larger private or state-owned entity. The operating components of the larger entity may be among the company's largest suppliers or customers. In certain instances, the same individual or group that controls the company might also control the company's suppliers and customers.²⁴ Such situations might provide opportunities for management to:

- Enter into undisclosed side agreements with the related parties, or
- Collude with the related parties to create false documentation to support fictitious transactions.

Some emerging market companies employ as their chief financial officer ("CFO") an individual based in, or from, another region or country. Such a CFO might lack knowledge of the local language and the company's business practices and, therefore, might not be able to effectively perform certain important entity-level controls, thereby creating opportunities for company personnel to commit or conceal fraudulent misstatement of the financial statements. Similar conditions and risks may be present at significant subsidiaries of multi-national companies in emerging markets.

In some emerging market countries, controlling shareholders exercise strong oversight over executive management and foster a corporate culture focused on long-term value creation. In other jurisdictions, controlling shareholders have the opportunity to engage in abusive conduct, a problem that is magnified in jurisdictions where transparency is poor and where a weak rule of law fails to give minority investors proper judicial recourse.²⁵

²¹ See Organization for Economic Cooperation and Development (OECD) *Corporate Governance in Asia 2011: Progress and Challenges*, Corporate Governance, OECD Publishing (2011), pg 36, at: <http://dx.doi.org/10.1787/9789264096790-en>.

²² *Ibid*, pg 25.

²³ See AU sec. 316.08.

²⁴ See OECD *Guide on Fighting Abusive Related Party Transactions in Asia*, OECD Publishing (2009), pgs 9-12 and 14-16, at: www.oecd.org/dataoecd/39/57/43626507.pdf.

²⁵ See Melsa Ararat and George Dallas (International Finance Corporation), *Corporate Governance in Emerging Markets: Why it Matters to Investors – and What They Can Do About It*, Global Corporate Governance Forum (2011), pg 11, at: http://www.ifc.org/ifcext/cgf.nsf/Content/PSO_22_Melsa.

The Auditor's Response to Fraud Risks

PCAOB standards require that the auditor design and implement audit responses that address the identified and assessed fraud risks.²⁶ The auditor's responses should include responses that have an overall effect on how the audit is conducted (e.g., making appropriate engagement assignments) and responses involving the nature, timing, and extent of audit procedures (e.g., modifying the planned audit procedures).²⁷

Under PCAOB standards, “[t]he auditor’s responses to the assessed risks of material misstatement, particularly fraud risks, should involve the application of professional skepticism in gathering and evaluating audit evidence.”²⁸ Ineffective responses to fraud risks may result in the auditor’s failure to detect material misstatement of the financial statements or failure to obtain sufficient appropriate audit evidence to support the opinion in the auditor’s report. Examples of the application of professional skepticism in response to the assessed fraud risks may include “modifying the planned audit procedures to obtain more reliable evidence regarding relevant assertions and ... obtaining sufficient appropriate evidence to corroborate management’s explanations or representations.”²⁹

Performing Audit Procedures to Respond to Fraud Risks

The auditor should perform substantive procedures, including tests of details, that are specifically responsive to the assessed fraud risks, including certain procedures to address the risk of management override of controls.³⁰

Many of the conditions discussed above that indicate heightened fraud risk appear to involve possible attempts to overstate the amounts of assets or revenues in the companies’ financial statements. When performing audit procedures to address certain fraud risks, especially those involving the existence of assets such as cash and accounts receivable, it is important to obtain audit evidence through direct written communication with a knowledgeable third party who is objective and free from bias with respect to the audited entity.³¹

If, through the performance of risk assessment procedures, other audit procedures, or by other means, the auditor becomes aware of conditions that call for a heightened degree of professional skepticism with respect to the authenticity of documents, the auditor should perform additional procedures to determine that the reliability of evidence obtained in the course of the audit has not been compromised.³² In such circumstances, it would be unlikely for auditors to rely solely on management-provided documentation without obtaining documentation directly from third parties to corroborate management’s assertions.

²⁶ See paragraph 3 of Auditing Standard No. 13.

²⁷ See Auditing Standard No. 13, which establishes requirements regarding designing and implementing appropriate responses to the risks of material misstatement.

²⁸ Paragraph 7 of Auditing Standard No. 13.

²⁹ Ibid.

³⁰ See paragraphs 13 and 15 of Auditing Standard No. 13. Additionally, as part of the auditor’s response to the assessed risks of material misstatement due to fraud, the auditor should incorporate an element of unpredictability in the selection of auditing procedures to be performed. See paragraph 5c of Auditing Standard No. 13. Also, see paragraphs 14-15 of Auditing Standard No. 5.

³¹ See paragraphs .26-.27 of AU sec. 330, *The Confirmation Process* and the section on confirmations below.

³² See paragraph 9 of Auditing Standard No. 15.

Confirmations

To respond to fraud risks related to the company's accounts with a bank or amounts due from customers, it is important for the auditor to confirm amounts included in the company's financial statements directly with a knowledgeable individual from the bank or customer who is objective and free from bias with respect to the audited entity rather than rely solely on information provided by the company's management.³³ Under PCAOB standards, "[e]vidence obtained from a knowledgeable source that is independent of the company is more reliable than evidence obtained only from internal company sources."³⁴

Further, under PCAOB standards, the auditor "should maintain control over the confirmation requests and responses."³⁵ If the auditor identifies a risk that the company's management, or someone else at management's request, could attempt to intercept or alter the confirmation requests or responses, the auditor should maintain control over the confirmation process by taking actions aimed specifically at addressing that risk. For example, if the auditor uses a courier to expedite the delivery of confirmation requests, the courier should be reliable and independent from management to ensure that the confirmation requests are delivered directly to the intended recipient. If there is a heightened risk of management interference in the confirmation process, it might be necessary for the auditor to deliver the confirmation request personally and/or to observe the intended recipient of the confirmation request complete the response in order to communicate directly with an independent and knowledgeable source.

Also, the auditor should evaluate who the intended recipient of the confirmation request is and whether the company's management has any influence over this individual to provide false or misleading information to the auditor.³⁶ For example, if the company is the only or a significant customer or supplier of the confirming entity, the staff of that entity may be more susceptible to pressure from the company's management to falsify documentation provided to the auditor. As another example, the auditor might determine that confirmation responses cannot be relied upon if it appears that management interfered with the process because responses to confirmation requests were received from a personal e-mail account rather than a company network domain, or multiple confirmations are returned with similar handwriting and the same date, or confirmations returned from companies with different physical addresses contain mail stamps indicating same time processing.

If there is a heightened risk that the intended recipient is susceptible to management influence, the auditor should consider whether the response will provide meaningful and appropriate evidence and determine whether other procedures are necessary to obtain sufficient appropriate audit evidence.³⁷

³³ See AU sec. 330.34, which states that there is a presumption that the auditor will request the confirmation of accounts receivable during an audit except under certain conditions that are unlikely to be present when fraud risks are present. For example, one of those conditions, the auditor's combined assessed level of inherent and control risk is low, is unlikely to be the case when a fraud risk is present.

³⁴ Paragraph 8 of Auditing Standard No. 15. Also, AU secs. 330.26-27 describe the auditor's responsibilities regarding confirmation with knowledgeable third parties who are objective and free from bias with respect to the audited entity.

³⁵ AU sec. 330.28.

³⁶ See AU sec. 330.26-27.

³⁷ See paragraph 4 of Auditing Standard No. 15 and AU sec. 330.27.

Revenue Recognition

Under PCAOB standards, “[t]he auditor should presume that there is a fraud risk involving improper revenue recognition and evaluate which types of revenue, revenue transactions, or assertions may give rise to such risks.”³⁸ Management might use a variety of tools to attempt to overstate revenue or conceal improprieties in recording revenue, including entering into improper bill-and-hold transactions, generating invoices and customer contracts for non-existent transactions, altering original documentation, and establishing fake customers and mailing addresses.

To develop an effective response to such fraud risks, it is important for the auditor to obtain an understanding of the company and its environment, including the sources and composition of revenues; specific attributes of revenue transactions; the company’s business and financial reporting processes regarding revenue and amounts due from customers; and unique industry considerations. Such an understanding is important in order for the auditor to consider the ways in which revenue could be fraudulently misstated in order to design appropriate audit procedures to detect those types of misstatements. Also, PCAOB standards require the auditor to gain an understanding of the business rationale for significant unusual transactions and whether that rationale (or the lack thereof) suggests that the transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.³⁹

Exercising professional skepticism requires the auditor to, among other things, perform procedures to obtain and critically evaluate evidence from all sources rather than rely solely on management representations about the company’s performance.⁴⁰ For example, if the auditor performs an analytical procedure regarding revenue and management represents that a significant unexpected increase in revenue from the prior year results from increased production, the auditor should obtain evidence to corroborate this representation and critically evaluate whether the representation is reasonable based on the evidence obtained, such as, whether the company is capable of producing the additional output.⁴¹

While the auditor is not expected to be an expert in document authentication, the auditor should exercise professional skepticism in reviewing documentation obtained as audit evidence, especially documentation provided by the company. Under PCAOB standards, “if conditions indicate that a document may not be authentic or that the terms in a document have been modified but that the modifications have not been disclosed to the auditor, the auditor should modify the planned audit procedures or perform additional audit procedures to respond to those conditions and should evaluate the effect, if any, on the other aspects of the audit.”⁴² For example, if the auditor suspects that management has falsified sales documentation, the auditor should perform additional procedures, such as performing procedures to obtain documentation directly from the company’s customers or suppliers to compare it to documents provided by management.

³⁸ Paragraph 68 of Auditing Standard No. 12.

³⁹ See AU sec. 316.66.

⁴⁰ See paragraph 7 of Auditing Standard No. 13 and AU sec. 333.02-.04.

⁴¹ See paragraphs 5-9 of Auditing Standard No. 14. When the auditor is performing an analytical procedure as a substantive test, see the requirements of AU sec. 329, *Substantive Analytical Procedures*.

⁴² Paragraph 9 of Auditing Standard No. 15.

Transactions with Related Parties

It is not uncommon for companies in emerging markets to be owned or controlled by a small group of individuals or a family. These individuals often serve as the senior members of the company's management and also may control some of the entities that the company does business with, such as customers or suppliers. Accordingly, transactions with related parties may play a significant role in the company's operations. The auditor, therefore, should be aware of a risk of undisclosed related party transactions or side agreements.

To obtain sufficient appropriate audit evidence with respect to related party transactions, an auditor should design and perform procedures that take into account the specific environment in which a company operates.⁴³ In addition, pursuant to section 10A(a)(2) of the Exchange Act, auditors are required to include "procedures designed to identify related party transactions that are material to the financial statements or otherwise require disclosure therein."⁴⁴

Some companies in emerging markets might have significant transactions with related entities that are not audited or are audited by another firm. For example, a company might purchase substantially all of its raw materials and utility services from or extend significant loans to a related unaudited entity. Paragraph A.2 of AU sec. 316.85 states in the Opportunities subsection that "significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm" constitute an example of a fraud risk factor that provides opportunities to engage in fraudulent financial reporting. Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions*, issued on April 7, 2010, describes certain requirements in PCAOB auditing standards regarding significant unusual transactions.⁴⁵

Other Matters that Affect Fraud Risk

Under PCAOB standards, "the auditor should evaluate whether the accumulated results of auditing procedures and other observations affect the assessment of the fraud risks made throughout the audit and whether the audit procedures need to be modified to respond to those risks."⁴⁶ Matters indicating a heightened risk of fraud may include, for example:⁴⁷

- *Inconsistent, vague, or implausible responses from management* – In situations in which management fraudulently recorded non-existent sales transactions, management's explanation of an unexpected increase in revenue may be vague or inconsistent with the auditor's understanding of the company's operations.
- *Conflicting or missing evidence* – Documents provided by management may appear to have been altered or have internal inconsistencies. The auditor should critically assess such inconsistencies and discrepancies to identify whether they are indicative of fraudulent activities by the company's management or employees. For example:

⁴³ See AU sec. 334, *Related Parties*, which describes procedures for the auditor to perform "to identify related party relationships and transactions and to satisfy himself concerning the required financial statement accounting and disclosure."

⁴⁴ See 15 U.S.C. §78j-1(a).

⁴⁵ Staff Audit Practice Alert No. 5 is located on the Board's web site at: http://pcaobus.org/Standards/QandA/04-07-2010_APA_5.pdf.

⁴⁶ Paragraph 28 of Auditing Standard No. 14.

⁴⁷ See Appendix C of Auditing Standard No. 14.

- The name of a third party on the letterhead of a confirmation response may be different from the name on a seal used to authenticate a signed document.
- Amounts confirmed by the local branch of a bank may be different from those confirmed by the bank headquarters.
- There may be conflicting or missing documentary support for the company's rights to assets.
- *Problematic relationships between the auditor and management* – To conceal fraudulent financial reporting, management might attempt to control the audit process by limiting the auditor's access to sources of audit evidence, such as the company's personnel or third parties. For example:
 - Management could request that the auditor send confirmation requests and receive replies through personnel of the company.
 - Management could instruct the bank not to respond to the auditor's request to confirm the company's cash, deposit, or loan payable balances with the bank.
 - Management engaged in fraudulent financial reporting might be unwilling to add or revise disclosures in the financial statements to make them more transparent.
 - Management engaged in fraudulent financial reporting might be unwilling to appropriately address significant deficiencies in internal control on a timely basis, e.g., before the end of a financial reporting period.

Under PCAOB standards, restrictions on the scope of the audit imposed by the company's management or by circumstances, such as – among other things – the inability to obtain sufficient appropriate evidence or an inadequacy in the accounting records, may require the auditor to qualify his or her opinion or to disclaim an opinion on the company's financial statements.⁴⁸

Other Considerations

Client Acceptance and Continuance

Under PCAOB standards, client acceptance and continuance is a required element of quality control for an auditor.⁴⁹ This includes establishing policies and procedures to provide reasonable assurance that the auditor:

- “Undertakes only those engagements that the firm can reasonably expect to be completed with professional competence.
- Appropriately considers the risks associated with providing professional services in the particular circumstances.”⁵⁰

Conditions and situations previously described in this alert that indicate heightened fraud risk in companies with operations in emerging markets may also place additional demands on the auditor's professional competence. In performing acceptance and continuance assessments for clients with operations

⁴⁸ See paragraph .22 of AU sec. 508, *Reports on Audited Financial Statements*. Also, Auditing Standard No. 5 provides direction regarding modifications to the auditor's report due to restrictions on the scope of the audit of internal control over financial reporting.

⁴⁹ See paragraph .07 of QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*.

⁵⁰ QC sec. 20.15.

in emerging markets, the auditor should consider his or her own ability to perform audits in emerging markets and, if using the work of accountants outside the auditor's own firm, the auditor's ability to supervise or assume responsibility for that work in accordance with PCAOB standards.

The PCAOB previously directed auditors' attention to the standards that apply to using the work of other auditors and engaging assistants from outside the firm – including auditors and assistants based outside the U.S. – in Staff Audit Practice Alert No. 6, *Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants from Outside the Firm* (“Practice Alert No. 6”), issued on July 12, 2010.⁵¹ Practice Alert No. 6 noted, among other things, that the following factors may affect how an auditor plans and performs an audit of the financial statements of an issuer with substantially all of its operations outside of the U.S., including emerging market countries:

- Use of local audit firms or assistants from an outside firm to complete a portion of the audit work;
- The need to understand the local language;
- Additional travel time and expense necessary to complete an audit; and
- The need to understand the local business environment in which the client operates.

Making Engagement Assignments and Coordinating the Auditor's Response with Another Accounting Firm

PCAOB standards require that the knowledge, skill, and ability of engagement team members with significant engagement responsibilities, and the extent of supervision of engagement team members, be commensurate with the risks of material misstatement, including fraud risks.⁵² The higher risk areas of the audit, including the areas of fraud risk, require more supervisory attention from the engagement partner. When the auditor uses the work of accountants outside the auditor's own firm, the auditor should take into account the knowledge, skill, and ability of each engagement team member from outside the firm.⁵³ Through the Board's oversight activities, the Board's staff has observed instances in certain audits of emerging market companies in which the engagement partner or other engagement team members inappropriately delegated to junior assistants the identification of audit issues, analysis of documents provided by the company, and certain communication with management and third parties; additionally, supervision by the auditor of the junior personnel was not in compliance with PCAOB standards.

In some situations, another independent accounting firm (including accounting firms affiliated with the same network as the auditor) performs an audit of and issues a report on one or more of the company's subsidiaries, divisions, branches, components, or investments. The auditor should inquire about the professional reputation of the other auditor and adopt other appropriate measures, e.g., ascertaining that the other auditor is familiar with the relevant

⁵¹ Practice Alert No. 6 is located on the Board's web site at: http://pcaobus.org/Standards/Qanda/2010-07-12_APA_6.pdf

⁵² See paragraph 6 of Auditing Standard No. 10 and paragraph 5 of Auditing Standard No. 13. If the auditor uses as assistants personnel of another accounting firm or individual accountants not employed by an accounting firm, the auditor should follow the same requirements as for supervising assistants from the auditor's own firm.

⁵³ See paragraph 6 of Auditing Standard No. 10.

financial reporting requirements and PCAOB standards.⁵⁴ PCAOB inspection reports, when available, may provide the auditor with relevant information.⁵⁵ The auditor should adopt appropriate measures to assure the coordination of the auditor's activities with those of the other auditor, including the audit procedures performed in response to fraud risks.⁵⁶ Through the Board's oversight activities, the Board's staff has observed instances in certain audits of companies in emerging markets in which the auditor did not properly coordinate the audit with another auditor. When significant parts of the audit are performed by other auditors, the auditor must decide whether the auditor's own participation in the audit is sufficient.⁵⁷

Making appropriate engagement assignments and coordinating the auditor's response with another auditor necessarily entails overcoming any language barriers. In some audits of companies in emerging markets, key engagement team members⁵⁸ might be from outside the country in which substantially all of the company's operations, its top management, or the other auditor is located. In those circumstances, the auditor should take the necessary steps to enable effective communication among the engagement team members, effective communication between the auditor and the company's personnel or the other auditor, and effective review of documentation prepared in a foreign language.⁵⁹

Individual accountants or accounting firms that participate in the audit from the same region where the company is located (the "local accountants") may be aware of local customs, cultural norms, and business practices that have an impact on the company's corporate governance and business activities. When planning and performing the audit, the auditor should discuss such matters with the local accountants and determine whether any of these matters affect fraud risks. The auditor should discuss with the local accountants identified fraud risks and determine that appropriate steps are taken to respond to these risks.⁶⁰

Illegal Acts

During the course of an audit, the auditor may determine that violations of laws or government regulations by company management or employees may constitute illegal acts, as defined by AU sec. 317, *Illegal Acts by Clients*,⁶¹ and

⁵⁴ See paragraph .10 of AU sec. 543, *Part of Audit Performed by Other Independent Auditors*.

⁵⁵ According to PCAOB Rule 2100, each public accounting firm that (a) prepares or issues any audit report with respect to any issuer; or (b) plays a substantial role in the preparation or furnishing of an audit report with respect to any issuer must be registered with the Board. The Board publishes on its Web site a list that names every registered firm that has triggered an inspection requirement under PCAOB Rule 4003 and notes whether the firm has ever been inspected. See <http://pcaobus.org/Inspections/Pages/InspectedFirms.aspx>. In addition, the Board has published on its Web site a listing of issuer audit clients of non-U.S. registered firms in jurisdictions where the PCAOB had been denied access to conduct inspections. See <http://pcaobus.org/International/Inspections/Pages/IssuerClientsWithoutAccess.aspx>.

⁵⁶ See AU sec. 543.10, and AU sec. 316.53.

⁵⁷ See AU sec. 543.02.

⁵⁸ The term "key engagement team members" includes all engagement team members who have significant engagement responsibilities, including the engagement partner. See paragraph 50 of Auditing Standard No. 12.

⁵⁹ See paragraph 5 of Auditing Standard No. 10 and AU sec. 543.10.

⁶⁰ See paragraph 5 of Auditing Standard No. 10, paragraphs 51-52 of Auditing Standard No. 12, and AU sec. 316.53.

⁶¹ See AU sec. 317.02. For example, even though not fraud, a violation of the books and records provisions of the Foreign Corrupt Practices Act ("FCPA"), Exchange Act sections 13(b)(2) through (b)(7), would be an illegal act as defined in AU sec. 317. These FCPA provisions generally require issuers with securities registered under section 12 of the Exchange Act or required to file reports under section 15(d) of the Exchange Act, among other things, to make

section 10A of the Exchange Act.⁶² AU sec. 317 describes the considerations an auditor should give to the possibility of illegal acts as well as the auditor's responsibilities when a possible illegal act is detected. In addition, pursuant to section 10A(a)(1) of the Exchange Act, auditors are required to perform procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of the financial statement amounts.⁶³ The auditor's responsibility to detect and report misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for misstatements caused by error or fraud.⁶⁴

When the auditor becomes aware of information concerning a possible illegal act, the auditor should obtain an understanding of the nature of the act, the circumstances in which it occurred, and sufficient other information to evaluate the effect on the financial statements, as well as the implications for other aspects of the audit, such as the reliability of representations of management.⁶⁵ The implications of particular illegal acts will depend on the relationship of the perpetration and concealment, if any, of the illegal act to specific control procedures, and the level of management or employees involved.⁶⁶ The auditor should also evaluate the adequacy of disclosure in the financial statements of the potential effects of an illegal act on the entity's operations.⁶⁷ If the illegal act results in uncorrected misstatements of even relatively small amounts, it further 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.⁶⁸ If the auditor concludes that an illegal act has or is likely to have occurred, AU sec. 317 requires that the auditor, among other things, determine "that the audit committee, or others with equivalent authority and responsibility, is adequately informed with respect to [the] illegal acts."⁶⁹

Section 10A(b) of the Exchange Act imposes additional requirements that apply when the auditor "detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements) has or may have occurred."⁷⁰

Subsequent Discovery of Facts Existing at the Date of the Auditor's Report

AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, describes procedures that "should be followed by the auditor who, subsequent to the date of the [audit report], becomes aware that facts may have existed at that date which might have affected the report had he or she then

(footnote continued)

and keep books and records that fairly reflect the transactions and assets of the issuer and to devise and maintain internal accounting controls sufficient to permit the preparation of financial statements in conformity with the applicable financial reporting framework.

⁶² See 15 U.S.C. §78j-1(a).

⁶³ *Ibid.*

⁶⁴ See AU 317.05.

⁶⁵ See AU sec. 317.10 and .16. See also section 13(b)(2) of the Exchange Act.

⁶⁶ See AU sec. 317.16.

⁶⁷ See AU sec. 317.15.

⁶⁸ Paragraph 17 of Auditing Standard No. 14.

⁶⁹ AU sec. 317.17.

⁷⁰ See 15 U.S.C. §78j-1(b).

been aware of such facts.”⁷¹ The auditor should follow the requirements of AU sec. 561 if, subsequent to the date of the audit report, the auditor becomes aware of information indicating the possibility of fraudulent financial reporting.

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⁷¹ AU sec. 561.01.

.09 Staff Audit Practice Alert No. 9 Assessing and Responding to Risk in the Current Economic Environment

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Staff Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of the standards and rules of the PCAOB and relevant laws. Auditors should determine whether and how to respond to these circumstances based on the specific facts presented. The statements contained in Staff Audit Practice Alerts do not establish rules of the Board and do not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person.

Background

In December 2008, Staff Audit Practice Alert No. 3, *Audit Considerations in the Current Economic Environment* ("Practice Alert No. 3"),¹ was issued to assist auditors in identifying matters related to the then-current economic environment that might affect the risk of material misstatement of issuers' financial statements and the related auditor's responsibilities under Public Company Accounting Oversight Board ("PCAOB" or "the Board") standards.

Since the issuance of Practice Alert No. 3, economic conditions have been slower to recover than many had originally anticipated.² Uncertainty continues regarding global economic conditions, and certain volatility indicators are higher than they were before the financial crisis. In September 2011, the International Monetary Fund ("IMF") reduced its estimate of 2012 global growth from 4.5%, which was provided in June 2011, to 4% and, at the same time, reduced its 2012 growth forecast for U.S. growth from 2.7% to 1.8%.³

In November 2011, the Federal Reserve Board also reduced its projections for short- and longer-term GDP while increasing its estimated unemployment rate.⁴ While countries work toward addressing their economic challenges, market volatility continues, and economic conditions may vary significantly among different regions or sectors of the economy.

Difficult economic conditions may affect companies' operations and financial reporting and, in turn, may have implications for audits of financial statements and internal control over financial reporting. Matters discussed in Practice Alert No. 3, such as auditing fair value measurements, auditing accounting estimates, the auditor's consideration of a company's ability to continue as a going concern, and auditing financial statement disclosures, continue to be critical in the current economic environment.

¹ See Staff Audit Practice Alert No. 3 on the Board's web site at: http://pcaobus.org/Standards/QandA/12-5-2008_APA_3.pdf.

² For example, in August 2011, the Congressional Budget Office reported that "[a]lthough economic output began to expand again two years ago, the pace of the recovery has been slow, and the economy remains in a severe slump." Congress of the United States Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2011).

³ On September 15, 2011, Christine Lagarde, Managing Director of the IMF, said "[o]verall, global growth is continuing, but slowing down. The advanced countries in particular are facing an anemic and bumpy recovery, with unacceptably high unemployment." The full text of Ms. Lagarde's speech is available at: <http://www.imf.org/external/np/speeches/2011/091511.htm>.

⁴ See Federal Reserve Board *Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents, November 2011*, available at: <http://www.federalreserve.gov/newsevents/press/monetary/20111102b.htm>.

Although many of the risks discussed in Practice Alert No. 3 continue to have relevance, a number of the auditing standards referenced in that alert regarding the auditor's assessment of and response to risk were superseded in 2010 when the Board adopted a suite of eight new auditing standards ("risk assessment standards").⁵ The risk assessment standards, which enhance the effectiveness of the auditor's assessment of and response to risk of material misstatement in an audit, became effective for audits of fiscal years beginning on or after December 15, 2010. As compared to the Board's interim standards, the risk assessment standards, among other things, establish enhanced requirements pertaining to the performance of risk assessment procedures, provide additional factors relevant to identifying significant risks, and enhance requirements for auditing financial statement disclosures. Auditors should be alert to the new requirements contained in the risk assessment standards and how those requirements relate to audits performed in the current economic climate.

The purpose of this staff audit practice alert is to assist auditors in identifying matters related to the current economic environment that might affect the risk of material misstatement and, therefore, require additional audit attention. The practice alert discusses certain issues posed by the current economic environment, highlights certain requirements in the risk assessment standards, and is organized into four sections:

- Considering the impact of economic conditions on the audit;
- Auditing fair value measurements and estimates;
- The auditor's consideration of a company's ability to continue as a going concern; and
- Auditing financial statement disclosures.

While the alert highlights certain issues, it is not intended to identify all issues that might affect audit risk in the current economic environment or serve as a substitute for the relevant auditing standards. All audits of issuers must be conducted in accordance with the standards of the PCAOB.

Considering the Impact of Economic Conditions on the Audit

As year-end approaches for many issuers, changing economic conditions might require the auditor to reassess the appropriateness of the planned audit strategy, materiality levels, risk assessments (including identified fraud risks and other significant risks), and planned audit responses. Such a reassessment is especially important if the auditor planned the audit and performed the initial risk assessment procedures early in the year or performed initial testing as of or through an interim date.

Audit Planning and Materiality Considerations

Audit planning is not a discrete phase of an audit but, rather, a continual and iterative process.⁶ The nature and extent of planning activities that are necessary depend on, among other things, changes in circumstances that occur

⁵ Auditing Standards Nos. 8-15 were adopted by the Board on August 5, 2010. See PCAOB Release No. 2010-004, *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards* available at: http://pcaobus.org/Rules/Rulemaking/Docket%20026/Release_2010-004_Risk_Assessment.pdf.

⁶ See paragraph 5 of Auditing Standard No. 9, *Audit Planning*.

during the audit.⁷ Accordingly, the auditor should modify the overall audit strategy and the audit plan as necessary if circumstances change significantly during the course of the audit.⁸ For example, in an audit of the financial statements of a company with operations in multiple locations, changes in regional economic conditions might alter the risks associated with certain locations, which in turn, could affect the selection of locations for testing or determination of extent of testing at selected locations.⁹

The current economic environment may also require the auditor to re-evaluate the established materiality level or levels and tolerable misstatement (e.g., if the auditor initially established the materiality level or levels and tolerable misstatement based on estimated or preliminary financial statement amounts that differ significantly from actual amounts).¹⁰ The auditor should evaluate whether, in light of the particular circumstances, there are certain accounts or disclosures for which there is a substantial likelihood that misstatements of lesser amounts than the materiality level established for the financial statements as a whole would influence the judgment of a reasonable investor.¹¹ If so, the auditor should establish separate materiality levels for those accounts or disclosures to plan the nature, timing, and extent of audit procedures.¹² For example, this might be appropriate if certain financial statement line items are particularly important to a regulatory requirement or a debt covenant.

Risk Assessment

The effectiveness of a risk-based audit approach is dependent on the ability of the auditor to identify the risks of material misstatement and to have an appropriate basis for assessing those risks. Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, establishes requirements regarding the process of identifying and assessing risks of material misstatement of the financial statements, including the auditor's responsibilities for performing risk assessment procedures.

Examples of risk assessment procedures that may provide particularly relevant information in identifying and assessing the risks of material misstatement in the current economic environment include, among other things:

- Reading public information about the impact of the current economic environment on the company, including, for example, analyst reports and company-issued press releases.¹³
- Obtaining an understanding of the company's performance measures (including, for example, performance measures that form the basis for contractual commitments or incentive compensation arrangements or measures used by external parties, such as analysts and rating agencies, to review the company's performance).¹⁴ When slowdowns in a company's market or industry reduce the likelihood that a company will meet its consensus earnings estimate, there could be additional

⁷ See paragraph 7 of Auditing Standard No. 9.

⁸ See paragraph 15 of Auditing Standard No. 9.

⁹ See paragraphs 11–14 of Auditing Standard No. 9.

¹⁰ See paragraph 11 of Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*.

¹¹ Paragraph 7 of Auditing Standard No. 11.

¹² *Ibid.*

¹³ See paragraph 11 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

¹⁴ See paragraphs 16–17 of Auditing Standard No. 12.

pressure on management to manipulate the financial statements to achieve this estimate.¹⁵

- Obtaining an understanding of a company's current and prospective financing requirements. In the current economic environment, companies may not be able to regularly access funds through short-term borrowings, may have other liquidity issues, such as significant collateral calls or a lack of acceptable collateral, may be at risk of violating debt covenants, or may have significant tranches of debt becoming due within one year. In such cases, companies may be unable to settle their obligations as they become due. In turn, this situation could affect the risks of material misstatement related to, for example, the classification of long-term liabilities or valuation of long-term assets, or it could result in substantial doubt about the company's ability to continue as a going concern.¹⁶
- Performing analytical procedures designed to enhance the auditor's understanding of the client's business and the significant transactions and events that have occurred since the prior year-end and identify areas that might represent specific risks relevant to the audit.¹⁷ When performing an analytical procedure, the auditor should use his or her understanding of the company to develop expectations about plausible relationships among the data to be analyzed.¹⁸

The risk assessment standards include requirements for the auditor to incorporate knowledge obtained during past audits and interim reviews into the auditor's process for identifying risks of material misstatement; however, in a changing economic environment, the auditor should evaluate whether the prior years' information remains relevant and reliable.¹⁹ For example, when performing an analytical procedure in the current economic environment, prior period financial information may not be an appropriate data point in developing an expectation.

The risk assessment standards also require the auditor's assessment of the risks of material misstatement to continue throughout the audit.²⁰ For example, significant changes in industry or market conditions near year-end, such as a sovereign debt rating downgrade in a market in which a company has a concentration of customers, might provide audit evidence that contradicts the evidence on which the auditor originally based his or her risk assessments regarding the valuation of assets. In such cases, the auditor should revise the risk assessments and modify planned audit procedures or perform additional procedures in response to the revised risk assessments.²¹

Communication among the engagement team members about significant matters affecting the risks of material misstatement should continue throughout the audit, including when conditions change.²² For instance, the results of the "brainstorming" discussion among the key engagement team members about how and where they believe the company's financial statements might be susceptible to material misstatement due to fraud may need to be updated to

¹⁵ See, for example, paragraph 52 of Auditing Standard No. 12 and paragraph .85 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

¹⁶ See paragraph 14-15 of Auditing Standard No. 12.

¹⁷ See paragraph 46 of Auditing Standard No. 12.

¹⁸ See paragraph 48 of Auditing Standard No. 12.

¹⁹ See paragraphs 42-44 of Auditing Standard No. 12.

²⁰ See paragraph 74 of Auditing Standard No. 12.

²¹ *Ibid.*

²² Paragraph 51 of Auditing Standard No. 12.

reflect additional fraud risks that could result from the specific effects of the current economic environment on the company.²³

Identifying Fraud Risks and Other Significant Risks

In identifying and assessing risks of material misstatement, the auditor should evaluate whether the information gathered from the risk assessment procedures indicates that one or more fraud risk factors are present and should be taken into account in identifying and assessing fraud risks.²⁴ Staff Audit Practice Alert No. 8, *Audit Risks in Certain Emerging Markets* ("Practice Alert No. 8"), issued in October 2011, focuses on fraud risks that auditors might encounter in audits of companies with operations in emerging markets and auditors' responsibilities for addressing those risks.²⁵ While the focus of Practice Alert No. 8 was on emerging markets, fraud risks may be encountered in audits of companies in any region, especially when the company is faced with challenging economic conditions. In addition, auditors are reminded that their consideration of fraud includes misstatements from the misappropriation of assets.²⁶

Fraud risk factors are events or conditions that indicate (1) an incentive or pressure to perpetrate fraud, (2) an opportunity to carry out the fraud, or (3) an attitude or rationalization that justifies the fraudulent action.²⁷ Incentives or pressures to perpetrate fraud may exist when:

- Financial stability or profitability is threatened by economic conditions. For example, in the current economic environment, a company with substantial direct or indirect sovereign debt exposure may be motivated to not consider all relevant market information when determining a fair value measurement or enter into off-balance sheet arrangements that fail to be appropriately accounted for or disclosed.²⁸
- Excessive pressure exists for management to meet the requirements or expectations of third parties (e.g., due to expectations created by management in, for example, press releases or annual report messages that are no longer realistic).
- There is excessive pressure on operating personnel, including, for example, operating personnel in remote locations, to meet financial targets set by management, including sales or profitability incentive goals.²⁹

In identifying and assessing risks of material misstatement, the auditor should determine whether any of the auditor's identified and assessed risks are

²³ See paragraph 52 of Auditing Standard No. 12.

²⁴ Paragraph 65 of Auditing Standard No. 12.

²⁵ See Staff Audit Practice Alert No. 8 on the Board's web site at: <http://pcaobus.org/Standards/Pages/Guidance.aspx>.

²⁶ See AU sec. 316.06.

²⁷ Paragraph 65 of Auditing Standard No. 12.

²⁸ Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions*, discussed audit considerations regarding significant transactions that are outside the normal course of business for a company, or that otherwise appear to be unusual given the auditor's understanding of the company and its environment. See Staff Audit Practice Alert No. 5 on the Board's website at: http://pcaobus.org/Standards/QandA/04-07-2010_APA_5.

²⁹ AU sec. 316.85 A.2 describes further examples of risk factors relating to misstatements arising from fraudulent financial reporting.

significant risks.³⁰ A significant risk is defined as “[a] risk of material misstatement that requires special audit consideration.”³¹ To determine whether a risk is a significant risk, the auditor should evaluate whether the risk requires special audit consideration because of the nature of the risk or the likelihood and potential magnitude of misstatement related to the risk.³² One of the factors that should be evaluated in determining which risks are significant risks is whether the risk is related to recent significant economic developments.³³ Accordingly, risks of material misstatement that may be particularly susceptible to changes in the economic environment should be evaluated in this context. Other factors that the auditor should evaluate in determining significant risks include:³⁴

- The degree of complexity or judgment in the recognition or measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty;
- Whether the risk involves significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature; and
- Whether the risk involves significant transactions with related parties. Transactions with related parties may be motivated solely, or in large measure, by conditions such as a lack of sufficient working capital or credit to continue the business, an overly optimistic earnings forecast, or a declining industry characterized by a large number of business failures.³⁵

Planned Audit Responses

When the identified and assessed risks of material misstatement change, corresponding changes to planned audit responses may be necessary to adequately address the assessed risks.³⁶ Depending on the circumstances, these changes may need to be pervasive.³⁷ An example of such a pervasive change includes modifying the audit strategy to increase the substantive testing of the valuation of numerous significant accounts at year-end because of significant volatility in market conditions.³⁸

For significant risks, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.³⁹ Accordingly, for significant risks, the auditor’s substantive procedures should include tests of details that are specifically responsive to the assessed risks.⁴⁰

When using an analytical procedure as a substantive test, the expected effectiveness of the procedure depends on, among other things, the plausibility and predictability of relationships among financial and non-financial data.⁴¹ As

³⁰ See paragraph 59f of Auditing Standard No. 12.

³¹ Paragraph A5 of Appendix A to Auditing Standard No. 12.

³² See paragraph 70 of Auditing Standard No. 12.

³³ See paragraph 71 of Auditing Standard No. 12.

³⁴ *Ibid.*

³⁵ See paragraph .06 of AU sec. 334, *Related Parties*.

³⁶ See paragraph 3 of Auditing Standard No. 13, *The Auditor’s Responses to the Risks of Material Misstatement*.

³⁷ See paragraph 6 of Auditing Standard No. 13.

³⁸ *Ibid.*

³⁹ See paragraph .09 of AU sec. 329, *Substantive Analytical Procedures*.

⁴⁰ See paragraph 11 of Auditing Standard No. 13.

⁴¹ See AU sec. 329.11.

higher levels of assurance are desired from analytical procedures that are used as substantive procedures, more predictable relationships are required to develop the expected analytical relationships.⁴² Relationships in a stable environment are usually more predictable than relationships in a dynamic or unstable environment.⁴³

When testing controls over relevant assertions in an audit, the auditor should evaluate whether the controls are designed and operating effectively.⁴⁴ Practice Alert No. 3 discussed matters that may require additional auditor attention regarding the effective operation of internal controls, including job eliminations that may increase the risk of deficiencies in internal control over financial reporting because of, for example, lack of segregation of duties or lack of effective monitoring controls.

Auditing Fair Value Measurements and Estimates

The current economic environment continues to present challenges relating to auditing fair value measurements and estimates.⁴⁵ When auditing accounting estimates, the auditor should perform procedures to determine whether the accounting estimates are determined in conformity with the applicable financial reporting framework, are reasonable, and do not result in bias that materially misstates the financial statements.⁴⁶ When testing management's process for determining fair value measurements or estimates, the auditor should perform procedures commensurate with the related risk, including considering whether significant assumptions are best supported by the available audit evidence.⁴⁷ For example:

- Significant assumptions used in fair value measurements and estimates that are based on past experience and management expectations, such as revenue projections, cash flow estimates, charge-off rates, or projected rate of return assumptions and discount rates used in determining pension liabilities, may not reflect current market information or be representative of expected future conditions or events.
- Reductions in forecasts of macro-economic growth or extended periods of low interest rates may affect important assumptions underlying certain estimates, such as impairment determinations or the valuation of servicing assets. Uncertainty regarding the value of certain types of collateral or increasing counter-party risk may affect the valuation of financial instruments.

⁴² See AU sec. 329.14.

⁴³ Ibid.

⁴⁴ See, for example, paragraphs 16-22 of Auditing Standard No. 13.

⁴⁵ Fair value measurements and estimates were the subject of a number of audit deficiencies noted in the Board's Rule 4010 *Report on Observations of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis* (available at: http://pcaobus.org/Inspections/Documents/4010_Report_Economic_Crisis.pdf). In addition, fair value measurements and estimates were discussed in a number of previous staff audit practice alerts. See Staff Audit Practice Alert No. 2, *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists*, Practice Alert No. 3, *Staff Audit Practice Alert No. 4, Auditor Considerations Regarding Fair Value Measurements, Disclosures, and Other-Than-Temporary Impairments*, and Staff Audit Practice Alert No. 7, *Auditor Considerations of Litigation and Other Contingencies Arising from Mortgage and Other Loan Activities*. Staff Audit Practice Alerts are available at: <http://pcaobus.org/Standards/Pages/Guidance.aspx>.

⁴⁶ See, for example, paragraph 23 of AU sec. 328, *Auditing Fair Value Measurements and Disclosures*, paragraph .11 of AU sec. 342, *Auditing Accounting Estimates*, and paragraphs 13 and 24-27 of Auditing Standard No. 14, *Evaluating Audit Results*.

⁴⁷ Ibid.

- Additional risks, such as sovereign default risk or currency volatility, could add a higher level of complexity in determining the ultimate collectability of sales or the appropriateness of other significant assumptions used in certain fair value determinations or estimates, including the fair value of certain financial instruments.
- An active market may not exist for certain financial instruments which in turn may result in complex valuation methods. Assumptions are integral components of more complex valuation methods, for example, valuation methods that employ a combination of estimates of expected future cash flows together with estimates of the values of assets or liabilities in the future, discounted to the present. Auditors pay particular attention to the significant assumptions underlying a valuation method and evaluate whether such assumptions are reasonable and reflect, or are not inconsistent with, market information.⁴⁸

Auditors are reminded that audit evidence consists of both information that supports and corroborates management's assertions and information that contradicts such assertions including assertions regarding fair values, estimates and related disclosures.⁴⁹

Bias in Accounting Estimates

Business conditions today may create increased pressures to achieve certain financial results that could result in bias in management's estimates.⁵⁰ Applying professional skepticism is of particular importance when evaluating estimates and assumptions in judgmental areas that are susceptible to management bias.

The auditor should evaluate whether the difference between estimates best supported by the audit evidence and estimates included in the financial statements, which are individually reasonable, indicate a possible bias on the part of the company's management.⁵¹ A lack of consistency in assumptions used to support different estimates might be indicative of errors or bias in estimates. For instance, revenue assumptions used in the goodwill impairment test that are inconsistent with revenue assumptions used to accrue discretionary compensation might be indicative of management bias. Further, bias might be evidenced by assumptions that are inconsistent with industry economic forecasts or the company's budgets or future business plans or the consistent use of overly optimistic assumptions (e.g. consistently missing projected revenue by a substantial amount in each recent period).⁵² If each accounting estimate included in the financial statements is individually reasonable but the effect of the difference between each estimate and the estimate best supported by the audit evidence is to increase earnings or loss, the auditor should evaluate whether these circumstances indicate potential management bias in the estimates.⁵³ Bias also can result from the cumulative effect of changes in multiple accounting estimates. If the estimates in the financial statements are grouped at one end of the range of reasonable estimates in the prior year and are grouped at the other end of the range of reasonable estimates in the current year, the auditor should evaluate whether management is using swings in

⁴⁸ AU sec. 328.29.

⁴⁹ See paragraph 2 of Auditing Standard No. 15, *Audit Evidence*.

⁵⁰ See paragraph 25d of Auditing Standard No. 14.

⁵¹ Paragraph 27 of Auditing Standard No. 14.

⁵² See, for example, AU sec. 342.09.

⁵³ Paragraph 27 of Auditing Standard No. 14.

estimates to achieve an expected or desired outcome, e.g., to offset higher or lower than expected earnings.⁵⁴

If the auditor identifies bias in management's judgments about the amounts and disclosures in the financial statements, the auditor should evaluate whether the effect of that bias, together with the effect of uncorrected misstatements, results in material misstatement of the financial statements.⁵⁵ Also, the auditor should evaluate whether the auditor's risk assessments, including, in particular, the assessment of fraud risks, and the related audit responses remain appropriate.⁵⁶ Auditors are reminded that indications of management bias in accounting estimates and in selecting accounting principles may affect the auditor's conclusions about the operating effectiveness of controls and should be included in the auditor's evaluation of controls in an integrated audit.⁵⁷

Consideration of Changes to Accounting Standards

Practice Alert No. 3 provided information on selected financial reporting areas that might be affected by the then-current economic environment. While these areas continue to pose audit and financial reporting risk, certain accounting requirements have been amended since the issuance of Practice Alert No. 3.⁵⁸ For example, the Financial Accounting Standards Board ("FASB") recently issued Accounting Standards Codification Update 2011-08, *Intangibles-Goodwill and Others (Topic 350): Testing Goodwill for Impairment* ("ASU No. 2011-08").⁵⁹ That guidance allows companies to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying value as a basis for determining whether it is necessary to perform the two-step goodwill impairment test described in Topic 350.⁶⁰

If a company opts to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount, ASU No. 2011-08 provides examples of events and circumstances that the company should consider in its evaluation.⁶¹ These examples include, among others:

- Macroeconomic conditions such as a deterioration in general economic conditions;
- Limitations on accessing capital;
- Fluctuations in foreign exchange rates, or other developments in equity and credit markets; and

⁵⁴ Ibid.

⁵⁵ Paragraph 26 of Auditing Standard No. 14.

⁵⁶ Ibid.

⁵⁷ See paragraph B8 of Appendix B to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit of Financial Statements*.

⁵⁸ The Board has no authority to prescribe the form or content of a company's financial statements. That authority, and the authority to make binding determinations concerning compliance with generally accepted accounting standards ("GAAP"), rests with the U.S. Securities and Exchange Commission. Accordingly, while this staff audit practice alert describes applicable GAAP, it does not establish or interpret GAAP.

⁵⁹ See <http://www.fasb.org/cs/ContentServer?site=FASB&c=Page&pagename=FASB%2FPage%2FSectionPage&cid=1176156316498>.

⁶⁰ ASU No. 2011-08 at 1.

⁶¹ ASU No. 2011-08 at 2.

- Industry and market considerations such as a deterioration in the environment in which an entity operates, an increased competitive environment, a decline in market-dependent multiples or metrics (considered in both absolute terms and relative to peers), a change in the market for an entity's products or services, or a regulatory or political development.⁶²

When reviewing and testing the process for a company's assessment of qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying value, audit considerations include, among others:

- Identifying the sources of data and factors that the company used in forming the assumptions, and consideration of whether such data and factors are relevant, reliable, and sufficient for the purpose based on information gathered in other audit tests.
- Considering whether there are additional key factors or alternative assumptions about the factors.
- Evaluating whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data.
- Considering whether changes in the business or industry may cause other factors to become significant to the assumptions.⁶³

The Auditor's Consideration of a Company's Ability to Continue as a Going Concern

Practice Alert No. 3 noted certain challenges companies may face in their ability to continue operating as a going concern in light of the then-current economic environment. These challenges included a reduction of the availability of funding under lines of credit or from short-term borrowing markets, difficulty in meeting debt covenants, and a lack of acceptable collateral. Some companies may continue to face such challenges in the current economic environment.

The auditor has a responsibility to evaluate whether there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited.⁶⁴ The auditor's going concern evaluation can affect the auditor's evaluation of financial disclosures and the auditor's report.⁶⁵

The auditor's going concern evaluation is based on his or her knowledge of relevant conditions and events that exist at or have occurred prior to the date of the auditor's report.⁶⁶ Information about such conditions or events is obtained from the application of auditing procedures planned and performed to achieve audit objectives that are related to management's assertions embodied in the financial statements being audited, as described in Auditing Standard No. 15, *Audit Evidence*.⁶⁷

⁶² ASU No. 2011-08, paragraph 350-20-35-3c.

⁶³ See AU sec. 342.11.

⁶⁴ Paragraph .02 of AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.

⁶⁵ See AU secs. 341.12 and 341.14.

⁶⁶ AU sec. 341.02.

⁶⁷ See paragraph 11 of Auditing Standard No. 15.

Conditions or events, such as negative trends and other indications of possible financial difficulties as well as internal and external matters that have occurred, when considered in the aggregate, may indicate there could be substantial doubt about the company's ability to continue as a going concern for a reasonable period of time.⁶⁸ If the auditor believes there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time, the auditor should (1) obtain information about management's plans that are intended to mitigate the effect of such conditions or events, and (2) assess the likelihood that such plans can be effectively implemented.⁶⁹

Management's plans for dealing with the adverse effects of the conditions or events may include the disposal of assets, borrowing additional funds or restructuring existing debt, planned reduction of expenditures, or increasing equity by raising capital.⁷⁰ When evaluating management's plans, the auditor should identify those elements that are particularly significant to overcoming the adverse effects of the conditions and events and should plan and perform auditing procedures to obtain evidential matter about them.⁷¹

In the current economic environment, it is important for the auditor to consider the adequacy of support for such plans,⁷² including whether it is likely that the adverse effects will be mitigated for a reasonable period of time and whether the plans can be effectively implemented.⁷³ For example, if management indicates that the company plans to dispose of assets to raise capital, audit considerations may include the existence of any restrictions on the disposal of the assets, issues related to the marketability of the assets, and any possible direct or indirect effects of disposal of the assets.⁷⁴ As another example, if management is relying on a pledge of financial support from a significant shareholder, consideration should be given to the impact of current economic conditions on the shareholder's ability to provide such funding.⁷⁵ Another important consideration in the current economic environment is the willingness of a third party to continue to provide financial support, especially if the third party has already provided support to ongoing operations or in light of a potentially longer time frame for the company to return to profitability or positive cash flow.

When prospective financial information is particularly significant to management's plans, the auditor should request management to provide that information and should consider the adequacy of support for significant assumptions underlying that information.⁷⁶ In considering the adequacy of support for significant assumptions, the auditor should consider whether the assumptions are consistent with current economic conditions, such as, recent reductions in economic growth forecasts and information obtained by the auditor in other audit areas.

In the current economic environment, assumptions that are especially sensitive or susceptible to change and that are important to the auditor's evaluation of

⁶⁸ See AU sec. 341.06.

⁶⁹ AU sec. 341.03.b.

⁷⁰ See AU sec. 341.07.

⁷¹ AU sec. 341.08.

⁷² *Ibid.*

⁷³ See AU sec. 341.07.

⁷⁴ *Ibid.*

⁷⁵ Such consideration may include information contained in, among other things, the audited financial statements of the shareholder, reports issued by regulatory agencies, financial publications, or credit agencies concerning the shareholder, and income tax returns of the shareholder, to the extent available.

⁷⁶ AU sec. 341.09.

whether or not substantial doubt remains about the company's ability to continue as a going concern may warrant particularly careful consideration by the auditor.⁷⁷ When, primarily because of the consideration of management's plans, the auditor concludes that substantial doubt about the company's ability to continue as a going concern for a reasonable period of time is alleviated, the auditor should consider the need for disclosure in the financial statements, the principal conditions and events that initially caused him or her to believe there was substantial doubt, including the possible effects of such conditions and events, and any mitigating factors, including management's plans.⁷⁸

Auditing Financial Statement Disclosures

The risk assessment standards recognize the importance of financial statement disclosures by directing the auditor's attention to them throughout the audit process. The current economic environment may increase the risk related to omitted, incomplete, or inaccurate disclosures, including, for example, disclosures regarding contingent liabilities, risks and uncertainties, concentrations of credit risk, and liquidity concerns.

The risk assessment standards require auditors to perform procedures to assess the risk of omitted, incomplete, or inaccurate disclosures, whether intentional or unintentional,⁷⁹ and to identify and test significant disclosures.⁸⁰ To identify and assess such risks, the auditor should develop expectations about the disclosures that are necessary for the company's financial statements to be presented fairly in conformity with the applicable financial reporting framework.⁸¹ The key engagement team members should discuss (1) the company's selection and application of accounting principles, including related disclosure requirements, and (2) the susceptibility of the company's financial statements to material misstatement due to error or fraud.⁸² The discussion among the key engagement team members should include how fraud might be perpetrated or concealed by omitting or presenting incomplete or inaccurate disclosures.⁸³

The nature of certain financial statement disclosure requirements, the complexity of the matters disclosed, and the qualitative nature of certain disclosures can pose additional risks of material misstatement. Also, internal controls over disclosures that are qualitative, judgmental, or complex often are different from those controls over the processing and reporting of routine historical transactions. For these types of disclosures, the necessary controls are more likely to be manual controls than automated controls and may require significant judgment in the operation of the control, which, in turn, can affect the risk associated with the control.

When evaluating whether the financial statements are fairly presented in conformity with the applicable financial reporting framework, the auditor also is required to evaluate the disclosures, which includes, among other things:

⁷⁷ Ibid.

⁷⁸ See AU sec. 341.11.

⁷⁹ See, for example, paragraphs 49, 52, and 67 of Auditing Standard No. 12.

⁸⁰ See, for example, paragraphs 59–64 of Auditing Standard No. 12 and paragraph 9 and footnote 6 of Auditing Standard No. 13. A disclosure is a significant disclosure if there is a reasonable possibility that the disclosure could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements. See paragraph A10 of Auditing Standard No. 5.

⁸¹ See paragraph 12 of Auditing Standard No. 12.

⁸² Paragraph 49 of Auditing Standard No. 12.

⁸³ See paragraph 52 of Auditing Standard No. 12.

- Evaluating whether the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation;⁸⁴ and
- Considering the form, arrangement, and content of the financial statements (including the accompanying notes), encompassing matters such as the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth.⁸⁵

Evaluation of disclosures also involves evaluation of the effect on the financial statements of uncorrected misstatements in disclosures, such as omitted, incomplete, or inaccurate disclosures. Qualitative considerations are particularly important when evaluating misstatements in disclosures that are more narrative in nature, such as those relating to risks and uncertainties or loss contingencies where an estimate has not yet been disclosed.⁸⁶ PCAOB auditing standards describe the auditor's responsibilities for considering qualitative factors in the context of the auditor's consideration of materiality.⁸⁷

To determine the extent of supervision necessary for engagement team members to perform their work as directed and form appropriate conclusions, the engagement partner and other engagement team members performing supervisory activities should take into account, among other things, the nature of the assigned work for each engagement team member, including the controls or accounts and disclosures to be tested.⁸⁸ For example, additional supervision over audit areas including disclosures that are more qualitative, judgmental, or complex in nature may be merited. Also, to effectively evaluate those disclosures, auditors need to exercise professional skepticism and be alert for events or conditions that may contradict management's assertions in the disclosures.⁸⁹ Events or conditions that may contradict information in the disclosures may arise during the performance of other audit procedures including reading information in documents containing audited financial statements or may be based on more general factors, such as conditions in the industry in which the company operates. PCAOB standards require auditors to read other information in documents containing audited financial statements and consider whether such information is materially inconsistent with information appearing in the financial statements, including disclosures.⁹⁰

Obtaining audit evidence that is relevant for evaluating disclosures that are more judgmental or qualitative in nature might require different auditing procedures from those used to evaluate disclosures of routine historical data. For example, the evidence needed to evaluate a disclosure relating to a loss contingency might come from sources outside the company's accounting system or possibly from sources outside the company.

⁸⁴ See paragraph .04 of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*.

⁸⁵ See paragraph 31 of Auditing Standard No. 14.

⁸⁶ Practice Alert No. 3 discussed communications with audit committee, including communications about the clarity and completeness of the financial statements, that include related disclosures.

⁸⁷ See, for example, paragraph 24 and Appendix B of Auditing Standard No. 14.

⁸⁸ See paragraph 6b(2) of Auditing Standard No. 10, *Supervision of the Audit Engagement*.

⁸⁹ See AU sec. 230, *Due Professional Care in the Performance of Work*.

⁹⁰ See paragraph .04 of AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*.

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.10 Staff Audit Practice Alert No. 10 Maintaining and Applying Professional Skepticism in Audits

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Staff Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of the standards and rules of the PCAOB and relevant laws. Auditors should determine whether and how to respond to these circumstances based on the specific facts presented. The statements contained in Staff Audit Practice Alerts do not establish rules of the Board and do not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person.

Executive Summary

Professional skepticism is essential to the performance of effective audits under Public Company Accounting Oversight Board (“PCAOB” or “Board”) standards. Those standards require that professional skepticism be applied throughout the audit by each individual auditor on the engagement team.

PCAOB standards define professional skepticism as an attitude that includes a questioning mind and a critical assessment of audit evidence. The standards also state that professional skepticism should be exercised throughout the audit process. While professional skepticism is important in all aspects of the audit, it is particularly important in those areas of the audit that involve significant management judgments or transactions outside the normal course of business. Professional skepticism also is important as it relates to the auditor’s consideration of fraud in an audit. When auditors do not appropriately apply professional skepticism, they may not obtain sufficient appropriate evidence to support their opinions or may not identify or address situations in which the financial statements are materially misstated.

Observations from the PCAOB’s oversight activities continue to raise concerns about whether auditors consistently and diligently apply professional skepticism. Certain circumstances can impede the appropriate application of professional skepticism and allow unconscious biases to prevail, including incentives and pressures resulting from certain conditions inherent in the audit environment, scheduling and workload demands, or an inappropriate level of confidence or trust in management. Audit firms and individual auditors should be alert for these impediments and take appropriate measures to assure that professional skepticism is applied appropriately throughout all audits performed under PCAOB standards.

Firms’ quality control systems can help engagement teams improve the application of professional skepticism in a number of ways, including setting a proper tone at the top that emphasizes the need for professional skepticism; implementing and maintaining appraisal, promotion, and compensation processes that enhance rather than discourage the application of professional skepticism; assigning personnel with the necessary competencies to engagement teams; establishing policies and procedures to assure appropriate audit documentation, especially in areas involving significant judgments; and appropriately monitoring the quality control system and taking necessary corrective actions to address deficiencies, such as, instances in which engagement teams do not apply professional skepticism.

The engagement partner is responsible for, among other things, setting an appropriate tone that emphasizes the need to maintain a questioning mind throughout the audit and to exercise professional skepticism in gathering and evaluating evidence, so that, for example, engagement team members have the confidence to challenge management representations. It is also important for the engagement partner and other senior engagement team members to be actively involved in planning, directing, and reviewing the work of other engagement team members so that matters requiring audit attention, such as unusual matters or inconsistencies in audit evidence, are identified and addressed appropriately.

It is the responsibility of each individual auditor to appropriately apply professional skepticism throughout the audit, including in identifying and assessing the risks of material misstatement, performing tests of controls and substantive procedures to respond to the risks, and evaluating the results of the audit. This involves, among other things, considering what can go wrong with the financial statements, performing audit procedures to obtain sufficient appropriate audit evidence rather than merely obtaining the most readily available evidence to corroborate management's assertions, and critically evaluating all audit evidence regardless of whether it corroborates or contradicts management's assertions.

The Office of the Chief Auditor is issuing this practice alert to remind auditors of the requirement to appropriately apply professional skepticism throughout their audits. The timing of this release is intended to facilitate firms' emphasis in upcoming calendar year-end audits, as well as in future audits, on the importance of the appropriate use of professional skepticism. Due to the fundamental importance of the appropriate application of professional skepticism in performing an audit in accordance with PCAOB standards, the PCAOB also is continuing to explore whether additional actions might meaningfully enhance auditors' professional skepticism.

Professional Skepticism and Due Professional Care

Professional skepticism, an attitude that includes a questioning mind and a critical assessment of audit evidence, is essential to the performance of effective audits under PCAOB standards. The audit is intended to provide investors with an opinion on whether the financial statements prepared by company management are presented fairly, in all material respects, in conformity with the applicable financial reporting framework. If the audit is conducted without professional skepticism, the value of the audit is impaired.

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.¹ This responsibility includes obtaining sufficient appropriate evidence to determine whether the financial statements are materially misstated rather than merely looking for evidence that supports management's assertions.²

PCAOB standards require the auditor to exercise due professional care in planning and performing the audit and in preparing the audit report. Due professional care requires the auditor to exercise professional skepticism. PCAOB standards define professional skepticism as an attitude that includes a questioning mind and a critical assessment of audit evidence. PCAOB

¹ Paragraph .02 of AU sec. 110, *Responsibilities and Functions of the Independent Auditor*.

² See, e.g., paragraph 3 of Auditing Standard No. 8, *Audit Risk* and paragraph 3 of Auditing Standard No. 14, *Evaluating Audit Results*.

standards require the auditor to exercise professional skepticism throughout the audit.³

While professional skepticism is important in all aspects of the audit, it is particularly important in those areas of the audit that involve significant management judgments or transactions outside the normal course of business, such as nonrecurring reserves, financing transactions, and related party transactions that might be motivated solely, or in large measure, by an expected or desired accounting outcome. Effective auditing involves diligent pursuit of sufficient appropriate audit evidence, particularly if contrary evidence exists, and critical assessment of all the evidence obtained.

Professional skepticism is also important as it relates to the auditor's consideration of fraud in the audit.⁴ Company management has a unique ability to perpetrate fraud because it frequently is in a position to directly or indirectly manipulate accounting records and present fraudulent financial information.⁵ Company personnel who intentionally misstate the financial statements often seek to conceal the misstatement by attempting to deceive the auditor. Because of this incentive, applying professional skepticism is integral to planning and performing audit procedures to address fraud risks. In exercising professional skepticism, the auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest.⁶

Examples of the application of professional skepticism in response to the assessed fraud risks are (a) modifying the planned audit procedures to obtain more reliable evidence regarding relevant assertions and (b) obtaining sufficient appropriate evidence to corroborate management's explanations or representations concerning important matters, such as through third-party confirmation, use of a specialist engaged or employed by the auditor, or examination of documentation from independent sources.⁷

PCAOB inspectors continue to observe instances in which the circumstances suggest that auditors did not appropriately apply professional skepticism in their audits.⁸ As examples, audit deficiencies like the following raise concerns that a lack of professional skepticism was at least a contributing factor:

- For certain hard-to-value Level 2 financial instruments, the engagement team did not obtain an understanding of the specific methods and/or assumptions underlying the fair value estimates that were obtained from pricing services or other third parties and used in the

³ See paragraphs .01 and .07-.08 of AU sec. 230, *Due Professional Care in the Performance of Work*.

⁴ See paragraph .13 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

⁵ AU sec. 316.08.

⁶ See AU secs. 230.07-.09.

⁷ Paragraph 7 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

⁸ The PCAOB is not alone in identifying concerns regarding professional skepticism in audits. Regulators in countries such as Australia, Canada, Germany, the Netherlands, Singapore, Switzerland, and the United Kingdom have cited concerns about professional skepticism in public reports on their inspections. See, e.g., the Financial Reporting Council's *Audit Quality Inspections Annual Report 2011/12*, available at <http://www.frc.org.uk/Our-Work/Publications/AIU/Audit-Quality-Inspections-Annual-Report-2011-12.aspx>, the Canadian Public Accountability Board's, *Meeting the Challenge "A Call to Action" 2011 Public Report*, available at http://www.epab-ccrc.ca/en/content/2011Public_Report_EN.pdf, the Australian Securities & Investments Commission's Report 242, *Audit inspection program public report for 2009 - 2010*, available at [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep242-published-29-June-2011.pdf/\\$file/rep242-published-29-June-2011.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep242-published-29-June-2011.pdf/$file/rep242-published-29-June-2011.pdf), and the Accounting and Corporate Regulatory Authority *Practise Monitoring Programme Sixth Public Report*, August 2012, available at <http://www.acra.gov.sg/NR/rdonlyres/E7E2A4BF-EC46-4AB2-877D-297D4E618042/0/PMPReport2012170712finalclean.pdf>.

engagement team's testing related to these financial instruments. Further, the firm used the price closest to the issuer's recorded price in testing the fair value measurements, without evaluating the significance of differences between the other prices obtained and the issuer's prices.

- The issuer discontinued production of a significant product line during the prior year and introduced a new product line to replace it. There were no sales of the discontinued product line during the last nine months of the year under audit. The engagement team did not test, beyond inquiry, the significant assumptions management used to calculate its separate inventory reserve for this product line.
- The engagement team did not evaluate the effects on the financial statements of management's determination not to test a significant portion of its property and equipment for impairment, despite indicators that the carrying amount may not have been recoverable. These indicators in this situation included operating losses for the relevant segment for the last three years, substantial charges for the impairment of goodwill and other intangible assets during the year, a projected loss for the segment for the upcoming year, and reduced and delayed customer orders.
- After the date of the issuer's balance sheet, but before the release of the firm's opinion, the issuer reported that it anticipated that comparable store sales for the first quarter of the year would be significantly lower than those for the first quarter of the year under audit. The engagement team had performed sensitivity analyses as part of its assessment on the issuer's evaluation of its compliance with its debt covenants, the issuer's ability to continue as a going concern, and the possibility of the impairment of the issuer's long-lived assets. The engagement team did not consider the implications of the anticipated decline in sales on its sensitivity analyses and its conclusions with respect to compliance with debt covenants, the issuer's ability to continue as a going concern, and impairment of long-lived assets.

The PCAOB's enforcement activities also have identified instances in which auditors did not appropriately apply professional skepticism. For example, in one recent disciplinary order, the Board found, among other things, that certain of a firm's audit partners accepted a company's reliance on an exception to generally accepted accounting principles ("GAAP") requirements for reserving for expected future product returns even though doing so conflicted with the plain language of the exception and the firm's internal accounting literature. The partners were aware of, but did not appropriately consider, contradictory audit evidence indicating that the returns were not eligible for the exception. This illustration of a lack of professional skepticism reappeared in the firm's response when the issue was questioned by the firm's internal audit quality reviewers. Although certain of the partners involved determined that the company's reliance on the exception to GAAP did not support the company's accounting, they, along with other firm personnel, formulated another equally deficient rationale that supported the company's existing accounting result.⁹

⁹ See *In the Matter of Ernst & Young LLP, Jeffrey S. Anderson, CPA, Ronald Butler, Jr., CPA, Thomas A. Christie, CPA, and Robert H. Thibault, CPA, Respondents*, PCAOB Release No. 105-2012-001, (Feb. 8, 2012).

Impediments to the Application of Professional Skepticism

Although PCAOB standards require auditors to appropriately apply professional skepticism throughout the audit, observations from the PCAOB's oversight activities indicate that, as a practical matter, auditors are often challenged in meeting this fundamental audit requirement. In maintaining an attitude that includes a questioning mind and a critical assessment of audit evidence, it is important for auditors to be alert to unconscious human biases and other circumstances that can cause auditors to gather, evaluate, rationalize, and recall information in a way that is consistent with client preferences rather than the interests of external users.

Certain conditions inherent in the audit environment can create incentives and pressures that can serve to impede the appropriate application of professional skepticism and allow unconscious bias to prevail. For example, incentives and pressures to build or maintain a long-term audit engagement, avoid significant conflicts with management, provide an unqualified audit opinion prior to the issuer's filing deadline, achieve high client satisfaction ratings, keep audit costs low, or cross-sell other services can all serve to inhibit professional skepticism.

In addition, over time, auditors may sometimes develop an inappropriate level of trust or confidence in management, which may lead auditors to accede to inappropriate accounting. In some situations, auditors may feel pressure to avoid potential negative interactions with, or consequences to, individuals they know (that is, management) instead of representing the interests of the investors they are charged to protect.

Other circumstances also can impede the appropriate application of professional skepticism. For example, scheduling and workload demands can put pressure on partners and other engagement team members to complete their assignments too quickly, which might lead auditors to seek audit evidence that is easier to obtain rather than evidence that is more relevant and reliable, to obtain less evidence than is necessary, or to give undue weight to confirming evidence without adequately considering contrary evidence.

Although powerful incentives and pressures exist that can impede professional skepticism, the importance of professional skepticism to an effective audit cannot be overstated, particularly given the increasing judgment and complexity in financial reporting and issues posed by the current economic environment.¹⁰ Auditors and audit firms must remember that their overriding duty is to put the interests of investors first. Appropriate application of professional skepticism is key to fulfilling the auditor's duty to investors. In the words of the U.S. Supreme Court:

By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.¹¹

¹⁰ See Staff Practice Alert No. 9, *Assessing and Responding to Risk in the Current Economic Environment* (Dec. 6, 2011).

¹¹ *U.S. v. Arthur Young & Co.*, 465 U.S. 805, 817-18 (1984).

However, inadequate performance of audit procedures may be caused by factors other than the lack of skepticism, or in combination with a lack of skepticism. As discussed further below, firms should take appropriate steps to understand the various factors that influence audit quality, including those circumstances and pressures that can impede the application of professional skepticism.

Promoting Professional Skepticism via an Appropriate System of Quality Control

PCAOB standards require firms to establish a system of quality control to provide the firm with reasonable assurance that its personnel comply with applicable professional standards and the firm's standards of quality.¹² This includes designing and implementing policies and procedures that lead engagement teams to appropriately apply professional skepticism in their audits.

Firms' quality control systems can help engagement teams improve the application of professional skepticism in a number of ways, including the following:

- *“Tone-at-the-Top” Messaging.* The PCAOB's inspection findings have identified instances in which the firm's culture allows or tolerates audit approaches that do not consistently emphasize the need for professional skepticism. Consistent communication from firm leadership that professional skepticism is integral to performing a high quality audit, backed up by a culture that supports it, could improve the quality of work performed by audit partners and staff. On the other hand, messages from firm leadership that are excessively focused on revenue or profit growth over achieving audit quality, can undermine the application of professional skepticism.
- *Performance Appraisal, Promotion, and Compensation Processes.* An audit firm's performance appraisal, promotion, and compensation processes can enhance or detract from the application of professional skepticism in its audit practice, depending on how they are designed and executed. For example, if a firm's promotion process emphasizes selling non-audit services or places an undue focus on reducing audit costs, or retaining and acquiring audit clients over achieving high audit quality, the firm's personnel may perceive those goals as being more important to their own compensation, job security, and advancement within the firm than the appropriate application of professional skepticism.
- *Professional Competence and Assigning Personnel to Engagement Teams.* A firm's quality control system depends heavily on the proficiency of its personnel,¹³ which includes their ability to exercise professional skepticism. To perform the audit with professional skepticism, it is important that personnel assigned to engagement teams have the necessary knowledge, skill, and ability required in the circumstances,¹⁴ which includes appropriate technical training and experience. Professional skepticism is interrelated with an auditor's training and experience, as auditors need an appropriate level of competence in order to appropriately apply professional skepticism throughout the audit. In addition, it is important for the firm's culture

¹² See paragraph .03 of Quality Control (“QC”) sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*.

¹³ QC sec. 20.11.

¹⁴ See QC sec. 20.12.

to continually reinforce the appropriate application of professional skepticism throughout the audit.

- *Documentation.* It is important for a firm's quality control system to establish policies and procedures that cover documenting the results of each engagement.¹⁵ Although documentation should support the basis for the auditor's conclusions concerning every relevant financial statement assertion, areas that require greater judgment generally need more extensive documentation of the procedures performed, evidence obtained, and rationale for the conclusions reached. In addition to the documentation necessary to support the auditor's final conclusions, audit documentation must include information the auditor has identified relating to significant findings or issues that is inconsistent with or contradicts the auditor's final conclusions.¹⁶
- *Monitoring.* Under PCAOB standards, a firm's quality control policies and procedures should include an element of monitoring to ensure that quality control policies and procedures are suitably designed and being effectively applied.¹⁷ If the firm identifies deficiencies, the firm should evaluate the reasons for the deficiencies and determine the necessary corrective actions or improvements to the quality control system.¹⁸ Accordingly, if a firm identifies deficiencies that include failures to appropriately apply professional skepticism as a contributing factor, the firm should take appropriate corrective actions.

Importance of Supervision to the Application of Professional Skepticism

The supervisory activities performed by the engagement partner and other senior engagement team members are important to the application of professional skepticism.¹⁹ The engagement partner is responsible for the proper supervision of the work of engagement team members.²⁰ Accordingly, the engagement partner is responsible for setting an appropriate tone that emphasizes the need to maintain a questioning mind throughout the audit and to exercise professional skepticism in gathering and evaluating evidence, so that, for example, engagement team members have the confidence to challenge management representations.²¹

It is also important for the engagement partner and other senior engagement team members to be actively involved in planning, directing, and reviewing the work of other engagement team members so that matters requiring audit attention are identified and addressed appropriately. In directing the work of others, senior engagement team members, including the engagement partner,

¹⁵ See QC secs. 20.17-.18. Also, see generally Auditing Standard No. 3, *Audit Documentation*.

¹⁶ See, e.g., paragraphs 7-8 of Auditing Standard No. 3.

¹⁷ See QC sec. 20.07 and paragraph .02 of QC sec. 30, *Monitoring a CPA Firm's Accounting and Auditing Practice*.

¹⁸ See QC sec. 30.03.

¹⁹ Besides supervision by the engagement partner and other engagement team members, the engagement quality reviewer also plays an important role in assessing the application of professional skepticism by the engagement team. In particular, the engagement quality reviewer is required to perform specific procedures to evaluate the significant judgments made by the engagement team.

²⁰ Paragraph 3 of Auditing Standard No. 10, *Supervision of the Audit Engagement*.

²¹ See paragraph 53 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

may have knowledge and experience that may assist less experienced engagement team members in applying professional skepticism. For example, senior engagement team members might help more junior auditors identify matters that are unusual or inconsistent with other evidence. In addition, senior members of the engagement team might be better able to challenge the assertions of senior levels of management, when necessary.

Appropriate Application of Professional Skepticism

Although a firm's quality control systems and the actions of the engagement partner and other senior engagement team members can contribute to an environment that supports professional skepticism, it is ultimately the responsibility of each individual auditor to appropriately apply professional skepticism throughout the audit, including the following areas among others:

- Identifying and assessing risks of material misstatement;
- Performing tests of controls and substantive procedures; and
- Evaluating audit results to form the opinion to be expressed in the auditor's report.

Identifying and Assessing Risks of Material Misstatement

By its nature, risk assessment involves looking at internal and external factors to determine what can go wrong with the financial statements, whether due to error or fraud. When properly applied, the risk assessment approach set forth in PCAOB standards should focus auditors' attention on those areas of the financial statements that are higher risk and thus most susceptible to misstatement. This includes considering events and conditions that create incentives or pressures on management or create opportunities for management to manipulate the financial statements. The evidence obtained from the required risk assessment procedures should provide a reasonable basis for the auditor's risk assessments, which, in turn, should drive the auditor's tests of accounts and disclosures in the financial statements.

The risk assessment procedures required by PCAOB standards also should provide the auditor with a thorough understanding of the company and its environment as a basis for identifying unusual transactions or matters that warrant further investigation. They also provide a basis for the auditor to evaluate and challenge management's assertions.²² It is important to note that the auditor's understanding should be based on actual information obtained from the risk assessment procedures. It is not sufficient for auditors merely to rely on their perceived knowledge of the industry or information obtained from prior audits or other engagements for the company.

Performing Tests of Controls and Substantive Procedures

Appropriately applying professional skepticism is critical to obtaining sufficient appropriate audit evidence to determine whether the financial statements are free of material misstatement and, in an integrated audit, whether internal controls over financial reporting are operating effectively. Application of professional skepticism is not merely obtaining the most readily available evidence to corroborate management's assertion.

The need for auditors to appropriately apply professional skepticism is echoed throughout PCAOB standards. For example, PCAOB standards caution that

²² For example, risk assessment procedures may provide the auditor a basis for challenging management's responses to the required inquiries of management in Auditing Standard No. 12.

representations from management 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.²³ Also, the standards warn that inquiry alone does not provide sufficient appropriate evidence to support a conclusion about a relevant assertion.²⁴

In addition, PCAOB standards require auditors to design and perform audit procedures in a manner that addresses the assessed risks of material misstatement and to obtain more persuasive evidence the higher the assessment of risk.²⁵ The auditor is required to apply professional skepticism, which includes a critical assessment of the audit evidence.²⁶ Substantive procedures generally provide persuasive evidence when they are designed and performed to obtain evidence that is relevant and reliable.²⁷ When discussing the characteristics of reliable audit evidence, PCAOB standards observe that generally, among other things, evidence obtained from a knowledgeable source independent of the company is more reliable than evidence obtained only from internal company sources and evidence obtained directly by the auditor is more reliable than evidence obtained indirectly.²⁸

Taken together, this means that in higher risk areas, the auditor's appropriate application of professional skepticism should result in procedures that are focused on obtaining evidence that is more relevant and reliable, such as evidence obtained directly and evidence obtained from independent, knowledgeable sources.²⁹ Further, if audit evidence obtained from one source is inconsistent with that obtained from another, the auditor should perform the audit procedures necessary to resolve the matter and should determine the effect, if any, on other aspects of the audit.³⁰

The following are examples of audit procedures in PCAOB standards that reflect the need for professional skepticism:

- Resolving inconsistencies in or doubts about the reliability of confirmations;³¹
- Examining journal entries and other adjustments for evidence of possible material misstatement due to fraud;³²
- Reviewing accounting estimates for biases that could result in material misstatement due to fraud;³³
- Evaluating the business rationale for significant unusual transactions;³⁴ and

²³ See paragraph .02 of AU sec. 333, *Management Representations*.

²⁴ Paragraph 39 of Auditing Standard No. 13.

²⁵ See paragraphs 8-9 of Auditing Standard No. 13. For fraud risks and significant risks, the auditor also is required to perform procedures, including tests of details, that are specifically responsive to the assessed risks.

²⁶ See AU sec. 230.07.

²⁷ Paragraph 39 of Auditing Standard No. 13.

²⁸ See paragraph 8 of Auditing Standard No. 15, *Audit Evidence*.

²⁹ See paragraph 9.a. of Auditing Standard No. 13.

³⁰ Paragraph 29 of Auditing Standard No. 15.

³¹ See, e.g., paragraphs .27 and .33 of AU sec. 330, *The Confirmation Process*.

³² See AU secs. 316.58-.62.

³³ See AU secs. 316.63-.65.

³⁴ See AU secs. 316.66-.67.

- Evaluating whether there is substantial doubt about an entity's ability to continue as a going concern.³⁵

Evaluating Audit Results to Form the Opinion to be Expressed in the Audit Report

When professional skepticism is applied appropriately, the auditor does not presume that the financial statements are presented fairly in conformity with the applicable financial reporting framework. Instead, the auditor employs an attitude that includes a questioning mind in making critical assessments of the evidence obtained to determine whether the financial statements are materially misstated. PCAOB standards indicate that the auditor should take into account all relevant audit evidence, regardless of whether the evidence corroborates or contradicts the assertions in the financial statements.³⁶ Examples of areas in the evaluation that reflect the need for the auditor to apply professional skepticism, include, but are not limited to, the following:

- *Evaluating uncorrected misstatements.* This includes evaluating whether the uncorrected misstatements identified during the audit result in material misstatement of the financial statements, individually or in combination, considering both qualitative and quantitative factors.³⁷
- *Evaluating management bias.* This includes evaluating potential bias in accounting estimates, bias in the selection and application of accounting principles, the selective correction of misstatements identified during the audit, and identification by management of additional adjusting entries that offset misstatements accumulated by the auditor.³⁸ When evaluating bias, it is important for auditors to consider the incentives and pressures on management to manipulate the financial statements.
- *Evaluating the presentation of the financial statements.* This includes evaluating whether the financial statements contain the information essential for a fair presentation of the financial statements in conformity with the applicable financial reporting framework.³⁹

When evaluating misstatements, bias, or presentation and disclosures, it is important for auditors to appropriately apply professional skepticism and avoid dismissing matters as immaterial without adequate consideration.

Conclusion

The Office of the Chief Auditor is issuing this practice alert to remind auditors of the requirement to appropriately apply professional skepticism throughout their audits, which includes an attitude of a questioning mind and a critical assessment of audit evidence. The timing of this release is intended to facilitate firms' emphasis in upcoming calendar year-end audits, as well as in future audits, on the importance of the appropriate use of professional skepticism. Due to the fundamental importance of the appropriate application of professional skepticism in performing an audit in accordance with PCAOB standards, the

³⁵ See AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.

³⁶ See paragraph 3 of Auditing Standard No. 14.

³⁷ See paragraph 17 of Auditing Standard No. 14.

³⁸ See paragraph 25 of Auditing Standard No. 14.

³⁹ See paragraphs 30-31 of Auditing Standard No. 14.

PCAOB also is continuing to explore whether additional actions might meaningfully enhance auditors' professional skepticism.

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.11 Staff Audit Practice Alert No. 11 Considerations for Audits of Internal Control Over Financial Reporting

October 24, 2013

Staff Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of the standards and rules of the PCAOB and relevant laws. Auditors should determine whether and how to respond to these circumstances based on the specific facts presented. The statements contained in Staff Audit Practice Alerts do not establish rules of the Board and do not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person.

Summary

The Office of the Chief Auditor is issuing this practice alert in light of significant auditing practice issues observed by the Public Company Accounting Oversight Board (“PCAOB” or the “Board”) staff in the past three years relating to audits of internal control over financial reporting (“audits of internal control”). The practice alert highlights certain requirements of the auditing standards of the PCAOB in aspects of audits of internal control in which significant auditing deficiencies have been cited frequently in PCAOB inspection reports. Specifically, this alert discusses the following topics:

- Risk assessment and the audit of internal control
- Selecting controls to test
- Testing management review controls
- Information technology (“IT”) considerations, including system-generated data and reports
- Roll-forward of controls tested at an interim date
- Using the work of others
- Evaluating identified control deficiencies

Auditors should take note of the matters discussed in this alert in planning and performing their audits of internal control. Because of the nature and importance of the matters covered in this alert, it is particularly important for the engagement partner and senior engagement team members to focus on these areas and for engagement quality reviewers to keep these matters in mind when performing their engagement quality reviews. Auditing firms also should consider whether additional training of their auditing personnel is needed for the topics discussed in this alert.

Audit committees of companies for which audits of internal control are conducted might wish to discuss with their auditors the level of auditing deficiencies in this area identified in their auditors’ internal inspections and PCAOB inspections, request information from their auditors about potential root causes of such findings, and ask how they are addressing the matters discussed in this alert. In particular, audit committees may want to inquire about the involvement and focus by senior members of the firm on these matters.

Introduction

Effective internal control over financial reporting (“internal control”) helps assure that companies produce reliable published financial statements that investors can use in making investment decisions. Since the 1970s, federal laws have required public companies to maintain sufficient “internal accounting controls.”¹ The Sarbanes-Oxley Act of 2002, as amended, (“Act”) requires company management to annually assess and report on the effectiveness of the company’s internal control. For larger companies, the Act also requires independent auditors to attest to management’s assessment of the effectiveness of the company’s internal control.²

Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, establishes requirements for performing and reporting on audits of internal control. The audit of internal control should be integrated with the audit of the financial statements. The objectives of the audits are not identical, and the auditor must plan and perform the work to achieve the objectives of both audits. In reporting on an integrated audit of internal control and financial statements (“integrated audit”), the auditor expresses an opinion on the financial statements and an opinion on the effectiveness of the company’s internal control.

Auditing Standard No. 5 establishes a top-down,³ risk-based approach to the audit of internal control. The auditing standard is designed to focus auditors on the most important matters in the audit of internal control and avoid procedures that are unnecessary to an effective audit.

When Auditing Standard No. 5 was adopted, the Board announced its intention to monitor the implementation of that auditing standard. The PCAOB has continued to monitor Auditing Standard No. 5 execution as part of its ongoing oversight activities. Over the last three years, the PCAOB’s inspections staff has observed a significant number of auditing deficiencies in audits of internal control. As reported in *Observations from 2010 Inspections of Domestic Annually Inspected Firms Regarding Deficiencies in Audits of Internal Control Over Financial Reporting* (“the general inspection report”),⁴ in 46 of the 309 integrated audit engagements (or 15 percent) covered by the general inspection

¹ See 15 U.S.C. 78m, which was added to federal securities law by the Foreign Corrupt Practices Act of 1977, which sets forth requirements for devising and maintaining a “system of internal accounting controls” sufficient to provide reasonable assurance that, among other things, transactions are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles or any other applicable criteria.

² See § 404 of the Act. The auditor attestation requirement applies to companies that qualify as “large accelerated filers” or “accelerated filers,” other than “emerging growth companies.” Pursuant to 17 C.F.R. § 240.12b-2, the designation of accelerated filers and large accelerated filers is based on, among other things, the aggregate worldwide market value of the voting and non-voting common equity held by non-affiliates as of the last business day of the issuer’s most recently completed second fiscal quarter. For an accelerated filer, the aggregate market value criterion is \$75 million or more, but less than \$700 million. For a large accelerated filer, the aggregate market value criterion is \$700 million or more.

³ Under PCAOB standards, a top-down approach begins at the financial statement level and with the auditor’s understanding of the overall risks to internal control over financial reporting. The auditor then focuses on entity-level controls and works down to significant accounts and disclosures and their relevant assertions. This approach directs the auditor’s attention to accounts, disclosures, and assertions that present a reasonable possibility of material misstatement to the financial statements and related disclosures. The auditor then verifies his or her understanding of the risks in the company’s processes and selects for testing those controls that sufficiently address the assessed risk of misstatement to each relevant assertion. See paragraph 21 of Auditing Standard No. 5.

⁴ See PCAOB Release 2012-006, *Observations from 2010 Inspections of Domestic Annually Inspected Firms Regarding Deficiencies in Audits of Internal Control Over Financial Reporting* (December 10, 2012).

report, inspections staff found that the firm, at the time it issued its audit report, had failed to obtain sufficient appropriate evidence to support its opinion on the effectiveness of internal control due to one or more auditing deficiencies identified by the inspections staff. The general inspection report also noted that, in an additional 16 percent of the engagements covered by the report, the inspections staff identified other deficiencies in the auditing of internal control that did not involve findings of such significance that they indicated a failure to support the firm's internal control opinion.⁵ Inspections in subsequent years have continued to identify similarly high levels of deficiencies in audits of internal control.

Deficiencies in audits of internal control also can affect the audit of the financial statements. In integrated audits, auditors often rely on controls to reduce their substantive testing of financial statement accounts and disclosures. Thus, deficiencies in testing and evaluating internal control can lead to inadequate testing of accounts and disclosures in the financial statement audit. The general inspection report notes that, in 39 of the 46 engagements (85 percent) in which the inspection staff found that the firm did not have sufficient appropriate evidence to support the firm's internal control opinion, representing 13 percent of the 309 integrated audit engagements that were inspected, inspection staff found that the firm also failed to obtain sufficient appropriate evidence to support its opinion on the financial statements.

Significant auditing deficiencies in audits of internal control that have been frequently cited in PCAOB inspection reports include failures to:

- Identify and sufficiently test controls that are intended to address the risks of material misstatement;
- Sufficiently test the design and operating effectiveness of management review controls that are used to monitor the results of operations;
- Obtain sufficient evidence to update the results of testing of controls from an interim date to the company's year end (i.e., the roll-forward period);
- Sufficiently test controls over the system-generated data and reports that support important controls;⁶
- Sufficiently perform procedures regarding the use of the work of others; and
- Sufficiently evaluate identified control deficiencies.⁷

This practice alert discusses the application of certain requirements of Auditing Standard No. 5 and other PCAOB standards to specific aspects of the audit of internal control in light of recent observations of auditing deficiencies. Specifically, this alert discusses the following topics:

- *Risk assessment and the audit of internal control.* This alert explains how the risk assessment process set forth in PCAOB standards relates to certain aspects of the audit of internal control. It also discusses

⁵ Although the general inspection report relates to inspections of eight domestic registered firms that have been inspected annually since the inception of the PCAOB inspections program, as the report states, PCAOB inspections have found similar problems with audits of internal control at other registered firms.

⁶ See paragraph 39 of Auditing Standard No. 5, which provides that the auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion.

⁷ See, e.g., PCAOB Release 2012-006, *Observations from 2010 Inspections of Domestic Annually Inspected Firms Regarding Deficiencies in Audits of Internal Control Over Financial Reporting* (December 10, 2012).

coordinating the procedures for obtaining an understanding of internal control with the Auditing Standard No. 5 objectives for understanding likely sources of misstatement, assessing risks for components of significant accounts and disclosures, and considering risk in determining the scope of testing in multi-location engagements.

- *Selecting controls to test.* The alert discusses the requirements for selecting controls to test and considerations for making an appropriate selection of controls to test, including controls that operate infrequently.
- *Testing management review controls.* The alert discusses management review controls and the requirements in PCAOB standards for testing those controls.
- *Information technology (“IT”) considerations, including system-generated data and reports.* The alert highlights requirements in PCAOB standards regarding the consideration of IT in audits of internal control, including testing controls that use system-generated data and reports and evaluating deficiencies in IT general controls (“ITGCs”).
- *Roll-forward of controls tested at an interim date.* The alert discusses the auditor’s responsibilities when controls are tested at an interim date in the audit of internal control, including the necessary roll-forward procedures to extend the results of interim testing to year end.
- *Using the work of others.* The alert discusses the requirements in PCAOB standards regarding when it is appropriate to use the work of others, how to determine the extent to which the work can be used, and the importance of testing the work of others.
- *Evaluating identified control deficiencies.* The alert discusses the auditor’s responsibilities for evaluating control deficiencies and highlights the importance of testing compensating controls and performing the evaluation with professional skepticism and careful analysis.

Risk Assessment and the Audit of Internal Control

One of the potential root causes for the deficiencies in audits of internal control, as cited in the general inspection report, is improper application of the top-down approach set forth in PCAOB standards.⁸ For example, the general inspection report notes that, in some instances, it appears that firms, in implementing a top-down approach, placed undue emphasis on testing management review controls and other detective controls without considering whether they adequately addressed the assessed risks of material misstatement of the significant account or disclosure. In some instances, inspections staff observed that firms failed to test controls for all relevant assertions of the significant accounts and disclosures. In other instances, it appeared to the inspections staff that firms did not sufficiently understand the likely sources of potential misstatements related to significant accounts or disclosures as part of selecting controls to test.

⁸ See paragraph 21 of Auditing Standard No. 5. Also, the general inspection report notes that the improper application of the top-down approach may be caused, in part, by other root causes discussed in that report and a reduced focus by firms on the requirements of Auditing Standard No. 5. See the general inspection report at 18.

Risk assessment is a key element of the top-down approach, and it underlies the entire audit process in the audit of internal control.⁹ An effective risk assessment process pursuant to PCAOB standards is fundamental to the audit of internal control.¹⁰ Identifying the risks of material misstatement – including the types of potential misstatements that can occur and the likely sources of those potential misstatements – is necessary for the auditor to select appropriate controls to test and to evaluate whether those controls adequately address the risks. For example, an auditor who identifies revenue overstatement as a risk, without assessing how overstatements might occur or understanding the controls in place to address the risk, lacks the basis to make an informed selection of controls to test or to meaningfully evaluate whether the selected controls are designed and operating to prevent or detect potential misstatements.

Auditing Standard No. 5 requires a risk-based audit approach. Proper application of the auditing standards for assessing and responding to risk (“risk assessment standards”)¹¹ is important for performing effective audits of internal control and integrating the audit of internal control with the audit of financial statements.

Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, establishes a process for identifying and assessing risks of material misstatement in an audit, which applies to audits of internal control and audits of financial statements. The risk assessment procedures required by Auditing Standard No. 12 include, among other things, obtaining an understanding of the company and its environment and obtaining an understanding of internal control. The auditing standard also sets forth a process for assessing identified risks, which includes determining the likely sources of potential misstatement and evaluating the types of misstatements that could result from the risks; the accounts, disclosures, and assertions that could be affected; and the likelihood and magnitude of potential misstatements. potential misstatement and evaluating the types of misstatements that could result from the risks; the accounts, disclosures, and assertions that could be affected; and the likelihood and magnitude of potential misstatements. potential misstatement and evaluating the types of misstatements that could result from the risks; the accounts, disclosures, and assertions that could be affected; and the likelihood and magnitude of potential misstatements.¹²

Obtaining an Understanding of Internal Control

In an audit of internal control, a thorough understanding of the company’s internal control is important because it enables the auditor to appropriately plan and perform the necessary tests of controls. Auditing Standard No. 12 requires the auditor to obtain a sufficient understanding of each component¹³ of internal control to (1) identify the types of potential misstatements, (2) assess

⁹ See paragraph 10 of Auditing Standard No. 5. Also, see generally, Auditing Standard No. 8, *Audit Risk*, Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, and Auditing Standard No. 13, *The Auditor’s Responses to the Risks of Material Misstatement*.

¹⁰ See paragraph 6 of Auditing Standard No. 12 and paragraphs 6 and 10 of Auditing Standard No. 5.

¹¹ Auditing Standard Nos. 8-15.

¹² See paragraphs 59 and 61 of Auditing Standard No. 12.

¹³ Paragraph 21 of Auditing Standard No. 12 provides that internal control can be described as consisting of the following components: the control environment, company’s risk assessment process, information and communication, control activities, and monitoring of controls.

the factors that affect the risks of material misstatement, and (3) design tests of controls and substantive procedures.¹⁴

Understanding internal control includes understanding the information system, including the related business processes, relevant to financial reporting, which comprise the following:

- a. The classes of transactions in the company's operations that are significant to the financial statements;
- b. The procedures, within both automated and manual systems, by which those transactions are initiated, authorized, processed, recorded, and reported;
- c. The related accounting records, supporting information, and specific accounts in the financial statements that are used to initiate, authorize, process, and record transactions;
- d. How the information system captures events and conditions, other than transactions, that are significant to the financial statements; and
- e. The period-end financial reporting process.¹⁵

In an audit of internal control, Auditing Standard No. 5 requires the auditor to perform procedures to achieve certain objectives for further understanding likely sources of potential misstatements and as part of selecting controls to test.¹⁶ The procedures performed to achieve those objectives may be performed concurrently with procedures for identifying and assessing risks of material misstatement pursuant to Auditing Standard No. 12. Performing the procedures concurrently could facilitate compliance with PCAOB standards, enhance the auditor's understanding of the company's processes and likely sources of potential misstatements, and avoid potential duplication of audit effort.

The following table illustrates how certain of the procedures required by Auditing Standard No. 12 can be coordinated with the procedures applied to meet certain of the Auditing Standard No. 5 objectives. For example, while obtaining an understanding of the information system pursuant to Auditing Standard No. 12, the auditor also can perform procedures to understand the flow of transactions for relevant assertions. Similarly, while obtaining an understanding of the company's risk assessment process and control activities, the auditor also can identify the controls that management has implemented to address potential misstatements.

<i>Procedures Required by Auditing Standard No. 12</i>	<i>Related Objective in Auditing Standard No. 5¹⁷</i>
Obtain an understanding of the information system, including the related business processes, relevant to financial reporting ¹⁸	Understand the flow of transactions related to the relevant assertions, including how these transactions are initiated, authorized, processed, and recorded

(continued)

¹⁴ See paragraph 18 of Auditing Standard No. 12 and paragraph 13 of Auditing Standard No. 15, *Audit Evidence*.

¹⁵ See paragraph 28 of Auditing Standard No. 12.

¹⁶ See paragraph 34 of Auditing Standard No. 5.

¹⁷ *Id.*

¹⁸ See paragraph 28 of Auditing Standard No. 12.

<i>Procedures Required by Auditing Standard No. 12</i>	<i>Related Objective in Auditing Standard No. 5¹⁷</i>
Identify and assess the risks of material misstatement at the assertion level and identify significant accounts and disclosures and their relevant assertions ¹⁹	Verify that the auditor has identified the points within the company's processes at which a misstatement – including a misstatement due to fraud – could arise that, individually or in combination with other misstatements, would be material
Obtain an understanding of the company's risk assessment process and ²⁰ control activities, ²¹ and consider controls that address fraud risks and other significant risks ²²	Identify the controls that management has implemented to address the potential misstatements Identify the controls that management has implemented over the prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could result in a material misstatement of the financial statements

Auditing Standard No. 5 and Auditing Standard No. 12 provide that, although walkthroughs are not required, performing walkthroughs that encompass the procedures set forth in the standard²³ is an effective way to meet the required Auditing Standard No. 5 objectives in the table above and may be used in testing the design of controls.²⁴ Thus, careful planning and execution of walkthroughs, particularly when performed or supervised by experienced personnel, can enhance the effectiveness of those aspects of the integrated audit and avoid duplication of effort. Incomplete or poorly executed walkthroughs, however, can lead to inadequate risk assessments, which can impair the effectiveness of auditors' selection and testing of controls.

The general inspection report notes that, in some situations, firms' walkthrough procedures were not adequate to verify the auditor's understanding of the risks in the company's processes and to identify and select for testing controls sufficient to address the risk of misstatement for the relevant assertions, as they were limited to:

- Performing inquiry and observation to confirm that there have been no significant changes to the processes;
- Obtaining an understanding through controls testing and substantive procedures;

¹⁹ See paragraphs 59-64 of Auditing Standard No. 12.

²⁰ See paragraphs 26-27 of Auditing Standard No. 12.

²¹ See paragraph 34 of Auditing Standard No. 12.

²² See paragraphs 72-73 of Auditing Standard No. 12.

²³ Paragraph 37 of Auditing Standard No. 5 provides that, in performing a walkthrough, the auditor follows a transaction from origination through the company's processes, including information systems, until it is reflected in the company's financial records, using the same documents and information technology that company personnel use. Walkthrough procedures usually include a combination of inquiry, observation, inspection of relevant documentation, and re-performance of controls.

²⁴ See paragraphs 37-38 and 43 of Auditing Standard No. 5, paragraphs 20 and 37-38 of Auditing Standard No. 12, and paragraph 20 of Auditing Standard No. 13.

- Reviewing walkthroughs performed by the company's internal auditor who did not provide direct assistance under the firm's supervision; or
- Relying on the auditor's knowledge and experience obtained from prior years' audits.

Assessing Risks of Material Misstatement in Components of Significant Accounts and Disclosures

In assessing risks of material misstatement and selecting controls to test, it is important for auditors to be aware that the components of a potential significant account or disclosure might be subject to significantly different risks.²⁵ Also, different risks of material misstatement affecting the same assertion of an account or disclosure might arise at different points within the company's processes. If risks differ among components, the auditor might need to select and test different controls to support a conclusion that the controls adequately address the risks to the account or disclosure.

The following are some examples of accounts and disclosures for which individual components could have different risks:

- Individual revenue categories might have different risks because of varying types of products and services, sales terms, information systems, including revenue processes, or accounting requirements.
- Individual investment securities or categories of securities in a portfolio might have different risks if they vary in nature and complexity, level of market activity, or availability of observable market data.
- The components of an allowance for loan losses might have different risks, for instance, if those components reflect different credit exposures, are determined using different methods, or are subject to different accounting requirements.
- The components of a reserve for sales returns and allowances might have different risks if they relate to different sales terms or repayment terms, use different information systems, including business processes, or are subject to different accounting requirements.

Effect of Risk Assessment on the Scope of Testing in Multi-location Engagements

Inspections staff have observed instances, such as the following, in which it appeared that firms did not sufficiently test controls that addressed the risks of material misstatement in multi-location engagements:

- Testing a sample of locations and extrapolating the results of that testing to other locations without performing procedures to evaluate whether the issuers' systems and controls were designed and implemented consistently across all of those locations.
- Excluding certain locations from testing without establishing whether there was a reasonable basis for excluding those locations.

Also, inspections staff have observed instances in which it appeared that firms, in implementing a top-down approach, placed undue emphasis on testing management review controls and other detective controls without considering whether the controls selected for testing, individually or in combination,

²⁵ See paragraph 63 of Auditing Standard No. 12.

adequately addressed the assessed risks of material misstatement of the significant account or disclosure across the significant locations.

In multi-location engagements, PCAOB standards require the auditor to assess the risks of material misstatement to the consolidated financial statements associated with the location or business unit and correlate the amount of auditing attention devoted to the location or business unit with the degree of risk.²⁶ Auditing Standard No. 9 lists factors that are relevant to the assessment of the risk of material misstatement associated with a location or business unit and the determination of the necessary audit procedures.²⁷ Certain of the factors listed in Auditing Standard No. 9 relate to the inherent risks of material misstatement, while others – such as the control environment, centralized processing, and monitoring activities – relate to entity-level controls. Auditing Standard No. 5 provides that, in lower risk locations, the auditor might first evaluate whether entity-level controls, including controls in place to provide assurance that appropriate controls exist throughout the organization, provide the auditor with sufficient evidence.²⁸ Auditing Standard No. 5 also provides that the auditor may take into account the work of others in determining the locations or business units at which to perform tests of controls.²⁹ Using the work of others is discussed later in this alert.

To illustrate the application of these principles, assume that an auditor is performing an integrated audit of a company with business units in several locations. After assessing the risks associated with the individual locations, an auditor might design an audit strategy involving:

- a. Identifying and testing controls over specific risks that present a reasonable possibility of material misstatement to the company's consolidated financial statements;
- b. To the extent not covered in item a above, identifying and testing controls at locations or business units that, individually or in combination, present a reasonable possibility of material misstatement through one or more of the following:
 - (1) Testing entity-level controls that operate at a level of precision that would detect material misstatements in the locations or business units, individually or in combination.
 - (2) For locations with centralized systems and processes and homogeneous controls, performing tests of the common controls across the locations or business units.
 - (3) Using the work of others who tested controls at the locations, to the extent appropriate, as discussed later in this release.
- c. No specific testing of controls for locations or business units that individually or in combination do not present a reasonable possibility of material misstatement of the consolidated financial statements.

In testing controls at locations or business units other than controls that address specific risks, the auditor should reassess the audit strategy if the auditor obtains information that is contrary to the premises under which the

²⁶ See paragraph 11 of Auditing Standard No. 9, *Audit Planning*, and paragraph B10 of Auditing Standard No. 5.

²⁷ See paragraph 12 of Auditing Standard No. 9.

²⁸ See paragraph B11 of Auditing Standard No. 5.

²⁹ See paragraph B12 of Auditing Standard No. 5.

audit strategy was developed.³⁰ For example, the strategy should be reassessed if the auditor obtains information indicating certain locations have risks not identified previously; certain locations have higher risk than the initial assessment; certain locations do not have homogeneous processes, systems, controls, or operating environments as previously thought; entity-level controls do not, by themselves, operate with the necessary level of precision; or the work of others cannot be used to the extent planned.

Selecting Controls to Test

As discussed previously, the general inspection report notes that, in some instances, it appears that firms, in implementing a top-down approach, placed undue emphasis on testing management review controls and other detective controls without considering whether they adequately addressed the assessed risks of material misstatement of the significant account or disclosure. In some instances, inspections staff observed that firms failed to test controls for all the relevant assertions of the significant accounts and disclosures.

In the audit of internal control, PCAOB standards require the auditor to test:³¹

- a. Entity-level controls that are important to the auditor's conclusion about whether the company has effective internal control over financial reporting, including evaluating the control environment and period-end financial reporting process;³² and
- b. Controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion (which may be entity-level controls or other controls).³³

Also, Auditing Standard No. 5 cautions that a control must be tested directly to obtain evidence about its effectiveness; an auditor cannot merely infer that a control is effective because no misstatements were detected by substantive procedures.³⁴

In selecting controls over significant accounts and disclosures, an important consideration is determining that the auditor has selected controls that, individually or in combination, are intended to address the identified risks of material misstatement, including risks for the relevant assertions and the components of the account or disclosure with differing risks. The following is a partial list from the general inspection report of assertions or account components for which inspections staff observed that auditors failed to identify and sufficiently test controls that addressed the risks of material misstatement:

- Revenue: Significant business units or significant revenue categories, significant contract provisions affecting revenue recognition, and significant inputs to percentage-of-completion calculations
- Inventory: Pricing of significant inventory components and determination of reserves for excess and obsolete inventory

³⁰ See paragraph 15 of Auditing Standard No. 9 and paragraph 74 of Auditing Standard No. 12, which discuss the auditor's responsibilities for changing the audit strategy and planned audit procedures when circumstances change or contrary information is identified.

³¹ Paragraph 14 of Auditing Standard No. 5 provides that the auditor also should evaluate whether the company's controls sufficiently address identified fraud risks and controls intended to address the risk of management override.

³² See paragraphs 22 and 26 of Auditing Standard No. 5.

³³ See paragraphs 23, 39, and 41 of Auditing Standard No. 5.

³⁴ See paragraph B9 of Auditing Standard No. 5.

- Fair value of financial instruments: Inputs used to value hard-to-value financial instruments and determinations of the classification of securities within the fair value hierarchy set forth in Financial Accounting Standards Board *Accounting Standards Codification* Topic 820, *Fair Value Measurement*
- Valuation of pension plan assets³⁵

To illustrate the process of selecting controls to test, assume that an auditor identifies risks of material misstatement related to reserves for excess and obsolete inventory. When selecting controls that are important to address the risks of material misstatement, it is important to look for controls that encompass each segment of inventory for which there is a reasonable possibility of material misstatement regarding the related reserve for excess and obsolete inventory. Limiting the selection to controls over inventory segments that have no reserves, for example, would not be sufficient to address the risk of material misstatement.

The procedures performed to obtain an understanding of internal control pursuant to Auditing Standard No. 12 and to meet the objectives of paragraph 34 of Auditing Standard No. 5 can provide a basis for the auditor to determine whether the selected controls cover the identified risks. For example, performing those procedures enables the auditor to understand the likely sources of potential misstatement and the controls intended to prevent or detect those misstatements.

Another important consideration in selecting controls to test is whether the controls, individually or in combination, are capable of addressing the risks of material misstatement to the relevant assertion.³⁶ Some risks, especially those related to complex processes or subjective estimates, might require a combination of controls to prevent or detect misstatements. For example, if a company has a complex income tax calculation, the controls needed to address the risks of material misstatement might consist of a combination of (1) a review of the overall tax calculation by a person with the necessary authority and competence and (2) certain other types of controls over key aspects of the calculation. As another example, an auditor might select a combination of a manual review control that uses system-generated data and IT controls over the completeness and accuracy of that data, as discussed later in this alert.

Controls over Infrequent Processes and Transactions

Internal control is not limited to frequent processes and normal recurring transactions. It also applies to infrequent processes, such as an analysis of whether long-term assets are impaired, and to nonrecurring transactions outside the normal course of business, such as a material business combination.

When a company has infrequent processes or enters into nonrecurring transactions that present a reasonable possibility of material misstatement of the financial statements, the auditor should test the controls over those processes or transactions. Performing substantive audit procedures to determine whether the accounts or transactions are accounted for properly is important for the financial statement audit but, by itself, does not provide sufficient appropriate evidence to support a conclusion that the controls over those transactions or analyses are designed and operating effectively. As discussed previously, Auditing Standard No. 5 cautions that a control must be tested directly to obtain evidence about its effectiveness; an auditor cannot merely infer that a control

³⁵ See the general inspection report at 5-6.

³⁶ See paragraphs 23, 39, and 41 of Auditing Standard No. 5.

is effective because no misstatements were detected by substantive procedures.³⁷

In some cases, auditors are able to design and perform procedures that test controls over nonrecurring transactions concurrently with substantive tests of those transactions, thereby obtaining sufficient appropriate evidence to fulfill the related objectives for the financial statement audit and the audit of internal control. For example, when auditing the company's accounting for a business combination, the auditor also might obtain an understanding of the company's financial reporting process, and related controls, regarding the business combination. In that situation, the auditor could test important controls over the accounting for business combinations when auditing the accounting for the business combination. In that situation, the auditor's substantive testing and tests of controls should be sufficient to meet the objectives of both tests.

Testing Management Review Controls

Auditors often select and test management review controls in audits of internal control. Such management reviews might be performed to monitor the results of operations, such as (1) monthly comparisons of actual results to forecasted revenues or budgeted expenses; (2) comparisons of other metrics, such as gross profit margins and expenses as a percentage of sales; and (3) quarterly balance sheet reviews. These reviews typically involve comparing recorded financial statement amounts to expected amounts and investigating significant differences from expectations.

As with other types of controls, the auditor should perform procedures to obtain evidence about how a management review control is designed and operates to prevent or detect misstatements.³⁸ Verifying that a review was signed off provides little or no evidence by itself about the control's effectiveness.

Evaluating the Precision of Management Review Controls

Many management review controls are entity-level controls, so testing those review controls can be an appropriate part of a top-down approach. Auditing Standard No. 5 provides that entity-level controls vary in nature and precision and that some entity-level controls might operate at a level of precision that would adequately prevent or detect misstatements on a timely basis.³⁹ Other entity-level controls, by themselves, might not operate with the necessary level of precision, but might be effective in combination with other controls in addressing the assessed risk of material misstatement.

Thus, the main consideration in assessing the level of precision is whether the control is designed and operating to prevent or detect on a timely basis misstatements that could cause the financial statements to be materially misstated. Factors that can affect the level of precision of an entity-level control include the following:

- *Objective of the review.* A procedure that functions to prevent or detect misstatements generally is more precise than a procedure that merely identifies and explains differences.
- *Level of aggregation.* A control that is performed at a more granular level generally is more precise than one performed at a higher level.

³⁷ See paragraph B9 of Auditing Standard No. 5.

³⁸ See paragraphs 42-45 of Auditing Standard No. 5, which describe the auditor's responsibilities for testing the design and operating effectiveness of controls.

³⁹ See paragraph 23 of Auditing Standard No. 5.

For example, an analysis of revenue by location or product line normally is more precise than an analysis of total company revenue.

- *Consistency of performance.* A control that is performed routinely and consistently generally is more precise than one performed sporadically.
- *Correlation to relevant assertions.* A control that is indirectly related to an assertion normally is less likely to prevent or detect misstatements in the assertion than a control that is directly related to an assertion. For example, a control designed to detect errors in the recorded amounts of accounts receivable might not operate with a sufficient level of precision to detect errors in the valuation of delinquent receivables.
- *Predictability of expectations.* Some entity-level controls are designed to detect misstatements by using key performance indicators or other information to develop expectations about reported amounts (“detective controls”). The precision of those controls depends on the ability to develop sufficiently precise expectations to highlight potentially material misstatements.
- *Criteria for investigation.* For detective controls, the threshold for investigating deviations or differences from expectations relative to materiality is an indication of a control’s precision. For example, a control that investigates items that are near the threshold for financial statement materiality has less precision and a greater risk of failing to prevent or detect misstatements that could be material than a control with a lower threshold for investigation.

Testing Design Effectiveness

Auditing Standard No. 5 provides that the auditor should test the design effectiveness of controls by determining whether the company’s controls, if they are operated as prescribed by persons possessing the necessary authority and competence, satisfy the company’s control objectives⁴⁰ and can effectively prevent or detect errors or fraud that could result in material misstatement of the financial statements.⁴¹

Evaluating whether a management review control is capable of preventing or detecting potential material misstatements generally involves obtaining an understanding of and evaluating the following:

- a. Whether the control satisfies the corresponding control objective, including whether it addresses the risks of material misstatement to the relevant assertion of the significant account or disclosure;
- b. The factors affecting the precision of the review, including the objective of the review and the appropriateness of the expectations, level of aggregation, and criteria for investigation for identifying potentially material misstatements;
- c. The steps involved in identifying, investigating, and resolving significant differences from expectations;
- d. The person(s) who performs the control, including the competence and authority of the person(s);

⁴⁰ See paragraph A2 of Auditing Standard No. 5 for the definition of the term “control objective.”

⁴¹ See paragraph 42 of Auditing Standard No. 5.

- e. The frequency of performance of the control, that is, whether the review occurs often enough to prevent or detect misstatements before they have a material effect on the financial statements; and
- f. The information used in the review, for example, whether the review uses system-generated data or reports, as discussed later in this alert.

The evaluation of design may be performed in conjunction with obtaining an understanding of internal control over financial reporting and performing procedures to achieve the objectives of paragraph 34 of Auditing Standard No. 5, which were presented in the prior table.⁴² For example, to assess whether a control is effectively designed, it is important to identify the risk of material misstatement to the relevant assertion of the significant account or disclosure that the control is intended to address.

Testing Operating Effectiveness

Auditing Standard No. 5 provides that the auditor should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control has the necessary authority and competence to perform the control effectively.⁴³ The auditing standard also provides that the evidence necessary to persuade the auditor that a control is effective depends upon the risk associated with the control.⁴⁴

Testing the operating effectiveness of a management review control involves performing procedures to evaluate whether the control is working as designed to prevent or detect potentially material misstatements. Testing typically involves, for selected operations of the control, obtaining and evaluating evidence about:⁴⁵

- a. The steps performed to identify and investigate significant differences; and
- b. The conclusions reached in the reviewer's investigation, including whether potential misstatements were appropriately investigated and whether corrective actions were taken as needed.

The nature, timing, and extent of testing should be commensurate with the risk associated with the controls. Higher risk controls warrant more testing.

The auditor also should take into account other relevant evidence obtained in the audit when evaluating the effectiveness of a control, such as identified misstatements that were not prevented or detected by the control.⁴⁶

Example: Test of a Management Review Control

To illustrate the process of testing management review controls, assume that, in an audit of a commercial enterprise with four similar branch locations, the auditor selects for testing a monthly control over the existence, completeness,

⁴² See paragraph 43 of Auditing Standard No. 5, which provides that procedures the auditor performs to test design effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation. Walk-throughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.

⁴³ See paragraph 44 of Auditing Standard No. 5.

⁴⁴ See paragraph 46 of Auditing Standard No. 5.

⁴⁵ If the control uses system-generated information or reports, the auditor also should obtain evidence about the completeness and accuracy of those reports, as discussed in the information technology considerations section of this alert. This also applies to other internally-produced information used by the company in an important control.

⁴⁶ See paragraph 71 of Auditing Standard No. 5.

and allocation assertions for certain selling, general, and administrative expenses, such as salaries and wages, utilities, facilities, and depreciation. In the selected control, each branch controller performs an analysis comparing the expense-related accounts in the branch's financial statements to the prior year and forecasted financial statements for the branch and investigates differences over a predetermined threshold set by the company's chief financial officer ("CFO"). Each branch controller discusses the results of the analysis with the CFO to enable the CFO to understand the basis for significant differences and determine whether any financial statement adjustments or other corrective actions are needed.

The auditor assesses a higher risk associated with the management review control because the control applies to multiple assertions for several material accounts with varying levels of risk of material misstatement.⁴⁷

In this illustration, the auditor's procedures may include the following:⁴⁸

- a. Evaluating whether the control addresses the risks of material misstatement to the relevant assertions of the selling, general, and administrative expense accounts, as intended;
- b. Evaluating whether the use of prior year and forecast information at the branch level is an appropriate basis for establishing expectations to identify potential misstatements;
- c. Evaluating whether the criteria used for identifying differences for investigation are set at an appropriate level to enable the branch controller to identify misstatements that could be material to the financial statements, individually or in combination with other misstatements;
- d. Evaluating the competencies of the CFO and branch controllers based on, among other things, the auditor's knowledge of the individuals and experience with them in current and prior audits;
- e. Evaluating whether the control operates often enough to prevent or detect misstatements before they have a material effect on the financial statements;
- f. For selected operations of the control, obtaining the information used by the branch controller in the analysis, understanding the steps performed by the branch controller to investigate significant differences, reperforming the analysis and comparing the auditor's identification of significant differences and evaluation of results – including identified misstatements, if any – to the branch controller's analysis; and
- g. Observing or reading summaries of selected meetings in which the results of the analyses by the branch controllers were discussed with the CFO; inspecting the information presented to the CFO; and evaluating the matters discussed, conclusions reached, and corrective actions taken, if any.

⁴⁷ See, e.g., paragraph 47 of Auditing Standard No. 5, which provides that two factors affecting the risk associated with a control are (1) the nature and materiality of misstatements that the control is intended to prevent or detect and (2) the inherent risk associated with the related account(s) and assertion(s).

⁴⁸ The procedures listed here are illustrative. The actual procedures needed for a particular management review control will depend on, among other things, the nature of the control, the risk associated with the control, the information used in the control, and the evidence of the control's operation.

The auditor also determined that the control uses financial statement and forecast information that is maintained and reported by the same IT system. The company's IT systems are centrally managed, and the IT controls for that system were tested in conjunction with tests of IT controls for the company's other financial statement related systems.

The preceding example illustrates an approach to testing accounts that tend to be routine and predictable. If testing controls over accounts or assertions that are more complex or less predictable, management review controls consisting primarily of comparisons to budgets or forecasts might not operate at a sufficient level of precision. In those situations, it might be necessary to test a combination of management review controls and other controls to conclude on whether the company's controls sufficiently address the risks of material misstatement for the relevant assertions of significant accounts.

Information Technology Considerations, Including System-generated Data and Reports

The general inspection report notes that inspections staff have observed instances in which firms selected controls for testing but failed to sufficiently test controls over the completeness and accuracy of system-generated data or reports used in the operation of those controls. For example, some firms failed to: (1) test ITGCs that are important to the effective operation of the applications that generated the data or reports, (2) test the logic of the queries (or parameters) used to extract data from the IT applications used in the reports, or (3) address control deficiencies that were identified with respect to the ITGCs over either the applications that process the data used in the reports or the applications that generated the reports.⁴⁹ Similarly, inspections staff have observed instances in which firms have identified that certain ITGCs were ineffective but failed to perform other procedures to test report writers and systems used to produce spreadsheets, queries, or reports. In other instances, the firms planned their tests of controls to include testing of ITGCs for IT-dependent controls, but those IT-dependent controls used customized data or queries that were not subject to the ITGCs the firms tested.

A company's use of IT can significantly affect a company's internal control. The following are examples of IT-related matters that can affect the auditor's evaluation of internal control:

- Risks of material misstatement resulting from the company's IT processes or systems;⁵⁰
- Important controls that depend on the effectiveness of IT controls ("IT-dependent controls"), for example, because they use system-generated data or reports; and
- Important IT controls, such as, automated controls that address risks of material misstatement to one or more assertions, along with the IT controls that support the effectiveness of the automated controls.

PCAOB standards require the auditor to obtain an understanding of the company's information system relevant to financial reporting and take into account IT considerations in assessing the risks of material misstatement. This includes obtaining an understanding of the extent of manual controls and

⁴⁹ See the general inspection report at 11.

⁵⁰ See, e.g., paragraphs 36 and 47 of Auditing Standard No. 5 and paragraphs B1-B6 and 29 of Auditing Standard No. 12.

automated controls used by the company, including the ITGCs that are important to the effective operation of the automated controls.⁵¹ The auditor also should obtain an understanding of specific risks to a company's internal control resulting from IT.⁵²

In an audit of internal control, if the auditor selects an IT-dependent control for testing, the auditor should test the IT-dependent controls and the IT controls on which the selected control relies to support a conclusion about whether those controls address the risks of material misstatement.⁵³ For example, if a control selected for testing uses system-generated data or reports, the effectiveness of the control depends in part on the controls over the accuracy and completeness of the system-generated data or reports. In those situations, supporting a conclusion on the effectiveness of the selected control involves testing both the selected control and the controls over the system-generated data and reports.

As discussed later in this alert, PCAOB standards require evaluation of the severity of identified control deficiencies. This includes deficiencies in IT controls. However, the nature of IT systems, processes, and controls can affect how deficiencies in IT controls should be evaluated. For example, an IT control might not be intended to prevent or detect misstatements by itself, but it might impair the effectiveness of important IT-dependent controls if it were deficient. In those situations, evaluating the severity of a deficient IT control involves assessing the effect of the deficiency on important IT-dependent controls and, in turn, the likelihood and magnitude of potential misstatements that could result, individually or in combination with other control deficiencies. Also, deficient IT controls might impair the effectiveness of multiple controls across multiple accounts. In those situations, it may be necessary to assess the severity of those impaired controls in combination across the affected accounts and with other control deficiencies affecting those accounts.

Roll-forward of Controls Tested at an Interim Date

The general inspection report notes that inspections staff have identified instances in which firms tested significant controls at an interim date and either did not perform any testing, or used inquiry alone, to update the results of their testing of higher risk controls that had been performed prior to year end. For example, an engagement team performed tests of highly subjective controls during the interim period, three to six months prior to year end. Yet the engagement team's procedures to update the results of its testing of these controls from the interim date to year end were limited to general inquires as to whether the operation of any of these controls had changed, despite higher degrees of risks associated with these controls, including, in some cases, high inherent risks or heightened fraud risks. In another example, the engagement team's procedures to update the results of its testing of internal control for the six-month period from the interim date to year end were limited to inquiry, including for higher-risk controls and controls affected by a change in management review and approval responsibilities.⁵⁴

Although the auditor expresses an opinion on internal control as of the end of the year, auditors may decide to test some important controls at an earlier date. When auditors test controls at an interim date, PCAOB standards require

⁵¹ See paragraph B1 of Auditing Standard No. 12.

⁵² See paragraph B4 of Auditing Standard No. 12.

⁵³ See, e.g., paragraphs 39-41 of Auditing Standard No. 5, which discuss selecting controls to test and paragraph 47 of Auditing Standard No. 5, which cite situations in which controls rely on the effectiveness of IT general controls.

⁵⁴ See the general inspection report at 10.

auditors to perform “roll-forward” procedures to update the results of interim testing to year end.⁵⁵ The amount of evidence needed from the roll-forward procedures depends on the following factors:

- The specific control tested at an interim date, including the risks associated with the control and the nature of the control, and the results of those tests;
- The sufficiency of the evidence of effectiveness obtained at an interim date;
- The length of the roll-forward period; and
- The possibility that there have been any significant changes in internal control over financial reporting subsequent to the interim date.⁵⁶

Auditing Standard No. 5 provides that inquiry might be a sufficient roll-forward procedure when evaluation of the preceding factors indicates a low risk that the controls are no longer effective during the roll-forward period.⁵⁷ For example, inquiry might be appropriate if the risk associated with the control were low, the auditor obtained substantially all of the evidence necessary to support the conclusion on the control as of the interim date with no observed test exceptions, the roll-forward period was relatively short, and there were no significant changes in internal control during the roll-forward period. Conversely, inquiry is unlikely to be sufficient if the control is more complex, subjective or otherwise higher risk; the control was not tested extensively at the interim date; exceptions were noted in the interim testing; the roll-forward period spans a significant portion of the year; or significant changes occurred in internal control during the roll-forward period. Similarly, when inquiry is not sufficient, the additional evidence to cover the roll-forward period cannot be inferred from the absence of misstatements detected by substantive procedures.⁵⁸

Using the Work of Others

The general inspection report notes that inspections staff have identified situations in which firms used the work of others, most often internal audit, who performed tests of controls without establishing a sufficient basis for using that work. For example, in some instances, the extent to which firms used the work of internal audit in higher risk areas involving significant judgment, such as aspects of revenue and the valuation of complex, hard-to-value investment securities, was inappropriate. Also, in some instances, firms failed to evaluate the design of internal audit’s control testing procedures, including the scoping and the identification of important controls. For example, the engagement team used the work of internal audit to test controls over revenue. The engagement team did not re-perform any of the tests of controls performed by the issuer’s internal audit group. In addition, there was no documentation of the nature, timing, and extent of the control testing performed by internal audit.⁵⁹

⁵⁵ See paragraph 55 of Auditing Standard No. 5. If the auditor plans to rely on controls in the financial statement audit, the auditor must obtain evidence about the controls over the entire period of reliance, as discussed in paragraphs 16 and 29-30 of Auditing Standard No. 13.

⁵⁶ See paragraph 56 of Auditing Standard No. 5.

⁵⁷ *Id.*

⁵⁸ See paragraph B9 of Auditing Standard No. 5.

⁵⁹ See the general inspection report at 12.

PCAOB standards allow the auditor to use the work of others as evidence of the effectiveness of selected controls, and Auditing Standard No. 5 requires auditors to determine the extent to which the work of others will be used.⁶⁰

PCAOB standards provide that the extent to which the work of others can be used depends on the following factors:

- The risk associated with the control being tested;⁶¹ and
- The competence and objectivity of the persons whose work the auditor plans to use.⁶² For example, persons who test controls are less objective if they report to those responsible for the operation of the controls being tested.

The risk associated with the control is the risk that a control might not be effective and, if not effective, that a material weakness would result.⁶³ Auditing Standard No. 5 discusses factors that affect the risk associated with a control, including the complexity of the control and significance of judgments that must be made in connection with its operation and the inherent risks of the related account or assertion.⁶⁴ As the risk associated with the control increases, the need for the auditor to perform his or her own testing of the control increases.⁶⁵ In higher risk areas, such as testing complex controls, controls that address specific fraud risks, or controls that require significant judgment to operate or evaluate, use of the work of others would be limited, if at all.⁶⁶ Conversely, the work of competent and objective persons could be used more extensively in lower risk areas.

PCAOB standards provide direction on evaluating the competence and objectivity of others.⁶⁷ The higher the degree of competence and objectivity, the greater use the auditor may make of the work. The impact of the work of others on the auditor's work also depends on the relationship between the risk associated with the control and the competence and objectivity of those who performed the work. As the risk decreases, the necessary level of competence and objectivity decreases.⁶⁸

When the auditor uses the work of others, the auditor also should test and evaluate that work, including evaluating the quality and effectiveness of the others' work.⁶⁹ The necessary extent of testing of that work depends on the risk associated with the control and the competence and objectivity of the others. More extensive testing of the others' work is needed as the risk increases or the others' level of competence or objectivity decreases. When using the work of

⁶⁰ See paragraphs 16-17 of Auditing Standard No. 5.

⁶¹ See paragraph 19 of Auditing Standard No. 5.

⁶² See paragraph 18 of Auditing Standard No. 5 and paragraphs .09-.11 of AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*.

⁶³ See paragraph 46 of Auditing Standard No. 5.

⁶⁴ See paragraph 47 of Auditing Standard No. 5.

⁶⁵ See paragraph 19 of Auditing Standard No. 5.

⁶⁶ See PCAOB Release 2007-005A, *Auditing Standard No. 5—An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements and Related Independence Rule and Conforming Amendments* (June 12, 2007), at 14.

⁶⁷ See paragraph 18 of Auditing Standard No. 5 and AU sec. 322.09-.11. For example, the objectivity of the others is lower when they report directly to management or to the person performing the control they are evaluating.

⁶⁸ See PCAOB Release 2007-005A at 14.

⁶⁹ See paragraph 16 of Auditing Standard No. 5 and AU sec. 322.24-.27. See also PCAOB Release 2007-005A at A4-4.

others that provide direct assistance, the auditor should supervise that work, including reviewing the work, as well as testing and evaluating it.⁷⁰

Evaluating Identified Control Deficiencies

The general inspection report notes that inspections staff observed instances in which firms failed to evaluate sufficiently the severity of the control deficiencies that they had identified. Specifically, in some cases firms did not:

- *Sufficiently evaluate whether audit adjustments and exceptions identified from substantive procedures were indicators of the existence of control deficiencies.* For example, the firm's valuation specialist concluded that the recorded fair values of certain of the issuer's assets were outside a reasonable range due to the use of unsupported assumptions. This resulted in a significant audit adjustment that the issuer recorded. The issuer's controls had failed to identify that the valuation assumptions were not supported; however, the engagement team failed to identify and evaluate this control deficiency.
- *Consider all of the relevant risk factors that should have affected the determination of whether there was a reasonable possibility that a deficiency, or a combination of deficiencies, could result in a material misstatement.* For example, a significant deficiency was identified over the issuer's process for valuing hard-to-value financial instruments. The engagement team failed to appropriately evaluate the severity of the deficiency as it did not evaluate relevant risk factors, such as, the nature of the accounts affected by the deficiency, and the subjectivity, complexity, or extent of judgment required to determine the valuations. In addition, the engagement team did not consider the magnitude of audit adjustments related to this control deficiency in determining whether the control deficiency was a material weakness rather than a significant deficiency.
- *Consider all of the relevant factors that should have affected the determination of the magnitude of potential misstatements.* For example, an engagement team did not sufficiently evaluate the severity of certain control deficiencies identified through tests of controls over revenue. Specifically, as part of the issuer's evaluation of control deficiencies, management calculated the magnitude of the potential misstatement resulting from the control deficiencies using certain significant assumptions. The engagement team used the issuer's evaluation but did not assess the reasonableness of the issuer's assumptions.
- *Sufficiently evaluate compensating controls, including identifying and testing those controls and determining whether they operated at a level of precision that would prevent or detect a misstatement that could be material.* For example, an engagement team concluded that certain compensating controls partially mitigated the effect of the deficiencies and that the control deficiencies therefore constituted a significant deficiency rather than a material weakness. The engagement team, however, failed to obtain sufficient appropriate audit evidence to support its conclusion that the compensating controls operated at a level of precision that would prevent or detect a misstatement that could be material. Specifically, the engagement team concluded that one of the compensating controls operated effectively even though the

⁷⁰ *Id.*

control failed to identify an error that was in excess of the engagement team's established materiality.⁷¹

Control deficiencies might be identified during the audit of the financial statements as well as the audit of internal control. For example, an error identified in the financial statement audit often results from a deficiency in the design or operation of controls, or a lack of controls, over that account or disclosure. PCAOB standards require auditors to evaluate the effect of the findings of the substantive procedures performed in the financial statement audit on the effectiveness of internal control.⁷² This includes identifying and evaluating any specific control deficiencies related to the identified misstatements.

PCAOB standards require auditors to evaluate the severity of each control deficiency that comes to his or her attention to determine whether the deficiencies, individually or in combination, are material weaknesses.⁷³ Auditing Standard No. 5 provides that the severity of a control deficiency depends on (1) whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement of an account balance or disclosure and (2) the magnitude of the potential misstatement resulting from the deficiency or deficiencies.⁷⁴ The severity of a deficiency does not depend on whether a misstatement actually has occurred but rather on whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement.⁷⁵

Auditing Standard No. 5 also provides additional direction on evaluating the severity of control deficiencies, including risk factors that affect the evaluation of the likelihood and potential magnitude of misstatements resulting from control deficiencies and indicators of material weaknesses.⁷⁶ For example, deficiencies in controls over the key assumptions in a significant accounting estimate could result in a reasonable possibility of misstatement because of the subjectivity, complexity, or extent of judgment required to determine the amount of the estimate. Also, multiple control deficiencies affecting the same account can increase the likelihood of misstatement. Similarly, the magnitude of potential misstatements resulting from a deficiency is greater for control deficiencies affecting processes with large transaction volumes or the existence of accounts with large recorded amounts.

In forming a conclusion about whether a control deficiency or combination of deficiencies is a material weakness, the auditor should evaluate the effect of compensating controls, if any. This includes testing the compensating controls to determine whether they operate at a level of precision that would prevent or detect a misstatement that could be material. This includes evaluating whether the control addresses the risk of material misstatement to the relevant assertion intended to be addressed by the deficient control. If the compensating control is a management review control, the previously discussed considerations for testing management review controls apply to the compensating control.

Evaluating whether a control deficiency, or a combination of control deficiencies, results in a material weakness requires professional skepticism and a

⁷¹ See the general inspection report at 13-14.

⁷² See paragraph B8 of Auditing Standard No. 5.

⁷³ See, e.g., paragraph 62 and the second note to paragraph 65 of Auditing Standard No. 5.

⁷⁴ See paragraph 63 of Auditing Standard No. 5.

⁷⁵ See paragraph 64 of Auditing Standard No. 5.

⁷⁶ See paragraphs 64-70 of Auditing Standard No. 5, which set forth additional requirements and direction regarding evaluating the severity of control deficiencies.

Careful analysis of all the evidence obtained. Auditors who perform a mechanical or cursory evaluation of deficiencies might reach premature conclusions without appropriately considering critical information. For example, a mechanical or cursory evaluation may lead an auditor to

- Assess control deficiencies in isolation, without considering the effects of deficiencies in combination;
- Consider only the amount of identified misstatements, without evaluating the magnitude of potential misstatement that could occur; or
- Focus on a checklist of material weakness indicators without considering other relevant factors.

Conclusion

An integrated audit of financial statements and internal control benefits investors because the auditor's reports address both the audited financial statements and the effectiveness of the controls the company uses to produce its financial statements. Appropriate application of the top-down, risk based approach pursuant to PCAOB standards can result in an effective audit of internal control while avoiding unnecessary work.

The PCAOB has observed through its inspections a significant number of audit deficiencies in audits of internal control over the past three years. This alert discusses certain significant matters relating to the application of PCAOB standards to audits of internal control, in light of these inspections observations.

Auditors should take note of the matters discussed in this alert in planning and performing their audits of internal control. Because of the nature and importance of the matters covered in this alert, it is particularly important for the engagement partner and senior engagement team members to focus on these areas and for engagement quality reviewers to keep these matters in mind when performing their engagement quality reviews. Auditing firms also should consider whether additional training of their auditing personnel is needed for the topics discussed in this alert.

Audit committees of companies for which audits of internal control are conducted might wish to discuss with their auditors the level of auditing deficiencies in this area identified in their auditors' internal inspections and PCAOB inspections, request information from their auditors about potential root causes of such findings and ask how they are addressing the matters discussed in this alert. In particular, audit committees may want to inquire about the involvement and focus by senior members of the firm on these matters.

As noted in the general report, audit committees may consider inquiring of the issuer's auditor how the controls to be tested will address the assessed risks of material misstatement for relevant assertions of significant accounts and disclosures. Also, audit committees may consider discussing with the auditor his or her assessment of risks, evaluation of control deficiencies, and whether the auditor has adjusted as necessary the nature, timing, and extent of his or her control testing and substantive audit procedures in response to risks related to identified control deficiencies.

The PCAOB will continue to monitor the execution of audits of internal control as part of its ongoing oversight activities.

* * *

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TRUST SERVICES PRINCIPLES, CRITERIA, AND ILLUSTRATIONS

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TSP**TRUST SERVICES PRINCIPLES,
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Section 100

Trust Services Principles and Criteria for Security, Availability, Processing Integrity, Confidentiality, and Privacy

(To supersede the 2009 version of *Trust Services Principles, Criteria, and Illustrations for Security, Availability, Processing Integrity, Confidentiality, and Privacy* (TSP section 100A). The privacy criteria are presented in appendix C. These criteria are the same criteria set forth in appendix D of TSP section 100A. The privacy criteria are currently under revision. The criteria in TSP section 100 are effective for periods ending on or after December 15, 2014, with earlier implementation permitted. TSP section 100A will retain the superseded material until March 31, 2016. The practitioner should identify which set of criteria was used for the report and assertion.)

Introduction

.01 The AICPA Assurance Services Executive Committee (ASEC) has developed a set of principles and criteria (trust services principles and criteria) to be used in evaluating controls relevant to the security, availability, and processing integrity of a system, and the confidentiality and privacy of the information processed by the system. In this document, a *system* is designed, implemented, and operated to achieve specific business objectives (for example, delivery of services, production of goods) in accordance with management-specified requirements. System components can be classified into the following five categories:

- *Infrastructure*. The physical structures, IT, and other hardware (for example, facilities, computers, equipment, mobile devices, and telecommunications networks).
- *Software*. The application programs and IT system software that supports application programs (operating systems, middleware, and utilities).
- *People*. The personnel involved in the governance, operation, and use of a system (developers, operators, entity users, vendor personnel, and managers).
- *Processes*. The automated and manual procedures.
- *Data*. Transaction streams, files, databases, tables, and output used or processed by a system.

.02 This document presents the trust services principles and criteria for assessing the effectiveness of an entity's controls over a system relevant to the security, availability, or processing integrity of the system, or the confidentiality or privacy of the information processed by the system. Management of an entity may use the principles and criteria to evaluate its controls over a system or may engage a CPA to report on or provide consulting services related to those controls.

.03 Attestation services, performed under the AICPA's Statements on Standards for Attestation Engagements (commonly known as the *attestation*

standards), include examination, review,¹ and agreed-upon procedures engagements. In the attestation standards, the CPA performing an attest engagement is known as a practitioner. In an examination engagement, the practitioner provides a report that expresses an opinion about subject matter or an assertion about subject matter in relation to an identified set of criteria. For example, a practitioner may report on whether controls over a system were operating effectively to meet the trust services criteria for processing integrity and confidentiality. In an agreed-upon procedures engagement, the practitioner does not express an opinion but rather performs procedures agreed upon by specified parties and reports the results of those procedures. Examination engagements are performed in accordance with AT section 101, *Attest Engagements*, of the attestation standards and agreed-upon procedures engagements are performed in accordance with AT section 201, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*).

.04 The following are the types of subject matter a practitioner may examine and report on using the trust services principles and criteria:

- The design and operating effectiveness of a service organization's controls over a system relevant to one or more of the trust services principles of security, availability, processing integrity, confidentiality, and privacy (SOC 3SM engagement).
- The fairness of the presentation of a description of a service organization's system relevant to one or more of the trust services principles of security, availability, processing integrity, confidentiality, and privacy using the description criteria in paragraph 1.34 of the AICPA Guide *Reporting on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality or Privacy* (SOC 2SM), and additionally in paragraph 1.35 for the privacy principle; for a type 1 report, the suitability of the design of controls to meet the related trust services criteria; and, for a type 2 report, the operating effectiveness of those controls throughout a specified period to meet those trust services criteria (SOC 2 engagement).
- The suitability of the design of an entity's controls over a system relevant to one or more of the trust services principles of security, availability, processing integrity, confidentiality, and privacy to meet the related trust services criteria. (This engagement would typically be performed prior to the system's implementation.)

.05 The nature and extent of the services that an organization provides to each user entity may vary significantly depending on the user entity's needs. For example, a social organization that uses a website for a monthly newsletter would have a much more limited need for data center hosting service availability than would a securities trading firm. The social organization is likely to be only slightly inconvenienced if its newsletter is unavailable for one day; whereas, the securities trading firm could experience a significant financial loss if the system is unavailable for 15 minutes. Such user needs generally are

¹ Review engagements generally consist of the performance of inquiries and analytical procedures designed to provide a moderate level of assurance (that is, negative assurance). However, the Assurance Services Executive Committee believes that a practitioner ordinarily could not perform meaningful analytical procedures on an entity's controls or compliance with requirements of specified laws, regulations, rules, contracts, or grants to achieve this level of assurance, and it is uncertain what other procedures could be identified that, when combined with inquiry procedures, could form the basis for a review engagement. Also due to this uncertainty, users of a review report are at greater risk of misunderstanding the nature and extent of the practitioner's procedures. Accordingly, the feasibility of a review engagement related to trust services is uncertain.

addressed by management declarations in written contracts, service level agreements, or public statements (for example, a privacy notice). These management declarations are referred to in the trust services principles and criteria as *commitments*. Specifications regarding how the system should function to enable management to meet its business objectives, commitments, and obligations (for example, legal and regulatory) are referred to as *requirements* in the trust services principles and criteria. For example, security requirements may result from management's commitments relating to security, availability, processing integrity, confidentiality, or privacy.

Commitments and requirements are the objectives for which the entity implements controls, and, consequently, the objectives of the trust services criteria. Accordingly, many of the trust services criteria refer to commitments and requirements. For example, "The entity has established workforce conduct standards, implemented workforce candidate background screening procedures, and conducts enforcement procedures to enable it to meet its commitments and requirements as they relate to *[insert the principle(s) being reported on; for example, security, availability, processing integrity, and confidentiality]*." In an engagement in which the practitioner expresses an opinion on compliance with or achievement of the commitments and requirements, they serve as the engagement criteria.

.06 Management is responsible for maintaining a record of and complying with its commitments and requirements. In identifying its commitments and requirements, management should specify in its assertion what its commitments and requirements consist of for the particular engagement, for example:

- Obligations included in written customer contracts
- Baseline obligations that are applicable to all customers but which exclude special commitments made to particular customers when those commitments result in the implementation of additional processes or controls outside the services provided to a broad range of users

In addition, trust services engagements do not require the practitioner to report on the entity's compliance, or internal control over compliance, with laws, regulations, rules, contracts, or grant agreements, related to the principles being reported upon. If the practitioner is engaged to report on compliance with laws, regulations, rules, contracts, or grant agreements in conjunction with an engagement to report on the operating effectiveness of an entity's controls (for example, a SOC 3 privacy engagement), such an engagement would be performed in accordance with AT section 601, *Compliance Attestation* (AICPA, *Professional Standards*).

.07 Consulting services include developing findings and recommendations for the consideration and use of management of an entity when making decisions. The practitioner does not express an opinion or form a conclusion about the subject matter in these engagements. Generally, the work is performed only for the use and benefit of the client. Practitioners providing such services follow CS section 100, *Consulting Services: Definitions and Standards* (AICPA, *Professional Standards*).

Principles, Criteria, Controls, and Risks

.08 Trust services principles represent attributes of a system that support the achievement of management's objectives.

.09 For each of the principles there are detailed criteria that serve as benchmarks used to measure and present the subject matter and against which the practitioner evaluates the subject matter. The attributes of suitable criteria are as follows:

- *Objectivity*. Criteria should be free from bias.
- *Measurability*. Criteria should permit reasonably consistent measurements, qualitative or quantitative, of subject matter.
- *Completeness*. Criteria should be sufficiently complete so that those relevant factors that would alter a conclusion about subject matter are not omitted.
- *Relevance*. Criteria should be relevant to the subject matter.

.10 ASEC has concluded that the trust services criteria for each individual principle that include the common criteria have all of the attributes of suitable criteria. In addition to being suitable, AT section 101 indicates that the criteria must be available to users of the practitioner's report. The publication of the principles and criteria makes the criteria available to users.

.11 The trust services principles and criteria are designed to be flexible and enable the achievement of the objectives of users and management. Accordingly, a practitioner may be engaged to perform an engagement related to a single principle, multiple principles, or all of the principles.

.12 The environment in which the system operates; the commitments, agreements, and responsibilities of the entity operating the system; as well as the nature of the components of the system result in risks that the criteria will not be met. These risks are addressed through the implementation of suitably designed controls that, if operating effectively, provide reasonable assurance that the criteria are met. Because each system and the environment in which it operates are unique, the combination of risks to meeting the criteria and the controls necessary to address the risks will be unique. As part of the design and operation of the system, management of an entity needs to identify the specific risks that the criteria will not be met and the controls necessary to address those risks. Appendix B provides examples of risks that may prevent the criteria from being met as well as examples of controls that would address those risks. These illustrations are not intended to be applicable to any particular entity or all-inclusive of the risks to meeting the criteria or the controls necessary to address those risks.

Trust Services Principles

.13 The following are the trust services principles:²

- a. *Security*. The system is protected against unauthorized access, use, or modification.

The *security principle* refers to the protection of the system resources through logical and physical access control measures in order to

² SysTrustSM, SysTrust for Service OrganizationsSM, and WebTrustSM are specific branded assurance services offerings developed by the AICPA and Canadian Institute of Chartered Accountants (CICA) that are based on the trust services principles and criteria. Practitioners must be licensed by CICA to use these registered service marks. Service marks can only be issued for engagements that result in an unqualified examination opinion. For more information on licensure, see www.webtrust.org.

support the achievement of management's commitments and requirements related to security, availability, processing integrity, and confidentiality. Controls over the security of a system prevent or detect the breakdown and circumvention of segregation of duties, system failure, incorrect processing, theft or other unauthorized removal of data or system resources, misuse of software, and improper access to, or use of, alteration, destruction, or disclosure of information.

- b. *Availability.* The system is available for operation and use as committed or agreed.

The *availability principle* refers to the accessibility of the system, products, or services as committed by contract, service-level agreement, or other agreements. This principle does not, in itself, set a minimum acceptable performance level for system availability. The *availability principle* does not address system functionality (the specific functions a system performs) and system usability (the ability of users to apply system functions to the performance of specific tasks or problems), but does address whether the system includes controls to support system accessibility for operation, monitoring, and maintenance.

- c. *Processing integrity.* System processing is complete, valid, accurate, timely, and authorized.

The *processing integrity principle* refers to the completeness, validity, accuracy, timeliness, and authorization of system processing. Processing integrity addresses whether the system achieves its aim or the purpose for which it exists, and whether it performs its intended function in an unimpaired manner, free from unauthorized or inadvertent manipulation. Processing integrity does not automatically imply that the information received and stored by the system is complete, valid, accurate, current, and authorized. The risk that data contains errors introduced prior to its input in the system often cannot be addressed by system controls and detecting such errors is not usually the responsibility of the entity. Similarly, users outside the boundary of the system may be responsible for initiating processing. In these instances, the data may become invalid, inaccurate, or otherwise inappropriate even though the system is processing with integrity.

- d. *Confidentiality.* Information designated as confidential is protected as committed or agreed.

The *confidentiality principle* addresses the system's ability to protect information designated as confidential in accordance with the organization's commitments and requirements through its final disposition and removal from the system. Information is confidential if the custodian of the information, either by law or regulation, the custodian's own assertion, commitment, or other agreement, is obligated to limit its access, use, and retention, and restrict its disclosure to a specified set of persons or organizations (including those that may otherwise have authorized access within the boundaries of the system). The need for information to be confidential may arise for many different reasons. For example, the information is proprietary information, information intended only for company personnel, personal information, or merely embarrassing information. Confidentiality is distinguished from privacy in that (i) privacy deals with personal information whereas, confidentiality refers to a broader range of information that is not

restricted to personal information; and (ii) privacy addresses requirement for the treatment, processing, and handling of personal information.

e. *Privacy.*

The *privacy principle* addresses the system's collection, use, retention, disclosure, and disposal of personal information³ in conformity with the commitments in the entity's privacy notice and with criteria set forth in generally accepted privacy principles (GAPP) issued by the AICPA and Canadian Institute of Chartered Accountants (see appendix C, "Generally Accepted Privacy Principles"). GAPP is a management framework that includes the measurement criteria for the trust services privacy principle. GAPP consists of 10 sub-principles:

- i. *Management.* The entity defines documents, communicates, and assigns accountability for its privacy policies and procedures.
- ii. *Notice.* The entity provides notice about its privacy policies and procedures and identifies the purposes for which personal information is collected, used, retained, and disclosed.
- iii. *Choice and consent.* The entity describes the choices available to the individual and obtains implicit or explicit consent with respect to the collection, use, and disclosure of personal information.
- iv. *Collection.* The entity collects personal information only for the purposes identified in the notice.
- v. *Use and retention.* The entity limits the use of personal information to the purposes identified in the notice and for which the individual has provided implicit or explicit consent. The entity retains personal information for only as long as necessary to fulfill the stated purposes or as required by law or regulations and thereafter appropriately disposes of such information.
- vi. *Access.* The entity provides individuals with access to their personal information for review and update.
- vii. *Disclosure to third parties.* The entity discloses personal information to third parties only for the purposes identified in the notice and with the implicit or explicit consent of the individual.
- viii. *Security for privacy.* The entity protects personal information against unauthorized access (both physical and logical).
- ix. *Quality.* The entity maintains accurate, complete, and relevant personal information for the purposes identified in the notice.
- x. *Monitoring and enforcement.* The entity monitors compliance with its privacy policies and procedures and has procedures to address privacy-related complaints and disputes.

³ Personal information is information that is about or can be related to an identifiable individual. It may include information about customers, employees, and other individuals.

Trust Services Criteria

.14 Many of the criteria used to evaluate a system are shared amongst all of the principles; for example, the criteria related to risk management apply to the security, availability, processing integrity, and confidentiality principles. As a result, the criteria for the security, availability, processing integrity, and confidentiality principles are organized into (a) the criteria that are applicable to all four principles (common criteria) and (b) criteria applicable only to a single principle. The common criteria constitute the complete set of criteria for the security principle. For the principles of availability, processing integrity, and confidentiality, a complete set of criteria is comprised of all of the common criteria and all of the criteria applicable to the principle(s) being reported on.

The common criteria are organized into seven categories:

- a. *Organization and management.* The criteria relevant to how the organization is structured and the processes the organization has implemented to manage and support people within its operating units. This includes criteria addressing accountability, integrity, ethical values and qualifications of personnel, and the environment in which they function.
- b. *Communications.* The criteria relevant to how the organization communicates its policies, processes, procedures, commitments, and requirements to authorized users and other parties of the system and the obligations of those parties and users to the effective operation of the system.
- c. *Risk management and design and implementation of controls.* The criteria relevant to how the entity (i) identifies potential risks that would affect the entity's ability to achieve its objectives, (ii) analyzes those risks, (iii) develops responses to those risks including the design and implementation of controls and other risk mitigating actions, and (iv) conducts ongoing monitoring of risks and the risk management process.
- d. *Monitoring of controls.* The criteria relevant to how the entity monitors the system, including the suitability, and design and operating effectiveness of the controls, and takes action to address deficiencies identified.
- e. *Logical and physical access controls.* The criteria relevant to how the organization restricts logical and physical access to the system, provides and removes that access, and prevents unauthorized access to meet the criteria for the principle(s) addressed in the engagement.
- f. *System operations.* The criteria relevant to how the organization manages the execution of system procedures and detects and mitigates processing deviations, including logical and physical security deviations, to meet the objective(s) of the principle(s) addressed in the engagement.
- g. *Change management.* The criteria relevant to how the organization identifies the need for changes to the system, makes the changes following a controlled change management process, and prevents unauthorized changes from being made to meet the criteria for the principle(s) addressed in the engagement.

The GAPP management framework does not use the common criteria structure for organizing the criteria. See appendix C for GAPP criteria.

Trust Services Principles and Criteria

.15

Criteria Common to All [Security, Availability, Processing Integrity, and Confidentiality] Principles	
CC1.0	Common Criteria Related to Organization and Management
CC1.1	The entity has defined organizational structures, reporting lines, authorities, and responsibilities for the design, development, implementation, operation, maintenance and monitoring of the system enabling it to meet its commitments and requirements as they relate to <i>[insert the principle(s) being reported on: security, availability, processing integrity, or confidentiality or any combination thereof]</i> .
CC1.2	Responsibility and accountability for designing, developing, implementing, operating, maintaining, monitoring, and approving the entity's system controls are assigned to individuals within the entity with authority to ensure policies and other system requirements are effectively promulgated and placed in operation.
CC1.3	Personnel responsible for designing, developing, implementing, operating, maintaining and monitoring the system affecting <i>[insert the principle(s) being reported on: security, availability, processing integrity, or confidentiality or any combination thereof]</i> have the qualifications and resources to fulfill their responsibilities.
CC1.4	The entity has established workforce conduct standards, implemented workforce candidate background screening procedures, and conducts enforcement procedures to enable it to meet its commitments and requirements as they relate to <i>[insert the principle(s) being reported on: security, availability, processing integrity, or confidentiality or any combination thereof]</i> .
CC2.0	Common Criteria Related to Communications
CC2.1	Information regarding the design and operation of the system and its boundaries has been prepared and communicated to authorized internal and external system users to permit users to understand their role in the system and the results of system operation.
CC2.2	The entity's <i>[insert the principle(s) being reported on: security, availability, processing integrity, or confidentiality or any combination thereof]</i> commitments are communicated to external users, as appropriate, and those commitments and the associated system requirements are communicated to internal system users to enable them to carry out their responsibilities.
CC2.3	The entity communicates the responsibilities of internal and external users and others whose roles affect system operation.
CC2.4	Internal and external personnel with responsibility for designing, developing, implementing, operating, maintaining, and monitoring controls, relevant to the <i>[insert the principle(s) being reported on: security, availability, processing integrity, or confidentiality or any combination thereof]</i> of the system, have the information necessary to carry out those responsibilities.
CC2.5	Internal and external system users have been provided with information on how to report <i>[insert the principle(s) being reported on: security, availability, processing integrity, or confidentiality or any combination thereof]</i> failures, incidents, concerns, and other complaints to appropriate personnel.

CC2.6	System changes that affect internal and external system user responsibilities or the entity's commitments and requirements relevant to <i>[insert the principle(s) being reported on: security, availability, processing integrity, or confidentiality or any combination thereof]</i> are communicated to those users in a timely manner.
CC3.0	<i>Common Criteria Related to Risk Management and Design and Implementation of Controls</i>
CC3.1	The entity (1) identifies potential threats that would impair system <i>[insert the principle(s) being reported on: security, availability, processing integrity, or confidentiality or any combination thereof]</i> commitments and requirements, (2) analyzes the significance of risks associated with the identified threats, and (3) determines mitigation strategies for those risks (including controls and other mitigation strategies).
CC3.2	The entity designs, develops, and implements controls, including policies and procedures, to implement its risk mitigation strategy.
CC3.3	The entity (1) identifies and assesses changes (for example, environmental, regulatory, and technological changes) that could significantly affect the system of internal control for <i>[insert the principle(s) being reported on: security, availability, processing integrity, or confidentiality or any combination thereof]</i> and reassesses risks and mitigation strategies based on the changes and (2) reassesses the suitability of the design and deployment of control activities based on the operation and monitoring of those activities, and updates them as necessary.
CC4.0	<i>Common Criteria Related to Monitoring of Controls</i>
CC4.1	The design and operating effectiveness of controls are periodically evaluated against <i>[insert the principle(s) being reported on: security, availability, processing integrity, or confidentiality or any combination thereof]</i> commitments and requirements, corrections and other necessary actions relating to identified deficiencies are taken in a timely manner.
CC5.0	<i>Common Criteria Related to Logical and Physical Access Controls</i>
CC5.1	Logical access security software, infrastructure, and architectures have been implemented to support (1) identification and authentication of authorized users; (2) restriction of authorized user access to system components, or portions thereof, authorized by management, including hardware, data, software, mobile devices, output, and offline elements; and (3) prevention and detection of unauthorized access.
CC5.2	New internal and external system users are registered and authorized prior to being issued system credentials, and granted the ability to access the system. User system credentials are removed when user access is no longer authorized.
CC5.3	Internal and external system users are identified and authenticated when accessing the system components (for example, infrastructure, software, and data).
CC5.4	Access to data, software, functions, and other IT resources is authorized and is modified or removed based on roles, responsibilities, or the system design and changes to them.
CC5.5	Physical access to facilities housing the system (for example, data centers, backup media storage, and other sensitive locations as well as sensitive system components within those locations) is restricted to authorized personnel.

(continued)

CC5.6	Logical access security measures have been implemented to protect against <i>[insert the principle(s) being reported on: security, availability, processing integrity, or confidentiality or any combination thereof]</i> threats from sources outside the boundaries of the system.
CC5.7	The transmission, movement, and removal of information is restricted to authorized users and processes, and is protected during transmission, movement, or removal enabling the entity to meet its commitments and requirements as they relate to <i>[insert the principle(s) being reported on: security, availability, processing integrity, or confidentiality or any combination thereof]</i> .
CC5.8	Controls have been implemented to prevent or detect and act upon the introduction of unauthorized or malicious software.
CC6.0	<i>Common Criteria Related to System Operations</i>
CC6.1	Vulnerabilities of system components to <i>[insert the principle(s) being reported on: security, availability, processing integrity, or confidentiality or any combination thereof]</i> breaches and incidents due to malicious acts, natural disasters, or errors are monitored and evaluated and countermeasures are implemented to compensate for known and new vulnerabilities.
CC6.2	<i>[Insert the principle(s) being reported on: security, availability, processing integrity, or confidentiality or any combination thereof]</i> incidents, including logical and physical security breaches, failures, concerns, and other complaints, are identified, reported to appropriate personnel, and acted on in accordance with established incident response procedures.
CC7.0	<i>Common Criteria Related to Change Management</i>
CC7.1	<i>[Insert the principle(s) being reported on: security, availability, processing integrity, or confidentiality or any combination thereof]</i> commitments and requirements, are addressed, during the system development lifecycle including design, acquisition, implementation, configuration, testing, modification, and maintenance of system components.
CC7.2	Infrastructure, data, software, and procedures are updated as necessary to remain consistent with the system commitments and requirements as they relate to <i>[insert the principle(s) being reported on: security, availability, processing integrity, or confidentiality or any combination thereof]</i> .
CC7.3	Change management processes are initiated when deficiencies in the design or operating effectiveness of controls are identified during system operation and monitoring.
CC7.4	Changes to system components are authorized, designed, developed, configured, documented, tested, approved, and implemented in accordance with <i>[insert the principle(s) being reported on: security, availability, processing integrity, or confidentiality or any combination thereof]</i> commitments and requirements.
<i>Additional Criteria for Availability</i>	
A1.1	Current processing capacity and usage are maintained, monitored, and evaluated to manage capacity demand and to enable the implementation of additional capacity to help meet availability commitments and requirements.
A1.2	Environmental protections, software, data backup processes, and recovery infrastructure are designed, developed, implemented, operated, maintained, and monitored to meet availability commitments and requirements.

A1.3	Procedures supporting system recovery in accordance with recovery plans are periodically tested to help meet availability commitments and requirements.
<i>Additional Criteria for Processing Integrity</i>	
PI1.1	Procedures exist to prevent, detect, and correct processing errors to meet processing integrity commitments and requirements.
PI1.2	System inputs are measured and recorded completely, accurately, and timely in accordance with processing integrity commitments and requirements.
PI1.3	Data is processed completely, accurately, and timely as authorized in accordance with processing integrity commitments and requirements.
PI1.4	Data is stored and maintained completely and accurately for its specified life span in accordance with processing integrity commitments and requirements.
PI1.5	System output is complete, accurate, distributed, and retained in accordance with processing integrity commitments and requirements.
PI1.6	Modification of data is authorized, using authorized procedures in accordance with processing integrity commitments and requirements.
<i>Additional Criteria for Confidentiality</i>	
C1.1	Confidential information is protected during the system design, development, testing, implementation, and change processes in accordance with confidentiality commitments and requirements.
C1.2	Confidential information within the boundaries of the system is protected against unauthorized access, use, and disclosure during input, processing, retention, output, and disposition in accordance with confidentiality commitments and requirements.
C1.3	Access to confidential information from outside the boundaries of the system and disclosure of confidential information is restricted to authorized parties in accordance with confidentiality commitments and requirements.
C1.4	The entity obtains confidentiality commitments that are consistent with the entity's confidentiality requirements from vendors and other third parties whose products and services comprise part of the system and have access to confidential information.
C1.5	Compliance with confidentiality commitments and requirements by vendors and others third parties whose products and services comprise part of the system is assessed on a periodic and as-needed basis and corrective action is taken, if necessary.
C1.6	Changes to confidentiality commitments and requirements are communicated to internal and external users, vendors, and other third parties whose products and services are included in the system.

Privacy Principles and Criteria

.16 These criteria are set forth in appendix C.

Effective Date

.17 The trust services principles and criteria are effective for periods ending on or after December 15, 2014. Early implementation is permitted.

Appendix A — Definitions

accuracy. The key information associated with the submitted transaction remains accurate throughout the processing of the transaction and that the transaction or service is processed or performed as intended.

authorization. The processing is performed in accordance with and subject to the required approvals and privileges defined by policies governing system processing.

authorized access. Access is authorized only if (a) the access has been approved by a person designated to do so by management, and (b) the access does not compromise segregation of duties, confidentiality commitments, or otherwise increase risk to the system beyond the levels approved by management (that is, access is appropriate).

boundary of the system. The physical and logical perimeter of that portion of an entity's operations that is used to achieve management's specific business objectives of a system. The boundary includes all components of the system for which the entity is responsible, including those provided by vendors and other third parties.

For a privacy or confidentiality engagement, the boundary of the system includes the components starting with the capture of the information through its disclosure and final disposition (often referred to as the information life cycle). The boundary of the system includes (a) the collection, use, retention, disclosure and de-identification, or anonymization of the information until its destruction and (b) all business segments and locations for the entire entity or only certain identified segments of the business (for example, retail operations but not manufacturing operations or only operations originating on the entity's website or specified Web domains) or geographic locations (for example, only Canadian operations).

commitments. Declarations made by management to customers regarding the performance of a system. Commitments can be communicated through individual agreements, standardized contracts, service level agreements, or published statements (for example, security practices statement). An individual commitment may relate to one or more principles. The practitioner need only consider commitments related to the principles on which he or she is engaged to report. Commitments may take many forms including the following:

- Specification of the algorithm used in a calculation
- Contractual agreement that states the hours a system will be available
- Published password standards
- Encryption standards used to encrypt stored customer data

completeness. Transactions are processed or all services are performed without omission.

environmental protections. Measures implemented by the entity to detect, prevent, and manage the risk of casualty damage to the physical parts of the system (for example, protections from fire, flood, wind, earthquake, power surge, or power outage).

external users. Individuals outside the boundary of the system who are authorized by customers, entity management, or other authorized persons to interact with the system.

internal users. Entity and entity vendor personnel whose job function causes them to be members of the people component of the system.

report users. Intended users of the practitioner's report in accordance with AT section 101, *Attest Engagements* (AICPA, *Professional Standards*). Report users may be the general public or may be restricted to specified parties in accordance with AT section 101 paragraph .78.

requirements. Specifications regarding how the system should function to meet management's business objectives, commitments to customers, and obligations (for example, legal and regulatory). Requirements are often specified in the system policies, system design documentation, contracts with customers, and government regulations. Examples of requirements are

- employee fingerprinting and background checks established in government banking regulations.
- input edits defined in application design documents.
- maximum acceptable intervals between periodic review of employee logical access as documented in the security policy manual.
- data definition and tagging standards, including any associated metadata requirements, established by industry groups of other bodies, such as the Simple Object Access Protocol.
- business processing rules and standards established by regulators; for example, security requirements under the Health Insurance Portability and Accountability Act (HIPAA).

Security requirements may result from management commitments relating to security, availability, processing integrity, or confidentiality. For example, a commitment to programmatically enforce segregation of duties between data entry and data approval creates system requirements regarding user access administration.

SOC 2 engagement. An examination engagement to report on the suitability of design (type 1) or suitability of design and operating effectiveness (type 2) of controls at a service organization using the Guide *Reporting on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy (SOC 2)*.

SOC 3 engagement. An examination engagement to report on the suitability of design and the operating effectiveness of an entity's controls over a system relevant to one or more trust services principles.

timeliness. The provision of services or the delivery of goods addressed in the context of commitments made for such delivery.

trust services. A set of professional attestation and advisory services based on a core set of principles and criteria that address the operation and protection of a system and related data.

workforce. Employees, contractors and others engaged by company to perform activities as part of the system.

Appendix B – Illustrative Risks and Controls

The illustrative risks and controls presented in this appendix are for illustrative purposes only. They are based on a hypothetical entity in a hypothetical industry. They are not intended to be a comprehensive set of risks and controls or applicable to any particular entity. Accordingly, they should not be used as a checklist of risks and controls for the criteria. Practitioners should consider using other frameworks such as, NIST 800-53, Cloud Controls Matrix (CCM) for such guidance.

Criteria	Risks	Illustrative Controls
Criteria Common to All [Security, Availability, Processing Integrity, and Confidentiality] Principles		
CC1.0 Common Criteria Related to Organization and Management		
CC1.1	The entity has defined organizational structures, reporting lines, authorities, and responsibilities for the design, development, implementation, operation, maintenance, and monitoring of the system enabling it to meet its commitments and requirements as they relate to <i>[insert the principle(s) being reported on: security, availability, processing integrity, or confidentiality or any combination thereof]</i> .	The entity's organizational structure does not provide the necessary information flow to manage <i>[security, availability, processing integrity, or confidentiality]</i> activities.
		The roles and responsibilities of key managers are not sufficiently defined to permit proper oversight, management, and monitoring of <i>[security, availability, processing integrity, or confidentiality]</i> activities.
		Job descriptions are reviewed by entity management on an annual basis for needed changes and where job duty changes are required necessary

Criteria		Risks	Illustrative Controls
			changes to these job descriptions are also made.
		Reporting relationships and organizational structure do not permit effective senior management oversight of <i>[security, availability, processing integrity, or confidentiality]</i> activities.	Reporting relationships and organizational structures are reviewed periodically by senior management as part of organizational planning and adjusted as needed based on changing entity commitments and requirements.
		Personnel have not been assigned responsibility or delegated insufficient authority to meet <i>[security, availability, processing integrity, or confidentiality]</i> commitments and requirements.	Roles and responsibilities are defined in written job descriptions.
CC1.2	Responsibility and accountability for designing, developing, implementing, operating, maintaining, monitoring, and approving the entity's system controls are assigned to individuals within the entity with authority to ensure policies, and other system requirements are effectively promulgated and placed in operation.	Personnel have not been assigned responsibility or delegated insufficient authority to meet <i>[security, availability, processing integrity, or confidentiality]</i> commitments and requirements.	Roles and responsibilities are defined in written job descriptions.
			Job descriptions are reviewed on a periodic basis for needed changes and updated if such changes are identified.
CC1.3	Personnel responsible for designing, developing, implementing, operating, maintaining, and	Newly hired or transferred personnel do not have sufficient knowledge and experience to perform their responsibilities.	Job requirements are documented in the job descriptions and candidates' abilities to meet these requirements are evaluated as part of

(continued)

Criteria		Risks	Illustrative Controls
	monitoring of the system affecting <i>[insert the principle(s) being reported on: security, availability, processing integrity, or confidentiality or any combination thereof]</i> have the qualifications and resources to fulfill their responsibilities.		the hiring or transfer evaluation process.
			The experience and training of candidates for employment of transfer are evaluated before they assume the responsibilities of their position.
		Personnel do not have sufficient continuous training to perform their responsibilities.	Management establishes skills and continued training with its commitments and requirements for employees.
			Management monitors compliance with training requirements.
		Tools and knowledge resources are insufficient to perform assigned tasks.	Management evaluates the need for additional tools and resources in order to achieve business objectives, during its ongoing and periodic business planning and budgeting process and as part of its ongoing risk assessment and management process.
CC1.4	The entity has established workplace conduct standards, implemented workplace candidate background screening procedures, and conducts enforcement procedures to enable it to meet its commitments and requirements as they relate to <i>[insert the principle(s) being</i>	Personnel do not adhere to the code of conduct.	Management monitors employees' compliance with the code of conduct through monitoring of customer and employee complaints and the use of an anonymous third-party administered ethics hotline.

Criteria		Risks	Illustrative Controls
	<i>reported on: security, availability, processing integrity, or confidentiality or any combination thereof].</i>		
			Personnel are required to read and accept the code of conduct and the statement of confidentiality and privacy practices upon their hire and to formally re-affirm them annually thereafter.
		Candidate has a background considered to be unacceptable by management of the entity.	Senior management develops a list of characteristics that would preclude employee candidate from being hired based on sensitivity or skill requirements for the given position.
			Personnel must pass a criminal and financial trust background check before they may be hired by the entity or third party vendors hired by the entity.
CC2.0 Common Criteria Related to Communications			
CC2.1	Information regarding the design and operation of the system and its boundaries has been prepared and communicated to authorized internal and external system users to permit users to understand their role in the system and the results of system operation.	Users misuse the system due to their failure to understand its scope, purpose, and design.	System descriptions are available to authorized external users that delineate the boundaries of the system and describe relevant system components as well as the purpose and design of the system. Documentation of the system description is available to authorized users via the entity's customer-facing website.
			A description of the system is posted on the entity's intranet and is available to the entity's internal users. This description delineates the boundaries of the

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Criteria		Risks	Illustrative Controls
			system and key aspects of processing.
		Users are unaware of key organization and system support functions, processes, and roles and responsibilities.	A description of the entity organization structure, system support functions, processes, and organizational roles and responsibilities is posted on the entity's intranet and available to entity internal users. The description delineates the parties responsible, accountable, consented, and informed of changes in design and operation of key system components.
		External users fail to address risks for which they are responsible that arise outside the boundaries of the system.	System descriptions are available to authorized external users that delineate the boundaries of the system and describe significant system components as well as the purpose and design of the system. The system description is available to users via ongoing communications with customers or via the customer website.
CC2.2	The entity's <i>[insert the principle(s) being reported on: security, availability, processing integrity, or confidentiality or any combination thereof]</i> commitments are communicated to external users, as appropriate, and those commitments and the associated system requirements are communicated to internal system users to enable them to carry out their responsibilities.	Users misunderstand the capabilities of the system in providing for <i>[security, availability, processing integrity, or confidentiality]</i> and take actions based on the misunderstanding.	The entity's <i>[security, availability, processing integrity, or confidentiality]</i> commitments regarding the system are included in the master services agreement and customer-specific service level agreements. In addition, a summary of these commitments is available on the entity's customer facing website.
		The entity fails to meet its commitments due to	Policy and procedures documents for

Criteria		Risks	Illustrative Controls
		lack of understanding on the part of personnel responsible for providing the service.	significant processes are available on the entity's intranet.
			Personnel are required to attend annual security, confidentiality, and privacy training.
			Personnel are required to read and accept the entity's code of conduct and the statement of security, confidentiality, and privacy practices upon hire and annually thereafter.
			Processes are monitored through service level management procedures that monitor compliance with service level commitments and agreements. Results are shared with applicable personnel and customers, and actions are taken and communicated to relevant parties, including customers, when such commitments and agreements are not met.
CC2.3	The entity communicates the responsibilities of internal and external users and others whose roles affect system operation.	The system fails to function as designed due to internal user failure to comply with their responsibilities.	Policy and procedures documents for significant processes that address system requirements are available on the intranet.
			Personnel are required to attend annual security, confidentiality, and privacy training.
			Personnel are required to read and accept the code of conduct and the statement of confidentiality and privacy practices upon hire and annually thereafter.

(continued)

Criteria		Risks	Illustrative Controls
			Processes are monitored through service level management procedures that monitor compliance with commitments and requirements. Results are shared with applicable personnel and customers.
		The system fails to function as designed due to external users' failure to meet their responsibilities.	Customer responsibilities are described on the customer website and in system documentation.
CC2.4	Internal and external personnel with responsibility for designing, developing, implementing, operating, maintaining, and monitoring controls, relevant to the <i>[insert the principle(s) being reported on: security, availability, processing integrity, or confidentiality or any combination thereof]</i> of the system, have the information necessary to carry out those responsibilities.	Controls fail to function as designed or operate effectively due to misunderstanding on the part of personnel responsible for implementing and performing those controls resulting in failure to achieve <i>[security, availability, processing integrity, or confidentiality]</i> commitments and requirements.	Policy and procedures documents for significant processes are available on the intranet.
			Processes are monitored following service level management procedures that monitor compliance with commitments and requirements. Results are shared according to policies.
			Customer responsibilities are described on the customer website and in system documentation.

Criteria		Risks	Illustrative Controls
CC2.5	Internal and external system users have been provided with information on how to report <i>[insert the principle(s) being reported on: security, availability, processing integrity, or confidentiality or any combination thereof]</i> failures, incidents, concerns, and other complaints to appropriate personnel.	System anomalies are detected by internal or external users but the failures are not reported to appropriate personnel resulting in the system failing to achieve its <i>[security, availability, processing integrity, or confidentiality]</i> commitments and requirements.	Policy and procedures documents for significant processes, which include responsibility for reporting operational failures, incidents, system problems, concerns, and user complaints (and the process for doing so), are published and available on the intranet.
			Customer responsibilities, which include responsibility for reporting operational failures, incidents, problems, concerns and complaints, and the process for doing so, are described on the customer website and in system documentation.
CC2.6	System changes that affect internal and external system user responsibilities or the entity's commitments and requirements relevant to <i>[insert the principle(s) being reported on: security, availability, processing integrity, or confidentiality or any combination thereof]</i> are communicated to those users in a timely manner.	Users misunderstand changes in system capabilities or their responsibilities in providing for <i>[security, availability, processing integrity, or confidentiality]</i> due to system changes and take actions based on the misunderstanding.	Proposed system changes affecting customers are published on the customer website XX days before their implementation. Users are given the chance to participate in user acceptance testing for major changes XX days prior to implementation. Changes made to systems are communicated and confirmed with customers through ongoing communications mechanisms such as customer care meetings and via the customer website.
			Management of the business unit must

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Criteria		Risks	Illustrative Controls
			confirm understanding of changes by authorizing them.
			The system change calendar that describes changes to be implemented is posted on the entity intranet.
			Updated system documentation is published on the customer website and intranet 30 days prior to implementation.
			System changes that result from incidents are communicated to internal and external users through e-mail as part of the implementation process.
		Changes in roles and responsibilities and changes to key personnel are not communicated to internal and external users in a timely manner.	Major changes to roles and responsibilities and changes to key personnel are communicated to affected internal and external users via e-mail as part of the change management process.
CC3.0 Common Criteria Related to Risk Management and Design and Implementation of Controls			
CC3.1	The entity (1) identifies potential threats that would impair system [<i>insert the principle(s) being reported on: security, availability, processing integrity, or confidentiality or any combination thereof</i>] commitments and requirements, (2) analyzes the significance of risks associated with the identified threats, and (3) determines mitigation strategies for those risks (including controls and other mitigation strategies).	Not all system components are included in the risk management process resulting in a failure to identify and mitigate or accept risks.	A master list of the entity's system components is maintained, accounting for additions and removals, for management's use.

	Criteria	Risks	Illustrative Controls
		Personnel involved in the risk management process do not have sufficient information to evaluate risks and the tolerance of the entity for those risks.	The entity has defined a formal risk management process that specifies risk tolerances and the process for evaluating risks based on identified threats and the specified tolerances.
		One or more internal or external risks, that are significant, threaten the achievement of [<i>security, availability, processing integrity, or confidentiality</i>] commitments and requirements that can be addressed by security controls, are not identified.	During the risk assessment and management process, risk management office personnel identify changes to business objectives, commitments and requirements, internal operations, and external factors that threaten the achievement of business objectives and update the potential threats to system objectives.
			Identified risks are rated using a risk evaluation process and ratings are reviewed by management.
			The risk and controls group evaluates the effectiveness of controls and mitigation strategies in meeting identified risks and recommends changes based on its evaluation.
			The risk and controls group's recommendations are reviewed and approved by senior management.
			The entity uses a configuration management database and related process to capture key system components, technical and installation specific implementation details, and to support ongoing asset and service management

(continued)

Criteria		Risks	Illustrative Controls
			commitments and requirements.
CC3.2	The entity designs, develops, and implements controls, including policies and procedures, to implement its risk mitigation strategy.	Controls and mitigation strategies selected, developed, and deployed do not adequately mitigate risk.	Control self-assessments are performed by operating units on a quarterly basis.
			Internal audits are performed based on the annual risk-based internal audit plan.
			Business recovery plans are tested annually.
			Internal and external vulnerability scans are performed quarterly and annually and their frequency is adjusted as required to meet ongoing and changing commitments and requirements.
		Deployed controls and mitigation strategies create new risks that fail to be assessed.	See CC3.1 illustrative controls.
CC3.3	The entity (1) identifies and assesses changes (for example, environmental, regulatory, and technological) that could significantly affect the system of internal control for <i>[insert the principle(s) being reported on: security, availability, processing integrity, or confidentiality or any combination thereof]</i> and reassesses risks and mitigation strategies based on the changes and (2) reassesses the suitability of the design and deployment of control activities based on the	Not all changes that significantly affect the system are identified resulting in a failure to reassess related risks.	During the risk assessment and management process, risk management personnel identify changes to business objectives, commitments and requirements, internal operations, and external factors that threaten the achievement of business objectives and update the potential threats to system objectives.

Criteria		Risks	Illustrative Controls
	operation and monitoring of those activities, and updates them as necessary.		
		Changes that are not properly identified create risks due to the failure of those changes to undergo the risk management process.	During the risk assessment and management process, risk management office personnel identify environmental, regulatory, and technological changes that have occurred.
CC4.0 Common Criteria Related to Monitoring of Controls			
CC4.1	The design and operating effectiveness of controls are periodically evaluated against <i>[insert the principle(s) being reported on: security, availability, processing integrity, or confidentiality or any combination thereof]</i> commitments and requirements, corrections and other necessary actions relating to identified deficiencies are taken in a timely manner.	Controls are not suitably designed, configured in accordance with established policies, or operating in an effective manner resulting in a system that does not meet system commitments and requirements.	Monitoring software is used to identify and evaluate ongoing system performance, security threats, changing resource utilization needs, and unusual system activity. This software sends a message to the operations center and automatically opens an incident, problem, or change management “ticket” record when specific predefined thresholds are met.
			Operations and security personnel follow defined protocols for resolving and escalating reported events.
CC5.0 Common Criteria Related to Logical and Physical Access Controls			
CC5.1	Logical access security software, infrastructure, and architectures have been implemented to support (1) identification and authentication of authorized users; (2) restriction of	Not all system infrastructure or system components are protected by logical access security measures resulting in unauthorized modification or use.	Established entity standards exist for infrastructure and software hardening and configuration that include requirements for implementation of access control software, entity configuration standards, and

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Criteria		Risks	Illustrative Controls
	authorized user access to system components, or portions thereof, authorized by management, including hardware, data, software, mobile devices, output, and offline elements; and (3) prevention and detection of unauthorized access.		standardized access control lists.
			Network scans are performed for infrastructure elements to identify variance from entity standards.
			Assets are assigned owners who are responsible for evaluating access based on job roles. The owners define access rights when assets are acquired or changed and periodically evaluate access for assets under their custody or stewardship.
			Online applications match each user ID to a single customer account number. Requests for access to system records require the matching of the customer account number against a list of privileges each user possesses when granted access to the system initially.
		Logical access security measures do not identify or authenticate users prior to permitting access to IT components.	Infrastructure components and software are configured to use the shared sign-on functionality when available. Systems not using the shared sign-on functionality are required to be implemented with separate user ID and password submission.

Criteria		Risks	Illustrative Controls
			External access by employees is permitted only through a two factor (for example, a swipe card and a password) encrypted virtual private network (VPN) connection.
		Logical access security measures do not provide for the segregation of duties required by the system design.	A role based security process has been defined with an access control system that is required to use roles when possible.
			Assets are assigned owners who are responsible for evaluating the appropriateness of access based on job roles. Roles are periodically reviewed and updated by asset owners and the risk and controls group on an annual basis. Access change requests resulting from the review are submitted to the security group via a change request record.
			For software or infrastructure that does not support the use of role-based security, a separate database of roles and related access is maintained. The security group uses this database when entering access rules in these systems.
		Logical access security measures do not restrict access to system configurations, privileged functionality, master passwords, powerful utilities, security devices, and other high risk resources.	Privileged access to sensitive resources is restricted to defined user roles and access to these roles must be approved by the chief information security officer. This access is reviewed by the chief information security officer on a periodic basis as established by the chief information security officer.

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Criteria		Risks	Illustrative Controls
CC5.2	New internal and external system users are registered and authorized prior to being issued system credentials and granted the ability to access the system. User system credentials are removed when user access is no longer authorized.	Valid user identities are granted to unauthorized persons.	On a daily basis, employee user IDs are automatically created in or removed from the active directory and the VPN systems as of the date of employment using an automated feed of new users collected from employee changes in the human resource management system.
			Employee access to protected resources is created or modified by the security group based on an authorized change request from the system's asset owner.
			Contractor and vendor IDs are created by the security group based on an authorized change request from the contractor office. These IDs are valid for the lesser of the expected period of relationship or XX days.
			Privileged customer accounts are created based on a written authorization request from the designated customer point of contact. These accounts are used by customers to create customer user access.
			System security is configured to require users to change their password upon initial sign-on and every XX days thereafter.
		A user that is no longer authorized continues to access system resources.	On a daily basis, the human resources system sends an automated feed to the active directory and the VPN for removal of access for employees for whom it is the last day of employment. The list is used by security

Criteria		Risks	Illustrative Controls
			personnel to remove access. The removal of the access is verified by the security manager.
			On a weekly basis, the human resources system sends to the security group a list of terminated employees for whose access is to be removed. The list is used by security personnel to remove access. The removal of the access is verified by a security manager.
			On a weekly basis, the contractor office sends to the security group a list of terminated vendors and contractors whose access is to be removed. The list is used by security personnel to remove access. The removal of the access is verified by a security manager.
			Entity policies prohibit the reactivation or use of a terminated employee's ID without written approval of the chief information security officer. Requests for reactivation are made using the change management record system and must include the purpose and justification of the access (for business need), the systems that are to be reactivated, and the time period for which the account will be active (no more than XX days). The account is reset with a new password and is activated for the time period requested. All use of the account is logged and reviewed by security personnel.

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Criteria		Risks	Illustrative Controls
			Account sharing is prohibited unless a variance from policy is granted by the chief information security officer as might be provided by the entity using an account and password vaulting software product that provides account sharing controlled circumstances and active logging of each use. Otherwise, shared accounts are permitted for low risk applications (for example, informational system where access with shared IDs cannot compromise segregation of duties) or when system technical limitations require their use (for example, UNIX root access). The chief information security officer must approve the use of all shared accounts. Mitigating controls are implemented when possible (for example, required use of <i>su</i> when accessing the UNIX root account).
CC5.3	Internal and external system users are identified and authenticated when accessing the system components (for example, infrastructure, software, and data).	Users are not identified when accessing information system components.	Entity standards are established for infrastructure and software hardening and configuration that includes requirements for implementation of access control software, entity configuration standards, and standardized access control lists.
			Account sharing is prohibited unless a variance from policy is granted by the chief information security officer as might be provided by the entity using an account and password vaulting

Criteria		Risks	Illustrative Controls
			software product that provides account sharing controlled circumstances and active logging of each use. Otherwise, shared accounts are permitted for low risk applications (for example, informational system where access with shared IDs cannot compromise segregation of duties) or when system technical limitations require their use (for example, UNIX root access). The chief information security officer must approve the use of all shared accounts. Mitigating controls are implemented when possible (for example, required use of <i>su</i> when accessing the UNIX root account).
		Valid user identities are assumed by an unauthorized person to access the system.	The online application matches each user ID to a single customer account number. Requests for access to system records require the matching of the customer account number.
			Two factor authentication and use of encrypted VPN channels help to ensure that only valid users gain access to IT components.
			Infrastructure components and software are configured to use the active directory shared sign-on functionality when available. Systems not using the shared sign-on functionality are configured to require a separate user ID and password.

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Criteria		Risks	Illustrative Controls
		User access credentials are compromised allowing an unauthorized person to perform activities reserved for authorized persons.	Users can only access the system remotely through the use of the VPN, secure sockets layer (SSL), or other encrypted communication system.
			Password complexity standards are established to enforce control over access control software passwords.
CC5.4	Access to data, software, functions, and other IT resources is authorized and is modified or removed based on roles, responsibilities, or the system design and changes to them.	Valid users obtain unauthorized access to the system resulting in a breakdown in segregation of duties or an increase in the risk of intentional malicious acts or error.	When possible, formal role-based access controls limit access to system and infrastructure components are created and these are enforced by the access control system. When it is not possible, authorized user IDs with two factor authentication are used.
			User access requests for a specific role are approved by the user manager and are submitted to the security group via the change management record system.
		Access granted through the provisioning process compromises segregation of duties or increases the risk of intentional malicious acts or error.	When possible, formal role-based access controls limit access to system and infrastructure components and these are enforced by the access control system. When it is not possible, authorized user IDs with two factor authentication are used.
			Roles are reviewed and updated by asset owners and the risk and controls group on an annual basis. Access change requests resulting from the review are submitted to the security group via a change request record.

Criteria		Risks	Illustrative Controls
CC5.5	Physical access to facilities housing the system (for example, data centers, backup media storage, and other sensitive locations as well as sensitive system components within those locations) is restricted to authorized personnel.	Unauthorized persons gain physical access to system components resulting in damage to components (including threats to personnel), fraudulent or erroneous processing, unauthorized logical access, or compromise of information.	An ID card-based physical access control system has been implemented within the perimeter of facilities and at the entry and exit points of sensitive areas within these facilities.
			ID cards that include an employee picture must be worn at all times when accessing or leaving the facility.
			ID cards are created by the human resources department during the employee orientation period and distributed after all required background investigations are completed. ID cards initially provide access only to nonsensitive areas.
			Access to sensitive areas is added to ID cards by the physical security director based on a request for access approved by the owner of the sensitive area and after required background investigations have been performed and any issues resolved. Requests for access and changes to access are made, approved, and communicated through the change management record system.
			The contractor office may request ID cards for vendors and contractors. Cards are created by the physical security director. Requests are made,

(continued)

Criteria		Risks	Illustrative Controls
			approved, and communicated through the change management record system.
			Visitors must be signed in by an employee before a single-day visitor badge that identifies them as an authorized visitor can be issued.
			Visitor badges are for identification purposes only and do not permit access to any secured areas of the facility.
			All visitors must be escorted by an entity employee when visiting facilities where sensitive system and system components are maintained and operated.
		Formerly appropriate physical access becomes inappropriate due to changes in user job responsibilities or system changes resulting in a breakdown in segregation of duties or an increase in the risk of intentional malicious acts or error.	Owners of sensitive areas of the facilities review the list of names and roles of those granted physical access to their areas on a semi-annual basis to check for continued business need. Requests for changes are made through the change management record system.
		A formerly authorized person continues to access system resources after that person is no longer authorized.	Owners of sensitive areas of the facilities review access to their areas on a semi-annual basis. Requests for changes are made through the change management record system.
			Vendors are asked to review a list of employees with ID cards on a semi-annual basis and request any modifications. The contractor office requests changes based on the vendor review.

Criteria		Risks	Illustrative Controls
			On a daily basis, as of the last day of employment, the human resources system sends to physical security a list of terminated employees for whom it is the last day of employment and whose access is to be removed and their pass cards to be disabled.
		A user obtains the identification credentials and authentication credentials of a formerly authorized person and uses them to gain unauthorized access to the system.	On a weekly basis, the contractor office sends to the security group a list of terminated vendors and contractors for whom access is to be removed.
			On a weekly basis, the human resources system sends to the physical security group a list of terminated employees for whom access is to be removed.
			Employees and contractors are required to return their ID cards during exit interviews, and all ID badges are disabled prior to exit interviews therefore employees and contractors must be physically escorted from the entity's facilities at the completion of the exit interview.
			The sharing of access badges and tailgating are prohibited by policy.
			Mantraps or other physical devices are used for controlling accessing highly sensitive facilities.
			Doors that bypass mantraps can only be opened by the ID cards

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Criteria		Risks	Illustrative Controls
			of designated members of management.
CC5.6	Logical access security measures have been implemented to protect against <i>[insert the principle(s) being reported on: security, availability, processing integrity, or confidentiality or any combination thereof]</i> threats from sources outside the boundaries of the system.	Threats to the system are obtained through external points of connectivity.	Defined entity standards exist for infrastructure and software hardening and configuration that include requirements for implementation of access control software, entity configuration standards, and standardized access control lists that define which privileges are attributable to each user or system account.
			External points of connectivity are protected by a firewall complex.
			Firewall hardening standards are based on relevant applicable technical specifications and these are compared against product and industry recommended practices and updated periodically.
			External access to nonpublic sites is restricted through the use of user authentication and message encryption systems such as VPN and SSL.
		Authorized connections to the system are compromised and used to gain unauthorized access to the system.	Firewall rules and the online system limit the times when remote access can be granted and the types of activities and service requests that can be performed from external connections.
CC5.7	The transmission, movement, and removal of information is restricted to authorized users and processes, and is protected during	Nonpublic information is disclosed during transmission over public communication paths.	VPN, SSL, secure file transfer program (SFTP), and other encryption technologies are used for defined points of connectivity and to protect communications

Criteria		Risks	Illustrative Controls
	transmission, movement, or removal enabling the entity to meet its commitments and requirements as they relate to <i>[insert the principle(s) being reported on: security, availability, processing integrity, or confidentiality or any combination thereof]</i> .		between the processing center and users connecting to the processing center from within or external to customer networks.
			Entity policies prohibit the transmission of sensitive information over the Internet or other public communications paths (for example, e-mail) unless it is encrypted.
			Data loss prevention software is used to scan for sensitive information in outgoing transmissions over public communication paths.
		Removable media (for example, USB drives, DVDs, or tapes) are lost, intercepted, or copied during physical movement between locations.	Backup media are encrypted during creation.
			Storage for workstations and laptops is encrypted. Removable media for workstations and laptops are encrypted automatically by the software. Removable media is readable only by other entity owned devices.
			Other removable media are produced by data center operations and are transported via courier.
		Removable media used to make unauthorized copies of software or	Storage for workstations and laptops is encrypted.

(continued)

Criteria		Risks	Illustrative Controls
		data are taken beyond the boundaries of the system.	Removable media for these devices is encrypted automatically by the software. Removable media is readable only by other entity owned devices.
			Backup media are encrypted during creation.
CC5.8	Controls have been implemented to prevent or detect and act upon the introduction of unauthorized or malicious software.	Malicious or otherwise unauthorized code is used to intentionally or unintentionally compromise logical access controls or system functionality through data transmission, removable media, and portable or mobile devices.	The ability to install software on workstations and laptops is restricted to IT support personnel.
			Antivirus software is installed on workstations, laptops, and servers supporting such software.
			Antivirus software is configured to receive an updated virus signature at least daily. A network operation receives a report of devices that have not been updated in 30 days and follows up on the devices.
			The ability to install applications on systems is restricted to change implementation and system administration personnel.
CC6.0 Common Criteria Related to System Operations			
CC6.1	Vulnerabilities of system components to [insert the principle(s) being reported on: security, availability, processing integrity, or confidentiality or any combination thereof] breaches and incidents due to	Vulnerabilities that could lead to a breach or incident are not detected in a timely manner.	Logging and monitoring software is used to collect data from system infrastructure components and endpoint systems and used to monitor system performance, potential security threats and vulnerabilities, resource utilization, and to

Criteria		Risks	Illustrative Controls
	malicious acts, natural disasters, or errors are monitored and evaluated and countermeasures are implemented to compensate for known and new vulnerabilities.		detect unusual system activity or service requests. This software sends a message to the operations center and security organization and automatically opens a priority incident or problem ticket and change management system record item.
			Call center personnel receive telephone and e-mail requests for support, which may include requests to reset user passwords or notify entity personnel of potential breaches and incidents. Call center personnel follow defined protocols for recording, resolving, and escalating received requests.
		Security or other system configuration information is corrupted or otherwise destroyed, preventing the system from functioning as designed.	Weekly full-system and daily incremental backups are performed using an automated system.
CC6.2	<i>[Insert the principle(s) being reported on: security, availability, processing integrity, or confidentiality or any combination thereof]</i> incidents, including logical and physical security breaches, failures, concerns, and other complaints are identified, reported to appropriate personnel, and acted on in accordance with established incident response procedures.	Breaches and incidents are not identified, prioritized, or evaluated for effects.	Operations personnel follow defined protocols for evaluating reported events. Security related events are assigned to the security group for evaluation
		Corrective measures to address breaches and incidents are not	Operations and security personnel follow defined protocols

(continued)

Criteria		Risks	Illustrative Controls
		implemented in a timely manner.	for resolving and escalating reported events.
			Resolution of security events (incidents or problems) is reviewed at the daily and weekly operations and security group meetings.
			Internal and external users are informed of incidents in a timely manner and advised of corrective measure to be taken on their part.
		Corrective measures are not effective or sufficient.	Resolution of events is reviewed at the weekly operations and security group meetings.
			Change management requests are opened for events that require permanent fixes.
		Lack of compliance with policies and procedures is not addressed through sanctions or remedial actions resulting in increased noncompliance in the future.	The resolution of events is reviewed at the weekly operations and security group meetings. Relevant events with effects on user or customer are referred to user and customer care management to be addressed.
			Entity policies include probation, suspension, and termination as potential sanctions for employee misconduct.
		Breaches and incidents recur because preventive measures are not implemented after a previous event.	Change management requests are opened for events that require permanent fixes.
CC7.0	<i>Common Criteria Related to Change Management</i>		
CC7.1	<i>[Insert the principle(s) being reported on: security, availability, processing integrity, or confidentiality or any combination thereof]</i> commitments and requirements	Commitments and requirements are not addressed at one or more points during the system development lifecycle resulting in a system that does not meet system commitments and requirements.	System change requests are evaluated to determine the potential effect of the change on security, availability, processing integrity, and confidentiality commitments and

Criteria		Risks	Illustrative Controls
	are addressed during the system development lifecycle including design, acquisition, implementation, configuration, testing, modification, and maintenance of system components.		requirements throughout the change management process.
			System changes other than those classified as minor require the approval of the chief information security officer and operations manager prior to implementation.
CC7.2	Infrastructure, data, software, and procedures are updated as necessary to remain consistent with the system commitments and requirements as they relate to <i>[insert the principle(s) being reported on: security, availability, processing integrity, or confidentiality or any combination thereof]</i> .	System components are not updated for changes in requirements resulting in a system that does not meet system commitments and requirements.	During the ongoing risk assessment process and the periodic planning and budgeting processes, infrastructure, data, software, and procedures are evaluated for needed changes. Change requests are created based on the identified needs.
			For high severity incidents, a root cause analysis is prepared and reviewed by operations management. Based on the root cause analysis, change requests are prepared and the entity's risk management process and relevant risk management data is updated to reflect the planned incident and problem resolution.
CC7.3	Change management processes are initiated when deficiencies in the design or operating effectiveness of	Identified breaches, incidents, and other system impairments are not considered during the change management lifecycle.	For high severity incidents, a root cause analysis is prepared and reviewed by operations management. Based on

(continued)

Criteria		Risks	Illustrative Controls
	controls are identified during system operation and monitoring.		the root cause analysis, change requests are prepared and the entity's risk management process and relevant risk management data is updated to reflect the planned incident and problem resolution.
CC7.4	Changes to system components are authorized, designed, developed, configured, documented, tested, approved, and implemented in accordance with <i>[insert the principle(s) being reported on: security, availability, processing integrity, or confidentiality or any combination thereof]</i> commitments and requirements.	System changes are not authorized by those responsible for the design and operation of the system resulting in changes to the system that impairs its ability to meet system commitments and requirements.	System change requests must be reviewed and approved by the owner of the infrastructure or software and the change advisory board prior to work commencing on the requested change.
		System changes do not function as intended resulting in a system that does not meet system commitments and requirements.	Functional and detailed designs are prepared for other than minor changes (more than XX hours). Functional designs are reviewed and approved by the application or infrastructure and software owner and detailed designs are approved by the director of development for the application and the change advisory board prior to work commencing on the requested change or development project.
			Test plans and test data are created and used in required system and regression testing. Test plans and test data are reviewed and approved by the testing manager prior to and at the completion of testing,

Criteria		Risks	Illustrative Controls
			and reviewed by the change advisory board prior to newly developed or changed software being authorized for migration to production. Security vulnerability testing is included in the types of tests performed on relevant application, database, network, and operating system changes.
			System and regression testing is prepared by the testing department using approved test plans and test data. Deviations from planned results are analyzed and submitted to the developer.
			Code review or walkthrough is required for high impact changes that meet established criteria (that mandate code reviews and walkthroughs) and these are performed by a peer programmer that does not have responsibility for the change.
			Changes are reviewed and approved by the change advisory board prior to implementation.
			Established entity standards exist for infrastructure and software hardening and configuration that include requirements for implementation of access control software, entity configuration standards, and standardized access control lists.

(continued)

Criteria		Risks	Illustrative Controls
			Changes to hardening standards are reviewed and approved by the director in infrastructure management.
		Unauthorized changes are made to the system resulting in a system that does not meet system commitments and requirements.	Separate environments are used for development, testing, and production. Developers do not have the ability to make changes to software in testing or production.
			Logical access controls and change management tools restrict the ability to migrate between development, test, and production to change deployment personnel.
			Changes are reviewed and approved by the change advisory board prior to implementation.
		Unforeseen system implementation problems impair system operation resulting in a system that does not function as designed.	A turnover process that includes verification of operation and back out steps is used for every migration.
			Post implementation procedures that are designed to verify the operation of system changes are performed for one week after the implementation for other than minor changes, and results are shared with users and customers as required to meet commitments and requirements.
		Incompatibility duties exist within the change management process, particularly between approvers, designers, implementers, testers, and owners, resulting in	The change management process has defined the following roles and assignments: <ul style="list-style-type: none"> • Authorization of change requests—

Criteria		Risks	Illustrative Controls
		the implemented system not functioning as intended.	<p>owner or business unit manager</p> <ul style="list-style-type: none"> • Development—application design and support department • Testing—quality assurance department • Implementation—software change management group
<i>Additional Criteria for Availability</i>			
A1.1	Current processing capacity and usage are maintained, monitored and evaluated to manage capacity demand and to enable the implementation of additional capacity to help meet availability commitments and requirements.	Current processing capacity is not sufficient to meet availability commitments and requirements in the event of the loss of individual elements within the system components.	Processing capacity is monitored on an ongoing basis.
			Critical infrastructure components have been reviewed for criticality classification and assignment of a minimum level of redundancy.
		Processing capacity is not monitored, planned, and expanded or modified, as necessary, to provide for the continued availability of the system in accordance with system commitments and requirements.	Processing capacity is monitored on a daily basis.
			Future processing demand is forecasted and compared to scheduled capacity on an ongoing basis. Forecasts are reviewed and approved by senior operations management. Change requests are initiated as needed based on approved forecasts.

(continued)

Criteria		Risks	Illustrative Controls
A1.2	Environmental protections, software, data backup processes, and recovery infrastructure are designed, developed, implemented, operated, maintained, and monitored to meet availability commitments and requirements.	Environmental vulnerabilities and changing environmental conditions are not identified or addressed through the use of environmental protections resulting in a loss of system availability.	Environmental protections have been installed including the following: <ul style="list-style-type: none"> • Cooling systems • Battery and natural gas generator backup in the event of power failure • Redundant communications lines • Smoke detectors • Dry pipe sprinklers
		Environmental vulnerabilities are not monitored or acted upon increasing the severity of an environmental event.	Operations personnel monitor the status of environmental protections during each shift.
			Environmental protections receive maintenance on at least an annual basis.
		Software or data are lost or not available due to processing error, intentional act, or environmental event.	Weekly full-system and daily incremental backups are performed using an automated system.
			Backups are monitored for failure using an automated system and the incident management process is automatically invoked.
			Backups are transported and stored offsite by a third-party storage provider.
		System availability commitments and requirements are not met due to a lack of recovery infrastructure.	Business continuity and disaster recovery plans have been developed and updated annually.
			The entity has contracted with a third-party recovery facility to permit the resumption of IT operations in the event of a disaster at its data center.
			The entity uses a multi-location strategy for its facilities to permit the resumption

Criteria		Risks	Illustrative Controls
			of operations at other entity facilities in the event of loss of a facility.
A1.3	Procedures supporting system recovery in accordance with recovery plans are periodically tested to help meet availability commitments and requirements.	Recovery plans are not suitably designed and backups are not sufficient to permit recovery of system operation in accordance with commitments and requirements.	Business continuity and disaster recovery plans, including restoration of backups, are tested annually.
			Test results are reviewed and the contingency plan is adjusted.
<i>Additional Criteria for Processing Integrity</i>			
PI1.1	Procedures exist to prevent and detect and correct processing errors to meet processing integrity commitments and requirements.	Software or data are lost or not available due to processing error, intentional act, or environmental event.	Weekly full-system and daily incremental backups are performed using an automated system.
			Backups are monitored for failure using an automated system and the incident management process is automatically invoked.
			Backups are transported and stored offsite by a third-party storage provider.
		Environmental vulnerabilities are not addressed through the use of environmental protections resulting in a loss of system availability.	Environmental protections have been installed including the following: <ul style="list-style-type: none"> • Cooling systems • Battery and natural gas generator backup in the event of power failure • Redundant communications lines • Smoke detectors • Dry pipe sprinklers
		Environmental vulnerabilities are not monitored or acted upon	Operations personnel monitor the status of environmental

(continued)

Criteria		Risks	Illustrative Controls
		increasing the severity of an environmental event.	protections during each shift.
			Environmental protections receive maintenance on at least an annual basis.
		Current processing capacity is not sufficient to meet processing requirements resulting in processing errors.	Processing capacity is monitored on a daily basis.
			Critical infrastructure components have at a minimum level of redundancy.
PI1.2	System inputs are measured and recorded completely, accurately, and timely in accordance with processing integrity commitments and requirements.	Inputs are captured incorrectly.	Application edits limit input to acceptable value ranges.
			The data preparation clerk batches documents by date received and enters the date and number of sheets on the batch ticket. Batched forms are scanned by a purchased imaging system. Upon completion of the scanning process, the scanned sheets are compared to the count per the batch ticket by the scanning operator.
			Scanned images are processed through the optical character recognition (OCR) system. Key fields including customer identifier, customer name, and record type are validated by the system against records in the master data file.
			Text from free form sections from scan sheets is manually entered. This information is input

Criteria		Risks	Illustrative Controls
			twice by two separate clerks. The input information is compared and records with differences are sent to a third clerk for resolution.
		Inputs are not captured or captured completely.	System edits require mandatory fields to be complete before record entry is accepted.
			The data preparation clerk batches documents by date received and enters the date and number of sheets on the batch ticket. Batched forms are scanned by a purchased imaging system. Upon completion of the scanning process, the sheets scanned are compared to the count per the batch ticket by the scanning operator.
			Scanned images are processed through the OCR system. Key fields including customer identifier, customer name, and record type are validated by the system against records in the master data file.
			Text from free form sections from scan sheets is manually entered. This information is input twice by two separate clerks. The input information is compared and records with differences are sent to a third clerk for resolution.
			Electronic files received contain batch control totals. During the load processing data captured is reconciled to batch totals

(continued)

Criteria		Risks	Illustrative Controls
			automatically by the application.
		Inputs are not captured in a timely manner.	Electronic files received are processed as received. The application monitors files that fail to process completely and generate an incident management error record.
			Manual forms for data entry are batched upon receipt. Batches are traced to batches entered for processing daily by the date entry supervisor and differences are investigated.
		The final disposition of input cannot be traced to its source to validate that it was processed correctly and the results of processing cannot be traced to initial input to validate completeness and accuracy.	Inputs are coded with identification numbers, registration numbers, registration information, or time stamps to enable them to be traced from initial input to output and final disposition and from output to source inputs.
PI1.3	Data is processed completely, accurately, and timely as authorized in accordance with processing integrity commitments and requirements.	Data is lost during processing.	Input record counts are traced from entry to final processing. Any differences are investigated.
		Data is inaccurately modified during processing.	Application regression testing validates key processing for the application during the change management process.
			Output values are compared against prior cycle values. Variances greater than X percent are flagged on the variance report, logged to the incident management system, and investigated by the output clerk. Resolutions are

Criteria		Risks	Illustrative Controls
			documented in the incident management system. Open incidents are reviewed daily by the operations manager.
			Daily, weekly, and monthly trend reports are reviewed by the operations manager for unusual trends.
		Newly created data is inaccurate.	Application regression testing validates key processing for the application during the change management process.
			The system compares generated data to allowable values. Values outside the allowable values are written to the value exception report. Items on the value exception report are reviewed by the output clerk on a daily basis.
		Processing is not completed within required timeframes.	Scheduling software is used to control the submission and monitoring of job execution. An incident management record is generated automatically when processing errors are identified.
PI1.4	Data is stored and maintained completely and accurately for its specified life span in accordance with processing integrity commitments and requirements.	Data is not available for use as committed or agreed.	A mirror image of application data files is created nightly and stored on a second system for use in recovery and restoration in the event of a system disruption or outage.
		Stored data is inaccurate.	Logical access to stored data is restricted to the application and database administrators.
		Stored data is incomplete.	Data is reconciled on a monthly basis to help

(continued)

Criteria		Risks	Illustrative Controls
			meet customer commitments and requirements.
PI1.5	System output is complete, accurate, distributed, and retained in accordance with processing integrity commitments and requirements.	System output is not complete.	Application regression testing validates key processing for the application during the change management process.
			Output values are compared against prior cycle values. Variances greater than five percent are flagged on the variance report, logged to the incident management system, and investigated by the output clerk. Resolutions are documented in the incident management system. Open incidents are reviewed daily by the operations manager.
			On a monthly basis, total records processed are compared versus total records received via electronic submission, manual entry, and sheet scanned by the OCR system.
		System output is not accurate.	Application regression testing validates key processing for the application during the change management process.
			Output values are compared against prior cycle values. Variances greater than x percent are flagged on the variance report, logged to the incident management system, and investigated by the output clerk. Resolutions are documented in the incident management system. Open incidents

Criteria		Risks	Illustrative Controls
			are reviewed daily by the operations manager.
			Daily, weekly, and monthly trend reports are reviewed by the operations manager for unusual trends.
		System output is provided to unauthorized recipients.	Application security restricts output to approved user IDs.
		System output is not available to authorized recipients.	Application regression testing validates key processing for the application during the change management process.
			Output is generated by the system based on a master schedule. Changes to the master schedule are managed through the change management process and are approved by the customer service executive. On a daily basis, an automated routine scans output files to validate that all required output has been generated. The routine generates an incident record for any missing output. Incident tickets are managed through the incident management process.
PI1.6	Modification of data is authorized, using authorized procedures in accordance with processing integrity commitments and requirements.	Data is modified by an unauthorized process or procedure resulting in inaccurate or incomplete data.	Application regression testing validates key processing for the application during the change management process.
			Access to data is restricted to authorized applications through access control software. Access rules are created and maintained by information security personnel during the

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Criteria		Risks	Illustrative Controls
			application development process.
			Application level security restricts the ability to access, modify, and delete data to authenticated users who have been granted access through a record in the access control list. Creation and modification of access control records occurs through the access provisioning process.
		Data is modified without authorization.	Logical access to stored data is restricted to the application and database administrators.
		Data is lost or destroyed.	Logical access to stored data is restricted to the application and database administrators.
			A mirror image of application data files is created nightly and stored on a second secure system for use in recovery and restoration in the event of a system disruption or outage.
<i>Additional Criteria for Confidentiality</i>			
C1.1	Confidential information is protected during the system design, development, testing, implementation, and change processes in accordance with confidentiality commitments and requirements.	Data used in nonproduction environments is not protected from unauthorized access as committed.	The entity creates test data using data masking software that replaces confidential information with test information prior to the creation of test databases.
C1.2	Confidential information within the boundaries of the system is protected against unauthorized access, use, and disclosure during input, processing, retention, output, and disposition in	Unauthorized access to confidential information is obtained during processing.	Access to data is restricted to authorized applications through access control software. Access rules are created and maintained by information security personnel during the application development process.

Criteria		Risks	Illustrative Controls
	accordance with confidentiality commitments and requirements.		
			Logical access other than through authorized application is restricted to administrators through database management system native security. Creation and modification of access control records for the database management systems occurs through the access provisioning process.
			Application level security restricts the ability to access, modify, and delete data to authenticated users who have been granted access through a record in the access control list. Creation and modification of access control records occurs through the access provisioning process.
		Unauthorized access to confidential information in output is obtained after processing.	Application security restricts output to approved roles or user IDs.
			Output containing sensitive information is printed at the secure print facility and is marked with the legend "Confidential."
			Paper forms are physically secured after data entry. Physical access is restricted to storage clerks.
C1.3	Access to confidential information from outside the boundaries of the system and disclosure of confidential information is restricted to	Confidential information transmitted beyond the boundaries of the system is provided to unauthorized user entity personnel.	Application security restricts output to approved user IDs.

(continued)

Criteria		Risks	Illustrative Controls
	authorized parties in accordance with confidentiality commitments and requirements.		
			Transmission of digital output beyond the boundary of the system occurs through the use of authorized software supporting the advanced encryption standard (AES).
			Logical access to stored data is restricted to application and database administrators.
			Data is stored in encrypted format using software supporting the AES.
		Confidential information is transmitted to related parties, vendors, or other approved parties contravening confidentiality commitments.	Application security restricts output to approved user IDs.
			Transmission of digital output beyond the boundary of the system occurs through the use authorized software supporting the advanced encryption standard.
C1.4	The entity obtains confidentiality commitments that are consistent with the entity's confidentiality requirements, from vendors and other third parties whose products and services comprise part of the system and have access to confidential information.	Related party and vendor personnel are unaware of the entity's confidentiality commitments.	Formal information sharing agreements are in place with related parties and vendors. These agreements include confidentiality commitments applicable to that entity. Agreement terms include requirements for marking and identifying data as confidential, handling standards for confidential data in the custody of related parties and vendors, and return and

Criteria		Risks	Illustrative Controls
			disposal of confidential information when no longer required.
		Requirements for handling of confidential information are not communicated to and agreed to by related parties and vendors.	Formal information sharing agreements are in place with related parties and vendors. These agreements include confidentiality commitments applicable to that entity.
C1.5	Compliance with confidentiality commitments and requirements by vendors and others third parties whose products and services comprise part of the system is assessed on a periodic and as-needed basis and corrective action is taken, if necessary.	Related party and vendor systems are not suitably designed or operating effectively to comply with confidentiality commitments.	Related party and vendor systems are subject to review as part of the vendor risk management process. Attestation reports (SOC 2 reports) are obtained and evaluated when available. Site visits and other procedures are performed based on the entity's vendor management criteria.
C1.6	Changes to confidentiality commitments and requirements are communicated to internal and external users, vendors, and other third parties whose products and services are included in the system.	Confidentiality practices and commitments are changed without the knowledge or ascent of user entities.	The chief information security officer is responsible for changes to confidentiality practices and commitments. A formal process is used to communicate these changes to users, related parties, and vendors.
		Confidentiality practices and commitments are changed without the knowledge of related parties or vendors resulting in their systems not complying with the required practices and not meeting the commitments.	The chief information security officer is responsible for changes to confidentiality practices and commitments. A formal process is used to communicate these changes to users, related parties, and vendors.
			Related party and vendor agreements are modified to reflect changes in confidentiality practices and commitments.

(continued)

Criteria		Risks	Illustrative Controls
			Related party and vendor systems are subject to review as part of the vendor risk management process. Attestation reports (SOC 2 reports) are obtained and evaluated when available. Site visits and other procedures are performed based on the entity's vendor management criteria.

Appendix C – Generally Accepted Privacy Principles

[**Notice to Readers:** The criteria for the trust services privacy principle are currently under revision. These criteria are being revised separately from the trust services principles and criteria for security, availability, processing integrity, and confidentiality. Accordingly, until the criteria for the trust service privacy principle are finalized, the 2009 version of the generally accepted privacy principles contained in this appendix should be used.]

Generally Accepted Privacy Principles

August 2009

Foreword

The AICPA and the Canadian Institute of Chartered Accountants (CICA) strongly believe that privacy is a business issue. Considering what organizations face when trying to address privacy issues, we quickly concluded that businesses did not have a comprehensive framework to manage their privacy risks effectively. The institutes decided that they could provide a significant contribution by developing a privacy framework that would address the needs of all of the parties affected by privacy requirements or expectations. Therefore, the institutes developed a privacy framework called AICPA and CICA *Generally Accepted Privacy Principles*. The institutes are making these principles and criteria widely available to all parties interested in addressing privacy issues.

These principles and criteria were developed and updated by volunteers who considered both current international privacy regulatory requirements and best practices. These principles and criteria were issued following the due process procedures of both institutes, which included exposure for public comment. The adoption of these principles and criteria is voluntary.

An underlying premise to these principles is that good privacy is good business. Good privacy practices are a key component of corporate governance and accountability. One of today's key business imperatives is maintaining the privacy of personal information collected and held by an organization. As business systems and processes become increasingly complex and sophisticated, growing amounts of personal information are being collected. Because more data is being collected and held, most often in electronic format, personal information may be at risk to a variety of vulnerabilities, including loss, misuse, unauthorized access, and unauthorized disclosure. Those vulnerabilities raise concerns for organizations, governments, individuals, and the public in general.

For organizations operating in a multijurisdictional environment, managing privacy risk can be an even more significant challenge. Adherence to generally accepted privacy principles does not guarantee compliance with all laws and regulations to which an organization is subject. Organizations need to be aware of the significant privacy requirements in all of the jurisdictions in which they do business. Although this framework provides guidance on privacy in general, organizations should consult their own legal counsel to obtain advice and guidance on particular laws and regulations governing an organization's specific situation.

With these issues in mind, the AICPA and CICA developed *Generally Accepted Privacy Principles* to be used as an operational framework to help management address privacy in a manner that takes into consideration many local, national, or international requirements. The primary objective is to facilitate privacy compliance and effective privacy management. The secondary objective is to

provide suitable criteria against which a privacy attestation engagement (usually referred to as a privacy audit) can be performed.

Generally Accepted Privacy Principles represents the AICPA and CICA contribution to aid organizations in maintaining the effective management of privacy risk, recognizing the needs of organizations, and reflecting the public interest. Additional history about the development and additional privacy resources can be found online at www.aicpa.org/INTERESTAREAS/INFORMATIONTECHNOLOGY/RESOURCES/PRIVACY/Pages/default.aspx and www.cica.ca/privacy. *Generally Accepted Privacy Principles* can be downloaded from the AICPA and the CICA websites, at www.aicpa.org/INTERESTAREAS/INFORMATIONTECHNOLOGY/RESOURCES/PRIVACY/Pages/default.aspx and www.cica.ca/privacy, respectively.

Because the privacy environment is constantly changing, *Generally Accepted Privacy Principles* will need to be revised from time to time; accordingly, please forward any comments about this document by e-mail to the AICPA (GAPP@aicpa.org) or the CICA (privacy@cica.ca).

AICPA

CICA

Privacy—An Introduction to Generally Accepted Privacy Principles

Introduction

Many organizations find challenges in managing privacy¹ on local, national, or international bases. Most are faced with a number of differing privacy laws and regulations whose requirements need to be operationalized.

Generally Accepted Privacy Principles (GAPP) has been developed from a business perspective, referencing some, but by no means all, significant local, national, and international privacy regulations. GAPP operationalizes complex privacy requirements into a single privacy objective that is supported by 10 privacy principles. Each principle is supported by objective, measurable criteria that form the basis for effective management of privacy risk and compliance in an organization. Illustrative policy requirements, communications, and controls, including monitoring controls, are provided as support for the criteria.

GAPP can be used by any organization as part of its privacy program. GAPP has been developed to help management create an effective privacy program that addresses privacy risks and obligations, and business opportunities. It can also be a useful tool to boards and others charged with governance and providing oversight. This introduction includes a definition of privacy and an explanation of why privacy is a business issue and not solely a compliance issue. Also illustrated is how these principles can be applied to outsourcing scenarios and the potential types of privacy initiatives that can be undertaken for the benefit of organizations and their customers.

This introduction and the set of privacy principles and related criteria that follow will be useful to those who

- oversee and monitor privacy and security programs.
- implement and manage privacy in an organization.
- implement and manage security in an organization.

¹ The first occurrence of each word contained in the glossary is linked to the top of glossary.

- oversee and manage risks and compliance in an organization.
- assess compliance and audit privacy and security programs.
- regulate privacy.

Why Privacy Is a Business Issue

Good privacy is good business. Good privacy practices are a key part of corporate governance and accountability. One of today's key business imperatives is maintaining the privacy of personal information. As business systems and processes become increasingly complex and sophisticated, organizations are collecting growing amounts of personal information. As a result, personal information is vulnerable to a variety of risks, including loss, misuse, unauthorized access, and unauthorized disclosure. Those vulnerabilities raise concerns for organizations, governments, and the public in general.

Organizations are trying to strike a balance between the proper collection and use of their customers' personal information. Governments are trying to protect the public interest and, at the same time, manage their cache of personal information gathered from citizens. Consumers are very concerned about their personal information, and many believe they have lost control of it. Furthermore, the public has a significant concern about identity theft and inappropriate access to personal information, especially financial and medical records, and information about children.

Individuals expect their privacy to be respected and their personal information to be protected by the organizations with which they do business. They are no longer willing to overlook an organization's failure to protect their privacy. Therefore, all businesses need to effectively address privacy as a risk management issue. The following are specific risks of having inadequate privacy policies and procedures:

- Damage to the organization's reputation, brand, or business relationships
- Legal liability and industry or regulatory sanctions
- Charges of deceptive business practices
- Customer or employee distrust
- Denial of consent by individuals to have their personal information used for business purposes
- Lost business and consequential reduction in revenue and market share
- Disruption of international business operations
- Liability resulting from identity theft

International Privacy Considerations

For organizations operating in more than one country, the management of their privacy risk can be a significant challenge.

For example, the global nature of the Internet and business means regulatory actions in one country may affect the rights and obligations of individual users and customers around the world. Many countries have laws regulating trans-border data flow, including the European Union's (EU) directives on data protection and privacy, with which an organization must comply if it wants to do business in those countries. Therefore, organizations need to comply with changing privacy requirements around the world. Further, different jurisdictions have different privacy philosophies, making international compliance a complex task. To illustrate this, some countries view personal information as

belonging to the individual and take the position that the enterprise has a fiduciary-like relationship when collecting and maintaining such information. Alternatively, other countries view personal information as belonging to the enterprise that collects it.

In addition, organizations are challenged to try and stay up to date with the requirements for each country in which they do business. By adhering to a high global standard, such as those set out in this document, compliance with many regulations will be facilitated.

Even organizations with limited international exposure often face issues of compliance with privacy requirements in other countries. Many of these organizations are unsure how to address often stricter overseas regulations. This increases the risk that an organization inadvertently could commit a breach that becomes an example to be publicized by the offended host country.

Furthermore, many local jurisdictions (such as states or provinces) and certain industries, such as healthcare or banking, have specific requirements related to privacy.

Outsourcing and Privacy

Outsourcing increases the complexity for dealing with privacy. An organization may outsource a part of its business process and, with it, some responsibility for privacy; however, the organization cannot outsource its ultimate responsibility for privacy for its business processes. Complexity increases when the entity that performs the outsourced service is in a different country and may be subject to different privacy laws or perhaps no privacy requirements at all. In such circumstances, the organization that outsources a business process will need to ensure it manages its privacy responsibilities appropriately.

GAPP and its supporting criteria can assist an organization in completing assessments (including independent examinations) about the privacy policies, procedures, and practices of the third party providing the outsourced services.

The fact that these principles and criteria have global application can provide comfort to an outsourcer that privacy assessments can be undertaken using a consistent measurement based on internationally known fair information practices.

What Is Privacy?

Privacy Definition

Privacy is defined in *Generally Accepted Privacy Principles* as “the rights and obligations of individuals and organizations with respect to the collection, use, retention, disclosure, and disposal of personal information.”

Personal Information

Personal information (sometimes referred to as personally identifiable information) is information that is about, or can be related to, an identifiable individual. It includes any information that can be linked to an individual or used to directly or indirectly identify an individual. Individuals, for this purpose, include prospective, current, and former customers, employees, and others with whom the entity has a relationship. Most information collected by an organization about an individual is likely to be considered personal information if it can be attributed to an identified individual. Some examples of personal information are as follows:

- Name
- Home or e-mail address

- Identification number (for example, a Social Security or Social Insurance Number)
- Physical characteristics
- Consumer purchase history

Some personal information is considered sensitive. Some laws and regulations define the following to be sensitive personal information:

- Information on medical or health conditions
- Financial information
- Racial or ethnic origin
- Political opinions
- Religious or philosophical beliefs
- Trade union membership
- Sexual preferences
- Information related to offenses or criminal convictions

Sensitive personal information generally requires an extra level of protection and a higher duty of care. For example, some jurisdictions may require explicit consent rather than implicit consent for the collection and use of sensitive information.

Some information about or related to people cannot be associated with specific individuals. Such information is referred to as *nonpersonal information*. This includes statistical or summarized personal information for which the identity of the individual is unknown or linkage to the individual has been removed. In such cases, the individual's identity cannot be determined from the information that remains because the information is deidentified or anonymized. Nonpersonal information ordinarily is not subject to privacy protection because it cannot be linked to an individual. However, some organizations may still have obligations over nonpersonal information due to other regulations and agreements (for example, clinical research and market research).

Privacy or Confidentiality?

Unlike personal information, which is often defined by law or regulation, no single definition of confidential information exists that is widely recognized. In the course of communicating and transacting business, partners often exchange information or data that one or the other party requires be maintained on a “need to know” basis. Examples of the kinds of information that may be subject to a confidentiality requirement include the following:

- Transaction details
- Engineering drawings
- Business plans
- Banking information about businesses
- Inventory availability
- Bid or ask prices
- Price lists
- Legal documents
- Revenue by client and industry

Also, unlike personal information, rights of access to confidential information to ensure its accuracy and completeness are not clearly defined. As a result, interpretations of what is considered to be confidential information can vary significantly from organization to organization and, in most cases, are driven by contractual arrangements. For additional information on criteria for confidentiality, refer to the AICPA and CICA *Trust Services Principles, Criteria, and Illustrations for Security, Availability, Processing Integrity, Confidentiality, and Privacy* (see www.aicpa.org/INTERESTAREAS/INFORMATIONTECHNOLOGY/RESOURCES/TRUSTSERVICES/Pages/default.aspx or www.webtrust.org).

Introducing Generally Accepted Privacy Principles

GAPP is designed to assist management in creating an effective privacy program that addresses their privacy obligations, risks, and business opportunities.

The privacy principles and criteria are founded on key concepts from significant local, national, and international privacy laws, regulations, guidelines,² and good business practices. By using GAPP, organizations can proactively address the significant challenges that they face in establishing and managing their privacy programs and risks from a business perspective. GAPP also facilitates the management of privacy risk on a multijurisdictional basis.

Overall Privacy Objective

The privacy principles and criteria are founded on the following privacy objective.

Personal information is collected, used, retained, disclosed, and disposed of in conformity with the commitments in the entity's privacy notice and with criteria set forth in *Generally Accepted Privacy Principles* issued by the AICPA and CICA.

Generally Accepted Privacy Principles

The privacy principles are essential to the proper protection and management of personal information. They are based on internationally known fair information practices included in many privacy laws and regulations of various jurisdictions around the world and recognized good privacy practices.

The following are the 10 *generally accepted privacy principles*:

1. *Management.* The entity defines, documents, communicates, and assigns accountability for its privacy policies and procedures.
2. *Notice.* The entity provides notice about its privacy policies and procedures and identifies the purposes for which personal information is collected, used, retained, and disclosed.
3. *Choice and consent.* The entity describes the choices available to the individual and obtains implicit or explicit consent with respect to the collection, use, and disclosure of personal information.

² For example, the Organisation for Economic Co-operation and Development has issued Guidelines on the Protection of Privacy and Transborder Flows of Personal Data and the European Union has issued Directive on Data Privacy (Directive 95/46/EC). In addition, the United States has enacted the Gramm-Leach-Bliley Act, the Health Insurance Portability and Accountability Act, and the Children's Online Privacy Protection Act. Canada has enacted the Personal Information Protection and Electronic Documents Act and Australia has enacted the Australian Privacy Act of 1988, as amended in 2001. A chart comparing these international privacy concepts with generally accepted privacy principles can be found online at www.aicpa.org/INTERESTAREAS/INFORMATIONTECHNOLOGY/RESOURCES/PRIVACY/Pages/default.aspx. Compliance with this set of generally accepted privacy principles and criteria may not necessarily result in compliance with applicable privacy laws and regulations, and entities should seek appropriate legal advice regarding compliance with any laws and regulations.

4. *Collection.* The entity collects personal information only for the purposes identified in the notice.
5. *Use, retention, and disposal.* The entity limits the use of personal information to the purposes identified in the notice and for which the individual has provided implicit or explicit consent. The entity retains personal information for only as long as necessary to fulfill the stated purposes or as required by law or regulations and thereafter appropriately disposes of such information.
6. *Access.* The entity provides individuals with access to their personal information for review and update.
7. *Disclosure to third parties.* The entity discloses personal information to third parties only for the purposes identified in the notice and with the implicit or explicit consent of the individual.
8. *Security for privacy.* The entity protects personal information against unauthorized access (both physical and logical).
9. *Quality.* The entity maintains accurate, complete, and relevant personal information for the purposes identified in the notice.
10. *Monitoring and enforcement.* The entity monitors compliance with its privacy policies and procedures and has procedures to address privacy related complaints and disputes.

For each of the 10 privacy principles, relevant, objective, complete, and measurable criteria have been specified to guide the development and evaluation of an entity's privacy policies, communications, and procedures and controls. *Privacy policies* are written statements that convey management's intent, objectives, requirements, responsibilities, and standards. *Communications* refers to the organization's communication to individuals, internal personnel, and third parties about its privacy notice and its commitments therein and other relevant information. *Procedures and controls* are the other actions the organization takes to achieve the criteria.

Using GAPP

GAPP can be used by organizations for the following:

- Designing, implementing, and communicating privacy policy
- Establishing and managing privacy programs
- Monitoring and auditing privacy programs
- Measuring performance and benchmarking

Establishing and managing a privacy program involves the following activities:

Strategizing. Performing privacy strategic and business planning.

Diagnosing. Performing privacy gap and risk analyses.

Implementing. Developing, documenting, introducing, and institutionalizing the program's action plan, including establishing controls over personal information.

Sustaining and managing. Monitoring activities of a privacy program.

Auditing. Internal or external auditors evaluating the organization's privacy program.

The following table summarizes and illustrates how GAPP can be used by an organization to address these business activities.

<i>Activity</i>	<i>General Discussion</i>	<i>Potential Use of Generally Accepted Privacy Principles</i>
Strategizing	<p>Vision. An entity's strategy is concerned with its long-term direction and prosperity. The vision identifies the entity's culture and helps shape and determine how the entity will interact with its external environment, including customers, competitors, and legal, social, and ethical issues.</p> <p>Strategic Planning. This is an entity's overall master plan, encompassing its strategic direction. Its objective is to ensure that the entity's efforts are all headed in a common direction. The strategic plan identifies the entity's long-term goals and major issues for becoming privacy compliant.</p> <p>Resource Allocation. This step identifies the human, financial, and other resources allocated to achieve the goals and objectives set forth in the strategic plan or business plan.</p>	<p>Vision. Within an entity's privacy effort, establishing the vision helps the entity integrate preferences and prioritize goals.</p> <p>Strategic Planning. Within an entity's privacy effort, <i>Generally Accepted Privacy Principles</i> (GAPP) can be used to assist the organization in identifying significant components that need to be addressed.</p> <p>Resource Allocation. Using GAPP, the entity would identify the people working with and responsible for areas that might include systems management, privacy and security concerns, and stipulate the resourcing for their activities.</p> <p>Overall Strategy. A strategic document describes expected or intended future development. GAPP can assist an entity in clarifying plans for the systems under consideration or for the business's privacy objectives. The plan identifies the process to achieve goals and milestones. It also provides a mechanism to communicate critical implementation elements, including details on services, budgets, development costs, promotion, and privacy advertising.</p>
Diagnosing	<p>This stage, often referred to as the assessment phase, encompasses a thorough analysis of the entity's environment, identifying opportunities where weaknesses, vulnerability, and threats exist. The most common initial project for an organization is a diagnostic assessment. The purpose of such an assessment is to evaluate the entity against its privacy goals and objectives and determine to what extent the organization is achieving those goals and objectives.</p>	<p>GAPP can assist the entity in understanding its high-level risks, opportunities, needs, privacy policy and practices, competitive pressures, and the requirements of the relevant laws and regulations to which the entity is subject.</p> <p>GAPP provides a legislative neutral benchmark to allow the entity to assess the current state of privacy against the desired state.</p>

<i>Activity</i>	<i>General Discussion</i>	<i>Potential Use of Generally Accepted Privacy Principles</i>
Implementing	At this point, an action plan is mobilized or a diagnostic recommendation is put into effect, or both. Implementing involves developing and documenting a privacy program and action plan and the execution of all planned and other tasks necessary to make the action plan operational. It includes defining who will perform what tasks, assigning responsibilities, and establishing schedules and milestones. This involves the planning and implementation of a series of planned projects to provide guidance, direction, methodology, and tools to the organization in developing its initiatives.	GAPP can assist the entity in meeting its implementation goals. At the completion of the implementation phase, the entity should have developed the following deliverables: <ul style="list-style-type: none"> • Systems, procedures, and processes to address the privacy requirements • Updated privacy compliant forms, brochures, and contracts • Internal and external privacy awareness programs
Sustaining and managing	Sustaining and managing involves monitoring the work to identify how progress differs from the action plan in time to initiate corrective action. Monitoring refers to the management policies, processes, and supporting technology to ensure compliance with organizational privacy policies and procedures and the ability to exhibit due diligence.	The entity can use GAPP to develop appropriate reporting criteria for monitoring requests for information, the sources used to compile the information and the information actually disclosed. It can also be used for determining validation procedures to ensure that the parties to whom the information was disclosed are entitled to receive that information.
Internal privacy audit	Internal auditors provide objective assurance and consulting services designed to add value and improve an entity's operations. They help an entity accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.	Internal auditors can evaluate an entity's privacy program and controls using GAPP as a benchmark and provide useful information and reporting to management.
External privacy audit	External auditors, notably certified public accountants (CPAs) and chartered accountants (CAs), can perform attestation and assurance services. Generally, these services, whether performed on financial and nonfinancial information, build trust and confidence for individuals, management, customers, business partners, and other users.	An external auditor can evaluate an entity's privacy program and controls in accordance with GAPP and provide reports useful to individuals, management, customers, business partners, and other users.

Presentation of Generally Accepted Privacy Principles and Criteria

Under each principle, the criteria are presented in a three column format. The first column contains the measurement criteria. The second column contains illustrative controls and procedures, which are designed to provide examples and enhance the understanding of how the criteria might be applied. The illustrations are not intended to be comprehensive, nor are any of the illustrations required for an entity to have met the criteria. The third column contains additional considerations, including supplemental information such as good privacy practices and selected requirements of specific laws and regulations that may pertain to a certain industry or country.

Some of the criteria may not be directly applicable to some organizations or some processes. When a criterion is considered not applicable, the entity should consider justifying that decision to support future evaluation.

These principles and criteria provide a basis for designing, implementing, maintaining, evaluating, and auditing a privacy program to meet an entity's needs.

Generally Accepted Privacy Principles and Criteria

Management

<i>Ref.</i>	<i>Management Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
1.0	The entity defines, documents, communicates, and assigns accountability for its privacy policies and procedures.		
1.1	Policies and Communications		
1.1.0	Privacy Policies The entity defines and documents its privacy policies with respect to the following: <i>a.</i> Notice (See 2.1.0) <i>b.</i> Choice and consent (See 3.1.0) <i>c.</i> Collection (See 4.1.0) <i>d.</i> Use, retention, and disposal (See 5.1.0) <i>e.</i> Access (See 6.1.0) <i>f.</i> Disclosure to third parties (See 7.1.0) <i>g.</i> Security for privacy (See 8.1.0) <i>h.</i> Quality (See 9.1.0) <i>i.</i> Monitoring and enforcement (See 10.1.0)	Privacy policies are documented in writing and made readily available to internal personnel and third parties who need them.	
1.1.1	Communication to Internal Personnel Privacy policies and the consequences of noncompliance with such policies are communicated, at least	The entity <ul style="list-style-type: none"> periodically communicates to internal personnel (for example, on a network or a website) relevant information about the entity's 	Privacy policies (as used herein) include security policies relevant to the protection of personal information.

<i>Ref.</i>	<i>Management Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
	<p>annually, to the entity's internal personnel responsible for collecting, using, retaining, and disclosing personal information. Changes in privacy policies are communicated to such personnel shortly after the changes are approved.</p>	<p>privacy policies. Changes to its privacy policies are communicated shortly after approval.</p> <ul style="list-style-type: none"> requires internal personnel to confirm (initially and periodically) their understanding of the entity's privacy policies and their agreement to comply with them. 	
1.1.2	<p>Responsibility and Accountability for Policies Responsibility and accountability are assigned to a person or group for developing, documenting, implementing, enforcing, monitoring, and updating the entity's privacy policies. The names of such person or group and their responsibilities are communicated to internal personnel.</p>	<p>The entity assigns responsibility for privacy policies to a designated person, such as a corporate privacy officer. (Those assigned responsibility for privacy policies may be different from those assigned for other policies, such as security).</p> <p>The responsibility, authority, and accountability of the designated person or group are clearly documented. Responsibilities include the following:</p> <ul style="list-style-type: none"> Establishing with management the standards used to classify the sensitivity of personal information and to determine the level of protection required Formulating and maintaining the entity's privacy policies Monitoring and updating the entity's privacy policies Delegating authority for enforcing the entity's privacy policies Monitoring the degree of compliance and initiating action 	<p>The individual identified as being accountable for privacy should be from within the entity.</p>

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<i>Ref.</i>	<i>Management Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		<p>to improve the training or clarification of policies and practices</p> <p>A committee of the board of directors includes privacy periodically in its regular review of overall corporate governance.</p>	
1.2	Procedures and Controls		
1.2.1	Review and Approval Privacy policies and procedures, and changes thereto, are reviewed and approved by management.	<p>Privacy policies and procedures are</p> <ul style="list-style-type: none"> • reviewed and approved by senior management or a management committee. • reviewed at least annually and updated as needed. 	
1.2.2	Consistency of Privacy Policies and Procedures With Laws and Regulations Policies and procedures are reviewed and compared to the requirements of applicable laws and regulations at least annually and whenever changes to such laws and regulations are made. Privacy policies and procedures are revised to conform with the requirements of applicable laws and regulations.	<p>Corporate counsel or the legal department</p> <ul style="list-style-type: none"> • determines which privacy laws and regulations are applicable in the jurisdictions in which the entity operates. • identifies other standards applicable to the entity. • reviews the entity's privacy policies and procedures to ensure they are consistent with the applicable laws, regulations, and appropriate standards. 	<p>In addition to legal and regulatory requirements, some entities may elect to comply with certain standards, such as those published by International Organization for Standardization (ISO), or may be required to comply with certain standards, such as those published by the payment card industry, as a condition of doing business. Entities may include such standards as part of this process.</p>
1.2.3	Personal Information Identification and Classification The types of personal information and sensitive personal information and the related processes, systems, and third parties involved in the handling of such information are identified. Such	<p>The entity has both an information classification policy and process, which include the following:</p> <ul style="list-style-type: none"> • A classification process, which identifies and classifies information into one or more of the following categories: <ul style="list-style-type: none"> — Business confidential 	

<i>Ref.</i>	<i>Management Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
	information is covered by the entity's privacy and related security policies and procedures.	<ul style="list-style-type: none"> — Personal information (sensitive and other personal information) — Business general — Public • Identifying processes, systems, and third parties that handle personal information • Specific security and privacy policies and procedures that apply to each category of information 	
1.2.4	<p>Risk Assessment</p> <p>A risk assessment process is used to establish a risk baseline and to, at least annually, identify new or changed risks to personal information and to develop and update responses to such risks.</p>	<p>A process is in place to periodically identify the risks to the entity's personal information. Such risks may be external (such as loss of information by vendors or failure to comply with regulatory requirements) or internal (such as emailing unprotected sensitive information). When new or changed risks are identified, the privacy risk assessment and the response strategies are updated.</p> <p>The process considers factors such as experience with privacy incident management, the complaint and dispute resolution process, and monitoring activities.</p>	<p>Ideally, the privacy risk assessment should be integrated with the security risk assessment and be a part of the entity's overall enterprise risk management program. The board or a committee of the board should provide oversight and review of the privacy risk assessment.</p>
1.2.5	<p>Consistency of Commitments With Privacy Policies and Procedures</p> <p>Internal personnel or advisers review contracts for consistency with privacy policies and procedures and address any inconsistencies.</p>	<p>Both management and the legal department review all contracts and service-level agreements for consistency with the entity's privacy policies and procedures.</p>	

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<i>Ref.</i>	<i>Management Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
1.2.6	<p>Infrastructure and Systems Management</p> <p>The potential privacy impact is assessed when new processes involving personal information are implemented, and when changes are made to such processes (including any such activities outsourced to third parties or contractors), and personal information continues to be protected in accordance with the privacy policies. For this purpose, processes involving personal information include the design, acquisition, development, implementation, configuration, modification and management of the following:</p> <ul style="list-style-type: none"> • Infrastructure • Systems • Applications • Websites • Procedures • Products and services • Data bases and information repositories • Mobile computing and other similar electronic devices <p>The use of personal information in process and system test and development is prohibited unless such information is anonymized or otherwise protected in accordance with the entity's privacy policies and procedures.</p>	<p>The following are used for addressing privacy impact:</p> <ul style="list-style-type: none"> • Management assesses the privacy impact of new and significantly changed products, services, business processes, and infrastructure. • The entity uses a documented systems development and change management process for all information systems and related technology (including manual procedures, application programs, technology infrastructure, organizational structure, and the responsibilities of users and systems personnel), used to collect, use, retain, disclose, and destroy personal information. • The entity assesses planned new systems and changes for their potential effect on privacy. • Changes to system components are tested to minimize the risk of any adverse effect on the protection of personal information. All test data are anonymized. A controlled test database is maintained for full regression testing to ensure that changes to one program do not adversely affect other programs that process personal information. • Procedures ensure the maintenance of 	<p>Some jurisdictions prohibit the use of personal information for test and development purposes unless it has been anonymized or otherwise protected to the same level required in its policies for production information.</p>

<i>Ref.</i>	<i>Management Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		<p>integrity and protection of personal information during migration from old to new or changed systems.</p> <ul style="list-style-type: none"> • Documentation and approval by the privacy officer, security officer, business unit manager, and IT management are required before implementing the changes to systems and procedures that handle personal information, including those that may affect security. Emergency changes are required to maintain the same level of protection of personal information; however, they may be documented and approved on an after-the-fact basis. 	
		<p>The IT function maintains a listing of all software that processes personal information and the respective level, version, and patches that have been applied.</p>	
		<p>Procedures exist to provide that only authorized, tested, and documented changes are made to the system.</p>	
		<p>Where computerized systems are involved, appropriate procedures are followed, such as the use of separate development, test, and production libraries to ensure that access to personal information is appropriately restricted.</p>	
		<p>Personnel responsible for initiating or implementing new systems and changes,</p>	

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<i>Ref.</i>	<i>Management Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		and users of new or revised processes and applications, are provided training and awareness sessions related to privacy. Specific roles and responsibilities are assigned related to privacy.	
1.2.7	<p>Privacy Incident and Breach Management A documented privacy incident and breach management program has been implemented that includes, but is not limited to, the following:</p> <ul style="list-style-type: none"> • Procedures for the identification, management, and resolution of privacy incidents and breaches • Defined responsibilities • A process to identify incident severity and determine required actions and escalation procedures • A process for complying with breach laws and regulations, including stakeholders breach notification, if required • An accountability process for employees or third parties responsible for incidents or breaches with remediation, penalties, or discipline as appropriate • A process for periodic review (at least on an annual basis) of actual incidents to identify necessary program updates based on the following: <ul style="list-style-type: none"> — Incident patterns and root cause 	<p>A formal, comprehensive privacy incident and breach management program has been implemented, which specifies the following:</p> <ul style="list-style-type: none"> • Incidents and breaches are reported to a member of the breach team, who assesses if it is privacy or security related, or both, classifies the severity of the incident, initiates required actions, and determines the required involvement by individuals who are responsible for privacy and security. • The chief privacy officer (CPO) has the overall accountability for the program and is supported by the privacy and security steering committees and assisted by the breach team. Incidents and breaches that do not involve personal information are the responsibility of the chief security officer. • The entity has a privacy breach notification policy, supported by (a) a process for identifying the notification and related requirements of other applicable jurisdictions 	<p>Some entities may adopt a breach notification policy for consistent use across all jurisdictions in which they operate. By necessity, such a policy would, at a minimum, be based on the most comprehensive legal requirements in any such jurisdiction.</p>

<i>Ref.</i>	<i>Management Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
	<ul style="list-style-type: none"> — Changes in the internal control environment or external requirements (regulation or legislation) • Periodic testing or walkthrough process (at least on an annual basis) and associated program remediation as needed 	<p>relating to the data subjects affected by the breach, (b) a process for assessing the need for stakeholders breach notification, if required by law, regulation, or policy, and (c) a process for delivering the notice in a timely manner. The entity has agreements in place with a third party to manage the notification process and provide credit monitoring services for individuals, if needed.</p> <ul style="list-style-type: none"> • The program includes a clear escalation path, based on the type or severity, or both, of the incident, up to executive management, legal counsel, and the board. • The program sets forth a process for contacting law enforcement, regulatory, or other authorities when necessary. • Program training for new hires and team members, and awareness training for general staff, is conducted annually, when a significant change in the program is implemented, and after any major incident. <p>The privacy incident and breach management program also specifies the following:</p> <ul style="list-style-type: none"> • After any major privacy incident, a formal incident evaluation is conducted by 	

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<i>Ref.</i>	<i>Management Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		<p>internal audit or outside consultants.</p> <ul style="list-style-type: none"> • A quarterly review of actual incidents is conducted and required program updates are identified based on the following: <ul style="list-style-type: none"> — Incident root cause — Incident patterns — Changes in the internal control environment and legislation • Results of the quarterly review are reported to the privacy steering committee and annually to the audit committee. • Key metrics are defined, tracked and reported to senior management on a quarterly basis. • The program is tested at least every six months and shortly after the implementation of significant system or procedural changes. 	
1.2.8	<p>Supporting Resources Resources are provided by the entity to implement and support its privacy policies.</p>	<p>Management annually reviews the assignment of personnel, budgets, and allocation of other resources to its privacy program.</p>	
1.2.9	<p>Qualifications of Internal Personnel The entity establishes qualifications for personnel responsible for protecting the privacy and security of personal information and assigns</p>	<p>The qualifications of internal personnel responsible for protecting the privacy and security of personal information are ensured by procedures such as the following:</p>	

<i>Ref.</i>	<i>Management Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
	such responsibilities only to those personnel who meet these qualifications and have received needed training.	<ul style="list-style-type: none"> • Formal job descriptions (including responsibilities, educational and professional requirements, and organizational reporting for key privacy management positions) • Hiring procedures (including the comprehensive screening of credentials, background checks, and reference checking) and formal employment and confidentiality agreements • Performance appraisals (performed by supervisors, including assessments of professional development activities) 	
1.2.10	<p>Privacy Awareness and Training</p> <p>A privacy awareness program about the entity's privacy policies and related matters, and specific training for selected personnel depending on their roles and responsibilities, are provided.</p>	<p>An interactive online privacy and security awareness course is required annually for all employees. New employees, contractors, and others are required to complete this course within the first month following employment in order to retain their access privileges.</p> <p>In-depth training is provided which covers privacy and relevant security policies and procedures, legal and regulatory considerations, incident response, and related topics. Such training is</p> <ul style="list-style-type: none"> • required annually for all employees who have access to personal information or are responsible for protection of personal information. 	

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<i>Ref.</i>	<i>Management Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		<ul style="list-style-type: none"> • tailored to the employee's job responsibilities. • supplemented by external training and conferences. <p>Attendance at the entity's privacy training and awareness courses is monitored.</p> <p>Training and awareness courses are reviewed and updated to reflect current legislative, regulatory, industry, and entity policy and procedure requirements.</p>	
1.2.11	<p>Changes in Regulatory and Business Requirements</p> <p>For each jurisdiction in which the entity operates, the effect on privacy requirements from changes in the following factors is identified and addressed:</p> <ul style="list-style-type: none"> • Legal and regulatory • Contracts, including service-level agreements • Industry requirements • Business operations and processes • People, roles, and responsibilities • Technology <p>Privacy policies and procedures are updated to reflect changes in requirements.</p>	<p>The entity has an ongoing process in place to monitor, assess, and address the effect on privacy requirements from changes in the following:</p> <ul style="list-style-type: none"> • Legal and regulatory environments • Industry requirements (such as those for the Direct Marketing Association) • Contracts, including service-level agreements with third parties (changes that alter the privacy and security related clauses in contracts are reviewed and approved by the privacy officer or legal counsel before they are executed) • Business operations and processes • People assigned responsibility for privacy and security matters • Technology (prior to implementation) 	<p>Ideally, these procedures would be coordinated with the risk assessment process.</p> <p>The entity also should consider emerging and good practices, such as breach notification in jurisdictions where none is required.</p>

Notice

<i>Ref.</i>	<i>Notice Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
2.0	The entity provides notice about its privacy policies and procedures and identifies the purposes for which personal information is collected, used, retained, and disclosed.		
2.1	Policies and Communications		
2.1.0	Privacy Policies		
	The entity's privacy policies address providing notice to individuals.		
2.1.1	Communication to Individuals	The entity's privacy notice	Notice also may describe situations in which personal information will be disclosed, such as the following:
	Notice is provided to individuals regarding the following privacy policies:	<ul style="list-style-type: none"> describes the personal information collected, the sources of such information, and purposes for which it is collected. indicates the purpose for collecting sensitive personal information and whether such purpose is part of a legal requirement. describes the consequences, if any, of not providing the requested information. indicates that certain information may be developed about individuals, such as buying patterns. may be provided in various ways (for example, in a face-to-face conversation, on a telephone interview, on an application form or questionnaire, or electronically). However, written notice is the preferred method. 	<ul style="list-style-type: none"> Certain processing for purposes of public security or defense Certain processing for purposes of public health or safety When allowed or required by law
	<ol style="list-style-type: none"> Purpose for collecting personal information Choice and consent (See 3.1.1) Collection (See 4.1.1) Use, retention, and disposal (See 5.1.1) Access (See 6.1.1) Disclosure to third parties (See 7.1.1) Security for privacy (See 8.1.1) Quality (See 9.1.1) Monitoring and enforcement (See 10.1.1) <p>If personal information is collected from sources other than the individual, such sources are described in the notice.</p>		<p>The purpose described in the notice should be stated in such a manner that the individual can reasonably understand the purpose and how the personal information is to be used. Such purpose should be consistent with the business purpose of the entity and not overly broad.</p> <p>Consideration should be given to providing a summary level notice with links to more detailed sections of the policy.</p>
2.2	Procedures and Controls		
2.2.1	Provision of Notice	The privacy notice is	See 3.2.2, "Consent for New Purposes and Uses."
	Notice is provided to the individual about the	<ul style="list-style-type: none"> readily accessible and available when personal information 	

(continued)

<i>Ref.</i>	<i>Notice Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
	entity's privacy policies and procedures (a) at or before the time personal information is collected, or as soon as practical thereafter, (b) at or before the entity changes its privacy policies and procedures, or as soon as practical thereafter, or (c) before personal information is used for new purposes not previously identified.	<p>is first collected from the individual.</p> <ul style="list-style-type: none"> provided in a timely manner (that is, at or before the time personal information is collected, or as soon as practical thereafter) to enable individuals to decide whether or not to submit personal information to the entity. clearly dated to allow individuals to determine whether the notice has changed since the last time they read it or since the last time they submitted personal information to the entity. <p>In addition, the entity</p> <ul style="list-style-type: none"> tracks previous iterations of the entity's privacy policies and procedures. informs individuals of a change to a previously communicated privacy notice, for example, by posting the notification on the entity's website, by sending written notice via postal mail, or by sending an e-mail. documents that changes to privacy policies and procedures were communicated to individuals. 	Some regulatory requirements indicate that a privacy notice is to be provided on a periodic basis, for example, annually in the Gramm-Leach-Bliley Act (GLBA).
2.2.2	<p>Entities and Activities Covered</p> <p>An objective description of the entities and activities covered by the privacy policies and procedures is included in the entity's privacy notice.</p>	<p>The privacy notice describes the particular entities, business segments, locations, and types of information covered, such as:</p> <ul style="list-style-type: none"> Operating jurisdictions (legal and political) Business segments and affiliates Lines of business 	

<i>Ref.</i>	<i>Notice Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
2.2.3	<p>Clear and Conspicuous The entity's privacy notice is conspicuous and uses clear language.</p>	<ul style="list-style-type: none"> • Types of third parties (for example, delivery companies and other types of service providers) • Types of information (for example, information about customers and potential customers) • Sources of information (for example, mail order or online) <p>The entity informs individuals when they might assume they are covered by the entity's privacy policies but, in fact, are no longer covered (for example, linking to another website that is similar to the entity's, or using services on the entity's premises provided by third parties).</p> <p>The privacy notice is</p> <ul style="list-style-type: none"> • in plain and simple language. • appropriately labeled, easy to see, and not in unusually small print. • linked to or displayed on the website at points of data collection. • available in the national languages used on the site or in languages required by law. 	<p>If multiple notices are used for different subsidiaries or segments of an entity, similar formats are encouraged to avoid consumer confusion and allow consumers to identify any differences.</p> <p>Some regulations may contain specific information that a notice must contain.</p> <p>Illustrative notices are often available for certain industries and types of collection, use, retention, and disclosure.</p>

Choice and Consent

<i>Ref.</i>	<i>Choice and Consent Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
3.0	The entity describes the choices available to the individual and obtains implicit or explicit consent with respect to the collection, use, and disclosure of personal information.		
3.1	Policies and Communications		
3.1.0	Privacy Policies		
	The entity's privacy policies address the choices available to individuals and the consent to be obtained.		
3.1.1	Communication to Individuals		
	Individuals are informed about (a) the choices available to them with respect to the collection, use, and disclosure of personal information, and (b) that implicit or explicit consent is required to collect, use, and disclose personal information, unless a law or regulation specifically requires or allows otherwise.	<p>The entity's privacy notice describes, in a clear and concise manner, the following:</p> <ul style="list-style-type: none"> • The choices available to the individual regarding the collection, use, and disclosure of personal information • The process an individual should follow to exercise these choices (for example, checking an opt out box to decline receiving marketing materials) • The ability of, and process for, an individual to change contact preferences • The consequences of failing to provide personal information required for a transaction or service <p>Individuals are advised of the following:</p> <ul style="list-style-type: none"> • Personal information not essential to the purposes identified in the privacy notice need not be provided. • Preferences may be changed, and consent may be withdrawn at a later time, subject to legal or contractual 	<p>Some laws and regulations (such as Principle 11, "Limits on disclosure of personal information," section 1 of the Australian Privacy Act of 1988) provide specific exemptions for the entity not to obtain the individual's consent. Examples of such situations include the following:</p> <ul style="list-style-type: none"> • The record keeper believes, on reasonable grounds, that use of the information for that other purpose is necessary to prevent or lessen a serious and imminent threat to the life or health of the individual concerned or another person. • Use of the information for that other purpose is required or authorized by or under law.

<i>Ref</i>	<i>Choice and Consent Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		restrictions and reasonable notice. The type of consent required depends on the nature of the personal information and the method of collection (for example, an individual subscribing to a newsletter gives implied consent to receive communications from the entity).	
3.1.2	<p>Consequences of Denying or Withdrawing Consent When personal information is collected, individuals are informed of the consequences of refusing to provide personal information or of denying or withdrawing consent to use personal information for purposes identified in the notice.</p>	<p>At the time of collection, the entity informs individuals of the following:</p> <ul style="list-style-type: none"> • About the consequences of refusing to provide personal information (for example, transactions may not be processed) • About the consequences of denying or withdrawing consent (for example, opting out of receiving information about products and services may result in not being made aware of sales promotions) • About how they will or will not be affected by failing to provide more than the minimum required personal information (for example, services or products will still be provided) 	
3.2	<p>Procedures and Controls</p>		
3.2.1	<p>Implicit or Explicit Consent Implicit or explicit consent is obtained from the individual at or before the time personal</p>	<p>The entity</p> <ul style="list-style-type: none"> • obtains and documents an individual's consent in a timely manner (that is, at or before the 	

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<i>Ref.</i>	<i>Choice and Consent Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
	information is collected or soon after. The individual's preferences expressed in his or her consent are confirmed and implemented.	<p>time personal information is collected or soon after).</p> <ul style="list-style-type: none"> • confirms an individual's preferences (in writing or electronically). • documents and manages changes to an individual's preferences. • ensures that an individual's preferences are implemented in a timely fashion. • addresses conflicts in the records about an individual's preferences by providing a process for users to notify and challenge a vendor's interpretation of their contact preferences. • ensures that the use of personal information, throughout the entity and by third parties, is in accordance with an individual's preferences. 	
3.2.2	<p>Consent for New Purposes and Uses If information that was previously collected is to be used for purposes not previously identified in the privacy notice, the new purpose is documented, the individual is notified, and implicit or explicit consent is obtained prior to such new use or purpose.</p>	<p>When personal information is to be used for a purpose not previously specified, the entity</p> <ul style="list-style-type: none"> • notifies the individual and documents the new purpose. • obtains and documents consent or withdrawal of consent to use the personal information for the new purpose. • ensures that personal information is being used in accordance with the new purpose or, if consent was withdrawn, not so used. 	
3.2.3	<p>Explicit Consent for Sensitive Information</p>	<p>The entity collects sensitive information only if the individual</p>	<p>Canada's Personal Information Protection and Electronic</p>

Ref.	<i>Choice and Consent Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
	<p>Explicit consent is obtained directly from the individual when sensitive personal information is collected, used, or disclosed, unless a law or regulation specifically requires otherwise.</p>	<p>provides explicit consent. <i>Explicit consent</i> requires that the individual affirmatively agree, through some action, to the use or disclosure of the sensitive information. Explicit consent is obtained directly from the individual and documented, for example, by requiring the individual to check a box or sign a form. This is sometimes referred to as opt in.</p>	<p>Documents Act (PIPEDA), Schedule 1, clause 4.3.6, states that an organization should generally seek explicit consent when the information is likely to be considered sensitive.</p> <p>Many jurisdictions prohibit the collection of sensitive data, unless specifically allowed. For example, in the EU member state of Greece, Article 7 of Greece's "Law on the protection of individuals with regard to the processing of personal data" states, "The collection and processing of sensitive data is forbidden." However, a permit to collect and process sensitive data may be obtained.</p> <p>Some jurisdictions consider government-issued personal identifiers, for example, Social Security numbers or Social Insurance numbers, to be sensitive information.</p>
3.2.4	<p>Consent for Online Data Transfers To or From an Individual's Computer or Other Similar Electronic Devices</p> <p>Consent is obtained before personal information is transferred to or from an individual's computer or other similar device.</p>	<p>The entity requests customer permission to store, alter, or copy personal information (other than cookies) in the customer's computer or other similar electronic device.</p> <p>If the customer has indicated to the entity that it does not want cookies, the entity has controls to ensure that cookies are not stored on the customer's computer or other similar electronic device.</p> <p>Entities will not download software that will transfer personal information without obtaining permission.</p>	<p>Consideration should be given to prevent or detect the introduction of software that is designed to mine or extract information from a computer or other similar electronic device and therefore may be used to extract personal information, for example, spyware.</p>

Collection

<i>Ref.</i>	<i>Collection Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
4.0	The entity collects personal information only for the purposes identified in the notice.		
4.1	Policies and Communications		
4.1.0	Privacy Policies The entity's privacy policies address the collection of personal information.		Some jurisdictions, such as some countries in Europe, require entities that collect personal information to register with their regulatory body.
4.1.1	Communication to Individuals Individuals are informed that personal information is collected only for the purposes identified in the notice.	The entity's privacy notice discloses the types of personal information collected, the sources and methods used to collect personal information, and whether information is developed or acquired about individuals, such as buying patterns.	
4.1.2	Types of Personal Information Collected and Methods of Collection The types of personal information collected and the methods of collection, including the use of cookies or other tracking techniques, are documented and described in the privacy notice.	Types of personal information collected include the following: <ul style="list-style-type: none"> • Financial (for example, financial account information) • Health (for example, information about physical or mental status or history) • Demographic (for example, age, income range, social geo-codes) Methods of collecting and third-party sources of personal information include the following: <ul style="list-style-type: none"> • Credit reporting agencies • Over the telephone • Via the Internet using forms, cookies, or Web beacons The entity's privacy notice discloses whether it uses cookies and Web beacons and how they are used. The notice also describes the	Some jurisdictions, such as those in the EU, require that individuals have the opportunity to decline the use of cookies.

<i>Ref</i>	<i>Collection Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		consequences if the cookie is refused.	
4.2	Procedures and Controls		
4.2.1	Collection Limited to Identified Purpose The collection of personal information is limited to that necessary for the purposes identified in the notice.	Systems and procedures are in place to <ul style="list-style-type: none"> • specify the personal information essential for the purposes identified in the notice and differentiate it from optional personal information. • periodically review the entity's program or service needs for personal information (for example, once every five years or when changes to the program or service are made). • obtain explicit consent when sensitive personal information is collected (see 3.2.3, "Explicit Consent for Sensitive Information"). • monitor that the collection of personal information is limited to that necessary for the purposes identified in the privacy notice and that all optional data is identified as such. 	
4.2.2	Collection by Fair and Lawful Means Methods of collecting personal information are reviewed by management before they are implemented to confirm that personal information is obtained (a) fairly, without intimidation or deception, and (b) lawfully, adhering to all relevant rules of law, whether derived from statute or common law,	The entity's management, privacy officer, and legal counsel, review the methods of collection and any changes thereto.	The following may be considered deceptive practices: <ul style="list-style-type: none"> • To use tools, such as cookies and Web beacons, on the entity's website to collect personal information without providing notice to the individual • To link information collected during an individual's visit to a website with personal information from other sources

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<i>Ref.</i>	<i>Collection Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
	relating to the collection of personal information.		<p>without providing notice to the individual</p> <ul style="list-style-type: none"> To use a third party to collect information in order to avoid providing notice to individuals <p>Entities should consider legal and regulatory requirements in jurisdictions other than the one in which they operate (for example, an entity in Canada collecting personal information about Europeans may be subject to certain European legal requirements).</p> <p>A review of complaints may help to identify whether unfair or unlawful practices exist.</p>
4.2.3	<p>Collection From Third Parties</p> <p>Management confirms that third parties from whom personal information is collected (that is, sources other than the individual) are reliable sources that collect information fairly and lawfully.</p>	<p>The entity</p> <ul style="list-style-type: none"> performs due diligence before establishing a relationship with a third-party data provider. reviews the privacy policies, collection methods, and types of consents of third parties before accepting personal information from third-party data sources. 	<p>Contracts include provisions requiring personal information to be collected fairly and lawfully and from reliable sources.</p>

<i>Ref.</i>	<i>Collection Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
4.2.4	<p>Information Developed about Individuals</p> <p>Individuals are informed if the entity develops or acquires additional information about them for its use.</p>	<p>The entity's privacy notice indicates that, if applicable, it may develop and acquire information about the individual using third-party sources, browsing, credit and purchasing history, and so on.</p>	

Use, Retention, and Disposal

<i>Ref.</i>	<i>Use, Retention, and Disposal Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
5.0	<p>The entity limits the use of personal information to the purposes identified in the notice and for which the individual has provided implicit or explicit consent. The entity retains personal information for only as long as necessary to fulfill the stated purposes or as required by law or regulations and thereafter appropriately disposes of such information.</p>		
5.1	<p>Policies and Communications</p>		
5.1.0	<p>Privacy Policies</p> <p>The entity's privacy policies address the use, retention, and disposal of personal information.</p>		
5.1.1	<p>Communication to Individuals</p> <p>Individuals are informed that personal information is (a) used only for the purposes identified in the notice and only if the individual has provided implicit or explicit consent, unless a law or regulation specifically requires otherwise, (b) retained for no longer than necessary to fulfill the stated purposes, or for a period specifically required by law or regulation, and (c) disposed of in a manner that prevents loss, theft, misuse, or unauthorized access.</p>	<p>The entity's privacy notice describes the following uses of personal information, for example:</p> <ul style="list-style-type: none"> • Processing business transactions such as claims and warranties, payroll, taxes, benefits, stock options, bonuses, or other compensation schemes • Addressing inquiries or complaints about products or services, or interacting during the promotion of products or services • Product design and development, or purchasing of products or services • Participation in scientific or medical research activities, 	

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<i>Ref.</i>	<i>Use, Retention, and Disposal Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		<p>marketing, surveys, or market analysis</p> <ul style="list-style-type: none"> • Personalization of websites or downloading software • Legal requirements • Direct marketing <p>The entity's privacy notice explains that personal information will be retained only as long as necessary to fulfill the stated purposes, or for a period specifically required by law or regulation and thereafter will be disposed of securely or made anonymous so that it cannot be identified to any individual.</p>	
5.2	Procedures and Controls		
5.2.1	<p>Use of Personal Information</p> <p>Personal information is used only for the purposes identified in the notice and only if the individual has provided implicit or explicit consent, unless a law or regulation specifically requires otherwise.</p>	<p>Systems and procedures are in place to ensure that personal information is used</p> <ul style="list-style-type: none"> • in conformity with the purposes identified in the entity's privacy notice. • in agreement with the consent received from the individual. • in compliance with applicable laws and regulations. 	<p>Some regulations have specific provisions concerning the use of personal information. Examples are the GLBA, the Health Insurance Portability and Accountability Act (HIPAA), and the Children's Online Privacy Protection Act (COPPA).</p>
5.2.2	<p>Retention of Personal Information</p> <p>Personal information is retained for no longer than necessary to fulfill the stated purposes unless a law or regulation specifically requires otherwise.</p>	<p>The entity</p> <ul style="list-style-type: none"> • documents its retention policies and disposal procedures. • retains, stores, and disposes of archived and backup copies of records in accordance with its retention policies. • ensures personal information is not kept beyond the standard retention time unless a justified business or legal reason for doing so exists. 	<p>Some laws specify the retention period for personal information. For example, HIPAA has retention requirements on accounting for disclosures of personal health information—three years for electronic health records, and six years for nonelectronic health records.</p> <p>Other statutory record retention requirements may exist; for example, certain data may need</p>

Ref.	<i>Use, Retention, and Disposal Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
5.2.3	<p>Disposal, Destruction and Redaction of Personal Information</p> <p>Personal information no longer retained is anonymized, disposed of, or destroyed in a manner that prevents loss, theft, misuse, or unauthorized access.</p>	<p>Contractual requirements are considered when establishing retention practices when they may be exceptions to normal policies.</p> <p>The entity</p> <ul style="list-style-type: none"> • erases or destroys records in accordance with the retention policies, regardless of the method of storage (for example, electronic, optical media, or paper based). • disposes of original, archived, backup and ad hoc or personal copies of records in accordance with its destruction policies. • documents the disposal of personal information. • within the limits of technology, locates and removes or redacts specified personal information about an individual as required, for example, removing credit card numbers after the transaction is complete. • regularly and systematically destroys, erases, or makes anonymous personal information no longer required to fulfill the identified purposes or as required by laws and regulations. 	<p>to be retained for tax purposes or in accordance with employment laws.</p> <p>Consideration should be given to using the services of companies that provide secure destruction services for personal information. Certain of these companies will provide a certificate of destruction where needed.</p> <p>Certain archiving techniques, such as DVDs, CDs, microfilm, or microfiche may not permit the removal of individual records without destruction of the entire database contained on such media.</p>
		<p>Contractual requirements are considered when establishing disposal, destruction, and redaction practices if they may result in exception to the entity's normal policies.</p>	

Access

<i>Ref.</i>	<i>Access Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
6.0	The entity provides individuals with access to their personal information for review and update.		
6.1	Policies and Communications		
6.1.0	Privacy Policies		
	The entity's privacy policies address providing individuals with access to their personal information.		
6.1.1	Communication to Individuals	The entity's privacy notice	
	Individuals are informed about how they may obtain access to their personal information to review, update, and correct that information.	<ul style="list-style-type: none"> explains how individuals may gain access to their personal information and any costs associated with obtaining such access. outlines the means by which individuals may update and correct their personal information (for example, in writing, by phone, by e-mail, or by using the entity's website). explains how disagreements related to personal information may be resolved. 	
6.2	Procedures and Controls		
6.2.1	Access by Individuals to Their Personal Information	Procedures are in place to	Some laws and regulations specify the following:
	Individuals are able to determine whether the entity maintains personal information about them and, upon request, may obtain access to their personal information.	<ul style="list-style-type: none"> determine whether the entity holds or controls personal information about an individual. communicate the steps to be taken to gain access to the personal information. respond to an individual's request on a timely basis. provide a copy of personal information, upon request, 	<ul style="list-style-type: none"> Provisions and requirements for providing access to personal information (for example, HIPAA) Requirements that requests for access to personal information be submitted in writing

Ref	Access Criteria	Illustrative Controls and Procedures	Additional Considerations
6.2.2	<p>Confirmation of an Individual's Identity The identity of individuals who request access to their personal information is authenticated before they are given access to that information.</p>	<p>in printed or electronic form that is convenient to both the individual and the entity.</p> <ul style="list-style-type: none"> • record requests for access and actions taken, including denial of access and unresolved complaints and disputes. <p>Employees are adequately trained to authenticate the identity of individuals before granting the following:</p> <ul style="list-style-type: none"> • Access to their personal information • Requests to change sensitive or other personal information (for example, to update information such as address or bank details) <p>The entity</p> <ul style="list-style-type: none"> • does not use government-issued identifiers (for example, Social Security numbers or Social Insurance numbers) for authentication. • mails information about a change request only to the address of record or, in the case of a change of address, to both the old and new addresses. • requires that a unique user identification and password (or equivalent) be used to access user account information online. 	<p>The extent of authentication depends on the type and sensitivity of personal information that is made available. Different techniques may be considered for the different channels, such as the following:</p> <ul style="list-style-type: none"> • Web • Interactive voice response system • Call center • In person

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<i>Ref.</i>	<i>Access Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
6.2.3	<p>Understandable Personal Information, Time Frame, and Cost</p> <p>Personal information is provided to the individual in an understandable form, in a reasonable timeframe, and at a reasonable cost, if any.</p>	<p>The entity</p> <ul style="list-style-type: none"> • provides personal information to the individual in a format that is understandable (for example, not in code, not in a series of numbers, not in overly technical language or other jargon), and in a form convenient to both the individual and the entity. • makes a reasonable effort to locate the personal information requested and, if personal information cannot be found, keeps sufficient records to demonstrate that a reasonable search was made. • takes reasonable precautions to ensure that personal information released does not identify another person, directly or indirectly. • provides access to personal information in a timeframe that is similar to the entity's normal response times for other business transactions, or as permitted or required by law. • provides access to personal information in archived or backup systems and media. • informs individuals of the cost of access at the time the access request is made or as soon as practicable thereafter. • charges the individual for access to personal information at an amount, if any, 	<p>Entities may provide individuals with access to their personal information at no cost or at a minimal cost because of the potential business and customer-relationship benefits, as well as the opportunity to enhance the quality of the information.</p>

Ref	Access Criteria	Illustrative Controls and Procedures	Additional Considerations
6.2.4	<p>Denial of Access Individuals are informed, in writing, of the reason a request for access to their personal information was denied, the source of the entity's legal right to deny such access, if applicable, and the individual's right, if any, to challenge such denial, as specifically permitted or required by law or regulation.</p>	<p>which is not excessive in relation to the entity's cost of providing access.</p> <ul style="list-style-type: none"> • provides an appropriate physical space to inspect personal information. <p>The entity</p> <ul style="list-style-type: none"> • outlines the reasons why access to personal information may be denied. • records all denials of access and unresolved complaints and disputes. • provides the individual with partial access in situations in which access to some of his or her personal information is justifiably denied. • provides the individual with a written explanation about why access to personal information is denied. • provides a formal escalation (appeal) process if access to personal information is denied. • conveys the entity's legal rights and the individual's right to challenge, if applicable. 	<p>Some laws and regulations (for example, Principle 5, "Information relating to records kept by record-keeper," point 2 of the Australian Privacy Act of 1988, and PIPEDA, Sections 8.(4), 8.(5), 8.(7), 9, 10, and 28) specify the situations in which access can be denied, the process to be followed (such as notifying the customer of the denial in writing within 30 days), and potential penalties or sanctions for lack of compliance.</p>
6.2.5	<p>Updating or Correcting Personal Information Individuals are able to update or correct personal information held by the entity. If practical and economically feasible to do so, the entity provides such updated or corrected information to third parties that previously were provided with the</p>	<p>The entity</p> <ul style="list-style-type: none"> • describes the process an individual must follow to update or correct personal information records (for example, in writing, by phone, by e-mail, or by using the entity's website). • verifies the accuracy and completeness of personal information that an individual updates or changes (for example, by edit 	<p>In some jurisdictions (for example, PIPEDA, Schedule 1, clauses 4.5.2 and 4.5.3), personal information cannot be erased, but an entity is bound to cease further processing.</p>

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<i>Ref.</i>	<i>Access Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
	individual's personal information.	<p>and validation controls, and forced completion of mandatory fields).</p> <ul style="list-style-type: none"> records the date, time, and identification of the person making the change if the entity's employee is making a change on behalf of an individual. notifies third parties to whom personal information has been disclosed of amendments, erasures, or blocking of personal information, if it is possible and reasonable to do so. 	
6.2.6	<p>Statement of Disagreement Individuals are informed, in writing, about the reason a request for correction of personal information was denied, and how they may appeal.</p>	<p>If an individual and an entity disagree about whether personal information is complete and accurate, the individual may ask the entity to accept a statement claiming that the personal information is not complete and accurate.</p> <p>The entity</p> <ul style="list-style-type: none"> documents instances where an individual and the entity disagree about whether personal information is complete and accurate. informs the individual, in writing, of the reason a request for correction of personal information is denied, citing the individual's right to appeal. informs the individual, when access to personal information is requested or when access is actually provided, that 	<p>See 10.1.1, "Communications to Individuals," 10.2.1, "Inquiry, Complaint, and Dispute Process," and 10.2.2, "Dispute Resolution and Recourse."</p> <p>Some regulations (for example, HIPAA) have specific requirements for denial of requests and handling of disagreements from individuals.</p> <p>If a challenge is not resolved to the satisfaction of the individual, when appropriate, the existence of such challenge is communicated to third parties having access to the information in question.</p>

<i>Ref</i>	<i>Access Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		<p>the statement of disagreement may include information about the nature of the change sought by the individual and the reason for its refusal by the entity.</p> <ul style="list-style-type: none"> • if appropriate, notifies third parties who have previously been provided with personal information that there is a disagreement and the nature of the disagreement. 	

Disclosure to Third Parties

<i>Ref</i>	<i>Disclosure to Third Parties Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
7.0	The entity discloses personal information to third parties only for the purposes identified in the notice and with the implicit or explicit consent of the individual.		
7.1	Policies and Communications		
7.1.0	Privacy Policies The entity's privacy policies address the disclosure of personal information to third parties.		
7.1.1	Communication to Individuals Individuals are informed that personal information is disclosed to third parties only for the purposes identified in the notice and for which the individual has provided implicit or explicit consent unless a law or regulation specifically allows or requires otherwise.	<p>The entity's privacy notice</p> <ul style="list-style-type: none"> • describes the practices related to the sharing of personal information (if any) with third parties and the reasons for information sharing. • identifies third parties or classes of third parties to whom personal information is disclosed. • informs individuals that personal information is disclosed to third parties only 	<p>The entity's privacy notice may disclose the following:</p> <ul style="list-style-type: none"> • The process used to assure the privacy and security of personal information that has been disclosed to a third party • How personal information shared with a third party will be kept up to date, so that outdated or incorrect information shared with a third party will be

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<i>Ref.</i>	<i>Disclosure to Third Parties Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		for the purposes (a) identified in the notice, and (b) for which the individual has provided implicit or explicit consent, or as specifically allowed or required by law or regulation.	changed if the individual has changed his or her information
7.1.2	<p>Communication to Third Parties Privacy policies or other specific instructions or requirements for handling personal information are communicated to third parties to whom personal information is disclosed.</p>	Prior to sharing personal information with a third party, the entity communicates its privacy policies or other specific instructions or requirements for handling personal information to, and obtains a written agreement from the third party that its privacy practices over the disclosed personal information adhere to those policies or requirements.	
7.2	Procedures and Controls		
7.2.1	<p>Disclosure of Personal Information Personal information is disclosed to third parties only for the purposes described in the notice, and for which the individual has provided implicit or explicit consent, unless a law or regulation specifically requires or allows otherwise.</p>	<p>Systems and procedures are in place to</p> <ul style="list-style-type: none"> • prevent the disclosure of personal information to third parties unless an individual has given implicit or explicit consent for the disclosure. • document the nature and extent of personal information disclosed to third parties. • test whether disclosure to third parties is in compliance with the entity's privacy policies and procedures, or as specifically allowed or required by law or regulation. • document any third-party disclosures for legal reasons. 	<p>Personal information may be disclosed through various legal processes to law enforcement or regulatory agencies.</p> <p>Some laws and regulations have specific provisions for the disclosure of personal information. Some permit disclosure of personal information without consent whereas others require verifiable consent.</p>

<i>Ref.</i>	<i>Disclosure to Third Parties Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
7.2.2	<p>Protection of Personal Information</p> <p>Personal information is disclosed only to third parties who have agreements with the entity to protect personal information in a manner consistent with the relevant aspects of the entity's privacy policies or other specific instructions or requirements. The entity has procedures in place to evaluate that the third parties have effective controls to meet the terms of the agreement, instructions, or requirements.</p>	<p>When providing personal information to third parties, the entity enters into contracts that require a level of protection of personal information equivalent to that of the entity's. In doing so, the entity</p> <ul style="list-style-type: none"> • limits the third party's use of personal information to purposes necessary to fulfill the contract. • communicates the individual's preferences to the third party. • refers any requests for access or complaints about the personal information transferred by the entity to a designated privacy executive, such as a corporate privacy officer. • specifies how and when third parties are to dispose of or return any personal information provided by the entity. <p>The entity evaluates compliance with such contract using one or more of the following approaches to obtain an increasing level of assurance depending on its risk assessment:</p> <ul style="list-style-type: none"> • The third party responds to a questionnaire about their practices. • The third party self-certifies that its practices meet the entity's requirements based on internal audit reports or other procedures. • The entity performs an onsite evaluation of the third party. • The entity receives an audit or similar 	<p>The entity is responsible for personal information in its possession or custody, including information that has been transferred to a third party.</p> <p>Some regulations (for example, from the U.S. federal financial regulatory agencies) require that an entity take reasonable steps to oversee appropriate service providers by exercising appropriate due diligence in the selection of service providers.</p> <p>Some jurisdictions, including some countries in Europe, require entities that transfer personal information to register with their regulatory body prior to transfer.</p> <p>PIPEDA requires a comparable level of protection while the personal information is being processed by a third party.</p> <p>Article 25 of the EU's Directive requires that such transfers take place only where the third party ensures an adequate level of protection.</p>

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<i>Ref.</i>	<i>Disclosure to Third Parties Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		report provided by an independent auditor.	
7.2.3	<p>New Purposes and Uses Personal information is disclosed to third parties for new purposes or uses only with the prior implicit or explicit consent of the individual.</p>	<p>Systems and procedures are in place to</p> <ul style="list-style-type: none"> • notify individuals and obtain their consent prior to disclosing personal information to a third party for purposes not identified in the privacy notice. • document whether the entity has notified the individual and received the individual's consent. • monitor that personal information is being provided to third parties only for uses specified in the privacy notice. 	<p>Other types of onward transfers include transfers to third parties who are</p> <ul style="list-style-type: none"> • subsidiaries or affiliates. • providing a service requested by the individual. • law enforcement or regulatory agencies. • in another country and may be subject to other requirements.
7.2.4	<p>Misuse of Personal Information by a Third Party The entity takes remedial action in response to misuse of personal information by a third party to whom the entity has transferred such information.</p>	<p>The entity</p> <ul style="list-style-type: none"> • reviews complaints to identify indications of any misuse of personal information by third parties. • responds to any knowledge of a third party using or disclosing personal information in variance with the entity's privacy policies and procedures or contractual arrangements. • mitigates, to the extent practicable, any harm caused by the use or disclosure of personal information by the third party in violation of the entity's privacy policies and procedures (for example, notify individuals affected, attempt to recover information disclosed to others, void affected numbers and reissue new numbers). 	

<i>Ref.</i>	<i>Disclosure to Third Parties Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		<ul style="list-style-type: none"> takes remedial action in the event that a third party misuses personal information (for example, contractual clauses address the ramification of misuse of personal information). 	

Security for Privacy

<i>Ref.</i>	<i>Security for Privacy Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
8.0	The entity protects personal information against unauthorized access (both physical and logical).		
8.1	Policies and Communications		
8.1.0	Privacy Policies The entity's privacy policies (including any relevant security policies), address the security of personal information.	Privacy policies adequately address security measures to safeguard the privacy of personal information whether in electronic, paper, or other forms. Security measures are consistent with the sensitivity of the personal information.	Personal information in any location under control of the entity or deemed to be under control of the entity must be protected.
8.1.1	Communication to Individuals Individuals are informed that precautions are taken to protect personal information.	The entity's privacy notice describes the general types of security measures used to protect the individual's personal information, for example: <ul style="list-style-type: none"> Employees are authorized to access personal information based on job responsibilities. Authentication is used to prevent unauthorized access to personal information stored electronically. Physical security is maintained over personal information stored in hard copy form, and encryption is used to prevent unauthorized access 	Users, management, providers, and other parties should strive to develop and adopt good privacy practices and to promote conduct that recognizes security needs and respects the legitimate interests of others. Consideration should be given to disclosing in the privacy notice the security obligations of individuals, such as keeping user IDs and passwords confidential and reporting security compromises. Consideration should be given to limiting the disclosure of detailed security procedures so

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Ref.	<i>Security for Privacy Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		to personal information sent over the Internet. <ul style="list-style-type: none"> Additional security safeguards are applied to sensitive information. 	as not to compromise internal security.
8.2	Procedures and Controls		
8.2.1	Information Security Program A security program has been developed, documented, approved, and implemented that includes administrative, technical, and physical safeguards to protect personal information from loss, misuse, unauthorized access, disclosure, alteration, and destruction. The security program should address, but not be limited to, the following areas ³ insofar as they relate to the security of personal information: <ol style="list-style-type: none"> a. Risk assessment and treatment [1.2.4] b. Security policy [8.1.0] c. Organization of information security [sections 1, 7, and 10] d. Asset management [section 1] e. Human resources security [section 1] f. Physical and environmental security [8.2.3 and 8.2.4] 	The entity's security program addresses the following matters related to protection of personal information: <ul style="list-style-type: none"> Periodic risk assessments Identification of all types of personal information and the related processes, systems, and third parties that are involved in the handling of such information Identification and documentation of the security requirements of authorized users Allowing access, the nature of that access, and who authorizes such access Preventing unauthorized access by using effective physical and logical access controls The procedures to add new users, modify the access levels of existing users, and remove users who no longer need access 	Safeguards employed may consider the nature and sensitivity of the data, as well as the size and complexity of the entity's operations. For example, the entity may protect personal information and other sensitive information to a level greater than it applies for other information. Some regulations (for example, HIPAA) provide a greater level of detail and guidance on specific security measures to be considered and implemented. Some security rules (for example, GLBA-related rules for safeguarding information) require the following: <ul style="list-style-type: none"> Board (or committee or individual appointed by the board) approval and oversight of the entity's information security program. That an entity take reasonable steps to

³ These areas are drawn from ISO/IEC 27002:2005, Information technology—Security techniques—Code of practice for information security management. Permission is granted by the American National Standards Institute (ANSI) on behalf of the International Organization for Standardization (ISO). Copies of ISO/IEC 27002 can be purchased from ANSI in the United States at <http://webstore.ansi.org/> and in Canada from the Standards Council of Canada at www.store.ansi.org/Canada. It is not necessary to meet all of the criteria of ISO/IEC 27002:2005 to satisfy *Generally Accepted Privacy Principles'* criterion 8.2.1. The references associated with each area indicate the most relevant *Generally Accepted Privacy Principles'* criteria for this purpose.

<i>Ref.</i>	<i>Security for Privacy Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
<i>g.</i>	Communications and operations management [sections 1, 7, and 10]	<ul style="list-style-type: none"> • Assignment of responsibility and accountability for security 	oversee appropriate service providers by <ul style="list-style-type: none"> — exercising appropriate due diligence in the selection of service providers.
<i>h.</i>	Access control [sections 1, 8.2, and 10]	<ul style="list-style-type: none"> • Assignment of responsibility and accountability for system changes and maintenance 	<ul style="list-style-type: none"> — requiring service providers by contract to implement and maintain appropriate safeguards for the personal information at issue.
<i>i.</i>	Information systems acquisition, development, and maintenance [1.2.6]	<ul style="list-style-type: none"> • Protecting operating system and network software and system files 	The payment card industry has established specific security and privacy requirements for cardholder information from certain brands.
<i>j.</i>	Information security incident management [1.2.7]	<ul style="list-style-type: none"> • Protecting cryptographic tools and information 	
<i>k.</i>	Business continuity management [section 8.2]	<ul style="list-style-type: none"> • Implementing system software upgrades and patches 	
<i>l.</i>	Compliance [sections 1 and 10]	<ul style="list-style-type: none"> • Testing, evaluating, and authorizing system components before implementation • Addressing how complaints and requests relating to security issues are resolved • Handling errors and omissions, security breaches, and other incidents • Procedures to detect actual and attempted attacks or intrusions into systems and to proactively test security procedures (for example, penetration testing) • Allocating training and other resources to support its security policies • Provision for the handling of exceptions and situations not specifically addressed in its system processing integrity and related system security policies • Business continuity management and disaster recovery 	

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<i>Ref.</i>	<i>Security for Privacy Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		<p>plans and related testing</p> <ul style="list-style-type: none"> • Provision for the identification of, and consistency with, applicable laws and regulations, defined commitments, service-level agreements, and other contracts • A requirement that users, management, and third parties confirm (initially and annually) their understanding of an agreement to comply with the entity's privacy policies and procedures related to the security of personal information • Procedures to cancel access privileges and ensure return of computers and other devices used to access or store personal information when personnel are terminated <p>The entity's security program prevents access to personal information in computers, media, and paper based information that are no longer in active use by the organization (for example, computers, media, and paper-based information in storage, sold, or otherwise disposed of).</p>	
8.2.2	<p>Logical Access Controls Logical access to personal information is restricted by procedures that address the following matters:</p> <p>a. Authorizing and registering internal</p>	<p>Systems and procedures are in place to</p> <ul style="list-style-type: none"> • establish the level and nature of access that will be provided to users based on the sensitivity of the data and the user's legitimate business 	<p>User authorization processes consider the following:</p> <ul style="list-style-type: none"> • How the data is accessed (internal or external network), as well as the media and technology platform of storage

<i>Ref.</i>	<i>Security for Privacy Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
	personnel and individuals	need to access the personal information.	<ul style="list-style-type: none"> • Access to paper and backup media containing personal information • Denial of access to joint accounts without other methods to authenticate the actual individuals
b.	Identifying and authenticating internal personnel and individuals	<ul style="list-style-type: none"> • authenticate users, for example, by user name and password, certificate, external token, or biometrics before access is granted to systems handling personal information. 	Some jurisdictions require stored data (at rest) to be encrypted or otherwise obfuscated.
c.	Making changes and updating access profiles		
d.	Granting privileges and permissions for access to IT infrastructure components and personal information	<ul style="list-style-type: none"> • require enhanced security measures for remote access, such as additional or dynamic passwords, callback procedures, digital certificates, secure ID cards, virtual private network (VPN), or properly configured firewalls. 	
e.	Preventing individuals from accessing anything other than their own personal or sensitive information		
f.	Limiting access to personal information to only authorized internal personnel based upon their assigned roles and responsibilities	<ul style="list-style-type: none"> • implement intrusion detection and monitoring systems. 	
g.	Distributing output only to authorized internal personnel		
h.	Restricting logical access to offline storage, backup data, systems, and media		
i.	Restricting access to system configurations, superuser functionality, master passwords, powerful utilities, and security devices (for example, firewalls)		
j.	Preventing the introduction of viruses, malicious code, and unauthorized software		
8.2.3	Physical Access Controls Physical access is restricted to personal	Systems and procedures are in place to <ul style="list-style-type: none"> • manage logical and physical access to 	

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<i>Ref.</i>	<i>Security for Privacy Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
	information in any form (including the components of the entity's system(s) that contain or protect personal information).	<p>personal information, including hard copy, archival, and backup copies.</p> <ul style="list-style-type: none"> • log and monitor access to personal information. • prevent the unauthorized or accidental destruction or loss of personal information. • investigate breaches and attempts to gain unauthorized access. • communicate investigation results to the appropriate designated privacy executive. • maintain physical control over the distribution of reports containing personal information. • securely dispose of waste containing confidential information (for example, shredding). 	sign in logs, and other techniques to control access to offices, data centers, and other locations in which personal information is processed or stored.
8.2.4	<p>Environmental Safeguards Personal information, in all forms, is protected against accidental disclosure due to natural disasters and environmental hazards.</p>	<p>Management maintains measures to protect against environmental factors (for example, fire, flood, dust, power failure, and excessive heat and humidity) based on its risk assessment. The entity's controlled areas are protected against fire using both smoke detectors and a fire suppression system.</p> <p>In addition, the entity maintains physical and other safeguards to prevent accidental disclosure of personal information in the event of an environmental incident.</p>	Some regulations, such as those in the EU Directive, also require that personal information is protected against unlawful destruction, accidental loss, natural disasters, and environmental hazards, in addition to accidental disclosure.

<i>Ref</i>	<i>Security for Privacy Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
8.2.5	<p>Transmitted Personal Information</p> <p>Personal information is protected when transmitted by mail or other physical means. Personal information collected and transmitted over the Internet, over public and other nonsecure networks, and wireless networks is protected by deploying industry standard encryption technology for transferring and receiving personal information.</p>	<p>Systems and procedures are in place to</p> <ul style="list-style-type: none"> define minimum levels of encryption and controls. employ industry standard encryption technology, for example, 128-bit Transport Layer Security (TLS), over VPNs, for transferring and receiving personal information. approve external network connections. protect personal information in both hardcopy and electronic forms sent by mail, courier, or other physical means. encrypt personal information collected and transmitted wirelessly and protect wireless networks from unauthorized access. 	<p>Some regulations (for example, HIPAA) have specific provisions for the electronic transmission and authentication of signatures with respect to health information records (that is, associated with the standard transactions).</p> <p>Some credit card vendors have issued minimum requirements for protecting cardholder data, including the requirement to use encryption techniques for credit card and transaction related data in transmission and in storage.</p> <p>As technology, market, and regulatory conditions evolve, new measures may become necessary to meet acceptable levels of protection (for example, 128-bit secure TLS, including user IDs and passwords).</p> <p>Voice transmission from wireless devices (for example, cell phones) of personal information may not be encrypted.</p>
8.2.6	<p>Personal Information on Portable Media</p> <p>Personal information stored on portable media or devices is protected from unauthorized access.</p>	<p>Policies and procedures prohibit the storage of personal information on portable media or devices unless a business need exists and such storage is approved by management.</p> <p>Policies, systems, and procedures are in place to protect personal information accessed or stored in manners such as using the following:</p>	<p>Consideration should be given to the protection needed for any personal information provided to, for example, regulators and auditors.</p>

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<i>Ref.</i>	<i>Security for Privacy Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		<ul style="list-style-type: none"> • Laptop computers, PDAs, smart-phones and similar devices • Computers and other devices used by employees while, for example, traveling and working at home • USB drives, CDs and DVDs, magnetic tape, or other portable media <p>Such information is encrypted, password protected, physically protected, and subject to the entity's access, retention, and destruction policies.</p> <p>Controls exist over creation, transfer, storage, and disposal of media containing personal information used for backup and recovery.</p> <p>Procedures exist to report loss or potential misuse of media containing personal information.</p> <p>Upon termination of employees or contractors, procedures provide for the return or destruction of portable media and devices used to access and store personal information, and of printed and other copies of such information.</p>	
8.2.7	<p>Testing Security Safeguards</p> <p>Tests of the effectiveness of the key administrative, technical, and physical safeguards protecting personal information are conducted at least annually.</p>	<p>Systems and procedures are in place to</p> <ul style="list-style-type: none"> • regularly test the effectiveness of the key administrative, technical, and physical safeguards protecting personal information. • periodically undertake independent audits of security 	<p>The frequency and nature of the testing of security safeguards will vary with the entity's size and complexity, the nature and scope of its activities, and the sensitivity of personal information.</p> <p>Some security regulations (for</p>

<i>Ref.</i>	<i>Security for Privacy Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		<p>controls using either internal or external auditors.</p> <ul style="list-style-type: none"> • test card access systems and other physical security devices at least annually. • document and test disaster recovery and contingency plans at least annually to ensure their viability. • periodically undertake threat and vulnerability testing, including security penetration and Web vulnerability and resilience. • make appropriate modifications to security policies and procedures on a periodic basis, taking into consideration the results of tests performed and new and changing threats and vulnerabilities. • periodically report the results of security testing to management. 	<p>example, GLBA-related rules for safeguarding information) require an entity to</p> <ul style="list-style-type: none"> • conduct regular tests of key controls, systems, and procedures by independent third parties or by staff independent of those that develop or maintain security (or at least have these independent parties review results of testing). • assess and possibly adjust its information security at least annually.

Quality

<i>Ref.</i>	<i>Quality Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Consideration</i>
9.0	The entity maintains accurate, complete, and relevant personal information for the purposes identified in the notice.		
9.1	Policies and Communications		
9.1.0	Privacy Policies		
	The entity's privacy policies address the quality of personal information.		
9.1.1	Communication to Individuals	The entity's privacy notice explains that personal information	

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<i>Ref.</i>	<i>Quality Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Consideration</i>
	Individuals are informed that they are responsible for providing the entity with accurate and complete personal information, and for contacting the entity if correction of such information is required.	needs to be kept accurate and complete only when the individual has an ongoing relationship with the entity.	
9.2	Procedures and Controls		
9.2.1	Accuracy and Completeness of Personal Information Personal information is accurate and complete for the purposes for which it is to be used.	<p>Systems and procedures are in place to</p> <ul style="list-style-type: none"> • edit and validate personal information as it is collected, created, maintained, and updated. • record the date when the personal information is obtained or updated. • specify when the personal information is no longer valid. • specify when and how the personal information is to be updated and the source for the update (for example, annual reconfirmation of information held and methods for individuals to proactively update personal information). • indicate how to verify the accuracy and completeness of personal information obtained directly from an individual, received from a third party (see 4.2.3, “Collection From Third Parties”), or disclosed to a third party (see 7.2.2, “Protection of Personal Information”). • ensure personal information used on an ongoing basis is sufficiently accurate and complete to 	

<i>Ref</i>	<i>Quality Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Consideration</i>
		<p>make decisions, unless clear limits exist for the need for accuracy.</p> <ul style="list-style-type: none"> ensure personal information is not routinely updated unless such a process is necessary to fulfill the purposes for which it is to be used. <p>The entity undertakes periodic assessments to check the accuracy of personal information records and to correct them, as necessary, to fulfill the stated purpose.</p>	
9.2.2	<p>Relevance of Personal Information Personal information is relevant to the purposes for which it is to be used.</p>	<p>Systems and procedures are in place to</p> <ul style="list-style-type: none"> ensure personal information is sufficiently relevant for the purposes for which it is to be used and to minimize the possibility that inappropriate information is used to make business decisions about the individual. periodically assess the relevance of personal information records and to correct them, as necessary, to minimize the use of inappropriate data for decision making. 	

Monitoring and Enforcement

<i>Ref.</i>	<i>Monitoring and Enforcement Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
10.0	The entity monitors compliance with its privacy policies and procedures and has procedures to address privacy related inquiries, complaints and disputes.		
10.1	Policies and Communications		
10.1.0	Privacy Policies The entity's privacy policies address the monitoring and enforcement of privacy policies and procedures.		
10.1.1	Communication to Individuals Individuals are informed about how to contact the entity with inquiries, complaints and disputes.	The entity's privacy notice <ul style="list-style-type: none"> describes how individuals can contact the entity with complaints (for example, via an e-mail link to the entity's website or a telephone number). provides relevant contact information to which the individual can direct complaints (for example, name, telephone number, mailing address, and e-mail address of the individual or office responsible for handling complaints). 	
10.2	Procedures and Controls		
10.2.1	Inquiry, Complaint, and Dispute Process A process is in place to address inquiries, complaints, and disputes.	The corporate privacy officer or other designated individual is authorized to address privacy related complaints, disputes, and other problems. Systems and procedures are in place that allow for <ul style="list-style-type: none"> procedures to be followed in communicating and resolving complaints about the entity. action that will be taken with respect to 	

Ref:	<i>Monitoring and Enforcement Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
10.2.2	<p>Dispute Resolution and Recourse Each complaint is addressed, and the resolution is documented and communicated to the individual.</p>	<p>the disputed information until the complaint is satisfactorily resolved.</p> <ul style="list-style-type: none"> • remedies to be available in case of a breach of personal information and how to communicate this information to an individual. • recourse and a formal escalation process to be in place to review and approve any recourse offered to individuals. • contact information and procedures to be followed with any designated third party dispute resolution or similar service (if offered). <p>The entity has a formally documented process in place to</p> <ul style="list-style-type: none"> • train employees responsible for handling individuals' complaints and disputes about the resolution and escalation processes. • document and respond to all complaints in a timely manner. • periodically review unresolved disputes and complaints to ensure they are resolved in a timely manner. • escalate unresolved complaints and disputes for review by management. • identify trends and the potential need to change the entity's privacy policies and procedures. • use specified independent third-party dispute resolution 	<p>Some regulations (for example HIPAA and COPPA) have specific procedures and requirements.</p> <p>Some laws (for example, PIPEDA) permit escalation through the court system up to the most senior court.</p>

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<i>Ref.</i>	<i>Monitoring and Enforcement Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		<p>services or other processes mandated by regulatory bodies in the event the individual is not satisfied with the entity's proposed resolution, together with a commitment from such third parties to handle such re-courses.</p> <p>If the entity offers a third-party dispute resolution process for complaints that cannot be resolved directly with the entity, an explanation is provided about how an individual can use that process.</p>	
10.2.3	<p>Compliance Review Compliance with privacy policies and procedures, commitments and applicable laws, regulations, service-level agreements, and other contracts is reviewed and documented, and the results of such reviews are reported to management. If problems are identified, remediation plans are developed and implemented.</p>	<p>Systems and procedures are in place to</p> <ul style="list-style-type: none"> • annually review compliance with privacy policies and procedures, commitments and applicable laws, regulations, service-level agreements, standards adopted by the entity, and other contracts. • document periodic reviews, for example, internal audit plans, audit reports, compliance checklists, and management sign offs. • report the results of the compliance review and recommendations for improvement to management, and implement a remediation plan. • monitor the resolution of issues and vulnerabilities noted in the compliance review to ensure that appropriate corrective action is taken on a timely basis (that is, privacy policies and procedures 	<p>In addition to legal, regulatory and contractual requirements, some entities may elect to comply with certain standards, such as those published by ISO, or may be required to comply with certain standards, such as those published by the payment card industry, as a condition of doing business.</p>

<i>Ref.</i>	<i>Monitoring and Enforcement Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
			are revised, as necessary).
10.2.4	<p>Instances of Noncompliance Instances of noncompliance with privacy policies and procedures are documented and reported and, if needed, corrective and disciplinary measures are taken on a timely basis.</p>	<p>Systems and procedures are in place to</p> <ul style="list-style-type: none"> • notify employees of the need to report privacy breaches and security vulnerabilities in a timely manner. • inform employees of the appropriate channels to report security vulnerabilities and privacy breaches. • document instances of noncompliance with privacy policies and procedures. • monitor the resolution of security vulnerabilities and privacy breaches to ensure appropriate corrective measures are taken on a timely basis. • discipline employees and others, as appropriate, who cause privacy incidents or breaches. • mitigate, to the extent practicable, any harm caused by the use or disclosure of personal information by the third party in violation of the entity's privacy policies and procedures (for example, notify individuals affected, attempt to recover information disclosed to others, void affected account numbers and reissue new numbers). • identify trends that may require revisions to privacy policies and procedures. 	

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<i>Ref.</i>	<i>Monitoring and Enforcement Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
10.2.5	<p>Ongoing Monitoring</p> <p>Ongoing procedures are performed for monitoring the effectiveness of controls over personal information, based on a risk assessment [1.2.4], and for taking timely corrective actions where necessary.</p>	<p>The entity uses the following:</p> <ul style="list-style-type: none"> • Control reports • Trend analysis • Training attendance and evaluations • Complaint resolutions • Regular internal reviews • Internal audit reports • Independent audit reports covering controls at service organizations • Other evidence of control effectiveness <p>The selection of controls to be monitored, and the frequency with which they are monitored are based on the sensitivity of the information and the risks of possible exposure of the information.</p> <p>Examples of such controls are as follows:</p> <ul style="list-style-type: none"> • Policies require that all employees take initial privacy training within 30 days of employment. Ongoing monitoring activities would include a review of human resource files of selected employees to determine that they contain the appropriate evidence of course completion. • Policies require that whenever an employee changes job responsibilities or is terminated, such employee's access to personal information be reviewed and appropriately modified or terminated within 24 hours (or immediately in the case of 	<p><i>Guidance on Monitoring Internal Control Systems</i>, published by COSO (the Committee of Sponsoring Organizations of the Treadway Commission), provides helpful guidance for monitoring the effectiveness of controls.</p>

<i>Ref:</i>	<i>Monitoring and Enforcement Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		<p>employee termination). This is controlled by an automated process within the human resource system which produces a report of employee status changes, which requires supervisor action to avoid automatic termination of access. This is monitored by the security group which receives copies of these reports and the related supervisor actions.</p> <ul style="list-style-type: none"> • Policies state that confirmation of a privacy-related complaint is provided to the complainant within 72 hours, and if not resolved within 10 working days, then the issue is escalated to the CPO. The control is a log used to record privacy complaints, including complaint date, and subsequent activities through to resolution. The monitoring activity is the monthly review of such logs for consistency with this policy. 	

Appendix A — Glossary

- affiliate.** An entity that controls, is controlled by, or is under common control with another entity.
- anonymize.** The removal of any person-related information that could be used to identify a specific individual.
- confidentiality.** The protection of nonpersonal information and data from unauthorized disclosure.
- consent.** Agreement by the individual for the entity to collect, use, and disclose personal information in accordance with the privacy notice. Such agreement can be explicit or implied. *Explicit consent* is given orally, electronically, or in writing, is unequivocal and does not require any inference on the part of the entity seeking consent. *Implicit consent* may reasonably be inferred from the action or inaction of the individual such as not having *opted out*, or providing credit card information to complete a transaction. (see opt in and opt out).
- cookies.** Cookies are pieces of information generated by a Web server and stored in the user's computer, ready for future access. The information can then be used to identify the user when returning to the website, to personalize Web content, and suggest items of potential interest based on previous buying habits. Certain advertisers use tracking methods, including cookies, to analyze the patterns and paths through a site.
- encryption.** The process of transforming information to make it unreadable to anyone except those possessing special key (to decrypt).
- entity.** An organization that collects, uses, retains, and discloses personal information.
- individual.** The person about whom the personal information is being collected (sometimes referred to as the *data subject*).
- internal personnel.** Employees, contractors, agents, and others acting on behalf of the entity and its affiliates.
- opt in.** Personal information may not be collected, used, retained and disclosed by the entity without the explicit consent of the individual.
- opt out.** Implied consent exists for the entity to collect, use, retain, and disclose personal information unless the individual explicitly denies permission.
- outsourcing.** The use and handling of personal information by a third party that performs a business function for the entity.
- personal information.** Information that is or can be about or related to an identifiable individual.
- personal information cycle.** The collection, use, retention, disclosure, disposal, or anonymization of personal information.
- policy.** A written statement that communicates management's intent, objectives, requirements, responsibilities, and standards.
- privacy.** The rights and obligations of individuals and organizations with respect to the collection, use, retention, disclosure, and destruction of personal information.
- privacy breach.** A privacy breach occurs when personal information is collected, retained, accessed, used, or disclosed in ways that are not in accordance with the provisions of the enterprise's policies, applicable privacy laws, or regulations.

privacy program. The policies, communications, procedures, and controls in place to manage and protect personal information in accordance with business and compliance risks and requirements.

purpose. The reason personal information is collected by the entity.

redact. To delete or black out personal information from a document or file.

sensitive personal information. Personal information that requires an extra level of protection and a higher duty of care, for example, information on medical or health conditions, certain financial information, racial or ethnic origin, political opinions, religious or philosophical beliefs, trade union membership, sexual preferences, or information related to offenses or criminal convictions.

third party. An entity that is not affiliated with the entity that collects personal information or any affiliated entity not covered by the entity's privacy notice.

Web beacon. Web beacons, also known as Web bugs, are small strings of code that provide a method for delivering a graphic image on a Web page or in an e-mail message for the purpose of transferring data. Businesses use Web beacons for many purposes, including site traffic reporting, unique visitor counts, advertising and e-mail auditing and reporting, and personalization. For example, a Web beacon can gather a user's IP address, collect the referrer, and track the sites visited by users.

[The next page is 15,200-201.]

Section 100A

Trust Services Principles, Criteria, and Illustrations for Security, Availability, Processing Integrity, Confidentiality, and Privacy—2009

(To supersede the 2006 version of the *Suitable Trust Services Principles, Criteria, and Illustrations for Security, Availability, Processing Integrity, Confidentiality, and Privacy*)

Introduction

.01 This section provides guidance to a practitioner providing attestation services, advisory services, or both that address IT-enabled systems including electronic commerce (e-commerce) systems¹ and privacy programs. The guidance is relevant when providing services with respect to system security, availability, processing integrity, confidentiality, and privacy.

.02 The guidance provided in this section includes

- trust services principles and criteria;
- examples of system descriptions; and
- illustrative practitioner reports for trust services engagements.

Trust Services

.03 The term *trust services* is defined as a set of professional attestation and advisory services based on a core set of principles and criteria that addresses the risks and opportunities of IT-enabled systems and privacy programs. Trust services principles and criteria are issued by the Assurance Services Executive Committee of the AICPA (the committee).

Attestation Services

.04 Attestation services include examination, review,² and agreed-upon procedures engagements. In examination and review engagements, the reporting practitioner expresses an opinion. In an examination engagement, for example, there is an opinion as to whether controls over a defined system were

¹ A *system* consists of five key components organized to achieve a specified objective. The five components are categorized as follows:

- *Infrastructure*. The physical and hardware components of a system (facilities, equipment, and networks)
- *Software*. The programs and operating software of a system (systems, applications, and utilities)
- *People*. The personnel involved in the operation and use of a system (developers, operators, users, and managers)
- *Procedures*. The programmed and manual procedures involved in the operation of a system (automated and manual)
- *Data*. The information used and supported by a system (transaction streams, files, databases, and tables)

² A practitioner should not accept an engagement to review an entity's controls over a system related to the trust services principles and criteria.

operating effectively to meet the criteria for systems reliability. In an agreed-upon procedures engagement, the practitioner does not express an opinion but rather performs procedures agreed upon by specified parties and reports the findings. Attestation services are developed in accordance with AT section 101, *Attest Engagements* (AICPA, *Professional Standards*).

Advisory Services

.05 In the context of trust services, advisory services include strategic, diagnostic, implementation, sustaining, and managing services using trust services principles and criteria. Practitioners providing such services follow CS section 100, *Consulting Services: Definitions and Standards* (AICPA, *Professional Standards*). The practitioner does not express an opinion in these engagements.

Principles, Criteria, and Illustrative Controls

.06 The following guidance sets out (1) principles, which are broad statements of objectives, and (2) specific criteria that should be achieved to meet each principle. Criteria are benchmarks used to measure and present the subject matter and against which the practitioner evaluates the subject matter. The attributes of suitable criteria are objectivity, measurability, completeness, and relevance. The committee has concluded that the trust services criteria have all the attributes of suitable criteria. Furthermore, the publication of this guidance makes the criteria available to users. Trust services principles are used to describe the overall objective; however, the practitioner's opinion makes reference only to the criteria.

.07 In the trust services principles and criteria, the criteria are supported by a list of illustrative controls that, if operating effectively, enable a system to meet the criteria. These illustrations are not intended to be all-inclusive and are presented as examples only. Actual controls in place at an entity may not be included in the list, and some of the listed controls may not be applicable to all systems and client circumstances. The practitioner should identify and assess the relevant controls that the client has in place to satisfy the criteria. The choice and number of those controls would be based on such factors as the entity's management style, philosophy, size, and industry.

.08 The following are the types of engagements a practitioner may perform using the trust services principles and criteria:

- Reporting on the operating effectiveness of an entity's controls over the system.
- Reporting on the operating effectiveness of an entity's controls and the entity's compliance with its commitments related to the trust services principle(s) and criteria.
- Reporting on the suitability of the design of the entity's controls over the system to achieve the trust services principle(s) and criteria, if the controls were operating effectively. (This engagement would typically be performed prior to the system's implementation.)

When the subject matter of the engagement is an entity's privacy program, the report must cover the entity's compliance with its commitments. For purposes of brevity, this document primarily addresses engagements in which the practitioner reports on the operating effectiveness of controls over a system to achieve the trust services principles and criteria. However, the guidance is equally applicable to engagements to report on any of the subject matters listed in this paragraph, unless otherwise specified. In addition, AT section 101

permits a practitioner to report on either the subject matter or an assertion about the subject matter (see appendix C, “Management’s Assertion”).

Consistency with Applicable Laws and Regulations, Defined Commitments, Service-Level Agreements, and Other Contracts

.09 Several of the principles and criteria refer to “consistency with applicable laws and regulations, defined commitments, service-level agreements, and other contracts.” Management is responsible for identification of and compliance with laws and regulations. It is beyond the scope of the engagement for the practitioner to undertake identification of all relevant “applicable laws and regulations, defined commitments, service-level agreements, and other contracts.” Furthermore, when reporting on the operating effectiveness of an entity’s controls, trust services engagements do not require the practitioner to test or report on an entity’s compliance with applicable laws and regulations, defined commitments, service-level agreements, and other contracts but rather to report on the effectiveness of the entity’s controls over monitoring compliance with them. When reporting on compliance with commitments, reference also should be made to other professional standards related to reporting on an entity’s compliance with laws, regulations, and agreements.³

Foundation for Trust Services—Trust Services Principles and Criteria

.10 The following principles and related criteria have been developed by the AICPA and the Canadian Institute of Chartered Accountants (CICA) for use by practitioners in the performance of trust services engagements:⁴

- a. *Security*. The system is protected against unauthorized access (both physical and logical).
- b. *Availability*. The system is available for operation and use as committed or agreed.
- c. *Processing integrity*. System processing is complete, accurate, timely, and authorized.
- d. *Confidentiality*. Information designated as confidential is protected as committed or agreed.
- e. *Privacy*. Personal information⁵ is collected, used, retained, disclosed, and destroyed in conformity with the commitments in the entity’s privacy notice and with criteria set forth in generally accepted privacy principles (GAPP) issued by the AICPA and CICA (found in appendix D [paragraph .48]).

.11 The trust services principles and criteria of security, availability, processing integrity, and confidentiality are organized into four broad areas:

- a. *Policies*. The entity has defined and documented its policies relevant to the particular principle. (The term *policies* as used here refer to

³ See AT section 601, *Compliance Attestation* (AICPA, *Professional Standards*).

⁴ SysTrust and WebTrust are two specific assurance services offerings developed by the AICPA and Canadian Institute of Chartered Accountants (CICA) that are based on the Trust Services Principles and Criteria. Practitioners must be licensed by the CICA to use these registered service marks. For more information on licensure, see www.webtrust.org.

⁵ Personal information is information that is about or can be related to an identifiable individual.

written statements that communicate management's intent, objectives, requirements, responsibilities, and standards for a particular subject.)

- b. *Communications.*⁶ The entity has communicated its defined policies to responsible parties and authorized users of the system.
- c. *Procedures.* The entity placed in operation procedures to achieve its objectives in accordance with its defined policies.
- d. *Monitoring.* The entity monitors the system and takes action to maintain compliance with its defined policies.

.12 For the trust services principles and criteria of security, availability, processing integrity, and confidentiality, a two-column format has been used to present the criteria. The first column presents the criteria for each principle, and the second column provides illustrative controls.

.13 A system description is used to delineate the boundaries of the system under examination for the trust services principles and criteria of security, availability, processing integrity, and confidentiality. For engagements covering an entity's compliance with its commitments, those commitments should be included in system description or should otherwise accompany the report. Examples of system descriptions for both e-commerce and non-e-commerce systems are included in appendix A (paragraph .45) and appendix B (paragraph .46), respectively. Appendix A (paragraph .45) also includes sample disclosures related to specific principles and criteria for e-commerce systems.

.14 A reliable system is one that is capable of operating without material error, fault, or failure during a specified period in a specified environment. A practitioner may provide a report on systems reliability that addresses the trust services principles and criteria of security, availability, and processing integrity. These criteria are used to evaluate whether a system is reliable.

.15 The trust services principles and criteria of privacy are organized into two broad areas:

- a. *Policies and communications.* Privacy policies are written statements that convey management's intent, objectives, requirements, responsibilities, and standards concerning privacy. Communications refers to the organization's communication to individuals, internal personnel, and third parties about its privacy notice and its commitments therein and other relevant information.
- b. *Procedures and controls.* The other actions the organization takes to achieve the criteria.

.16 The scope of a privacy engagement can cover (1) either all personal information or only certain identified types of personal information, such as customer information or employee information, and (2) all business segments and locations for the entire entity or only certain identified segments of the business (for example, retail operations but not manufacturing operations or only operations originating on the entity's Web site or specified Web domains) or geographic locations (such as only Canadian operations). The scope of a privacy engagement should cover all of the activities in the information life

⁶ In certain e-commerce environments, the terms and conditions, including the rights, responsibilities, and commitments of both parties, are implicit in the user's completion of a transaction on the Web site. To meet the underlying intent of the "Communications" category of the criteria in such circumstances, the policies and processes required by each of the "Communications" criteria should be disclosed on the entity's Web site. Examples of such disclosures for each of the trust services principles are contained in appendix A (paragraph .45).

cycle that consists of the collection, use, retention, disclosure and destruction, de-identification, or anonymization.

.17 For the trust services principles and criteria of privacy, a three-column format has been used to present the criteria. The first column contains the measurement criteria for each principle—the attributes that the entity must meet to be able to demonstrate that it has achieved the principle. The second column provides illustrative controls and procedures, which are designed to enhance the understanding of the criteria. The illustrations are not intended to be comprehensive, nor are any of the illustrations necessary for an entity to have met the criteria. The third column presents additional considerations, including supplemental information such as good privacy practices and selected requirements of specific laws and regulations that pertain to a certain industry or country.

Effective Date

.18 The trust services principles and criteria are effective as of September 15, 2009.

Principles and Criteria

Security Principle and Criteria

.19 The *security principle* refers to the protection of the system from unauthorized access, both logical and physical. Limiting access to the system helps prevent potential abuse of the system, theft of resources, misuse of software, and improper access to, or the use, alteration, destruction, or disclosure of information. Key elements for the protection of the system include permitting authorized access based on relevant needs and preventing unauthorized access to the system in all other instances.

Security Principle and Criteria Table

.20 The system is protected against unauthorized access (both physical and logical)

	<i>Criteria</i>	<i>Illustrative Controls</i> ⁷
1.0	Policies: The entity defines and documents its policies for the security of its system.	
1.1	The entity's security policies are established and periodically reviewed and approved by a designated individual or group.	Written security policy, addressing both IT and physical security, has been approved by the IT standards committee and is implemented throughout the company.

(continued)

⁷ Illustrative controls are presented as examples only. It is the practitioner's responsibility to identify and document the policies, procedures, and controls actually in place at the entity under examination.

<i>Criteria</i>	<i>Illustrative Controls</i> ⁷
	<p>As part of the periodic corporate risk assessment process, the security officer identifies changes to the IT risk assessment based on new applications and infrastructure, significant changes to applications and infrastructure, new environmental security risks, changes to regulations and standards, and changes to user requirements as identified in service level agreements and other documents. The security officer then updates the security policy based on the IT risk assessment.</p> <p>Changes to the IT security policy are approved by the IT standards committee prior to implementation.</p>
<p>1.2 The entity's security policies include, but may not be limited to, the following matters:</p> <ul style="list-style-type: none"> a. Identifying and documenting the security requirements of authorized users b. Classifying data based on its criticality and sensitivity and that classification is used to define protection requirements, access rights and access restrictions, and retention and destruction requirements c. Assessing risks on a periodic basis d. Preventing unauthorized access e. Adding new users, modifying the access levels of existing users, and removing users who no longer need access f. Assigning responsibility and accountability for system security g. Assigning responsibility and accountability for system changes and maintenance h. Testing, evaluating, and authorizing system components before implementation 	<p><i>An example of an illustrative control for this criterion would be an entity's documented security policy addressing the elements set out in criterion 1.2. An illustrative security policy has been omitted for brevity.</i></p>

<i>Criteria</i>	<i>Illustrative Controls</i> ⁷
<ul style="list-style-type: none"> i. Addressing how complaints and requests relating to security issues are resolved j. Identifying and mitigating security breaches and other incidents k. Providing for training and other resources to support its system security policies l. Providing for the handling of exceptions and situations not specifically addressed in its system security policies m. Providing for the identification of and consistency with applicable laws and regulations, defined commitments, service-level agreements, and other contractual requirements n. Providing for sharing information with third parties 	
1.3 Responsibility and accountability for developing and maintaining the entity's system security policies, and changes and updates to those policies, are assigned.	Management has assigned responsibilities for the maintenance and enforcement of the entity security policy to the security officer under the directions of the CIO. The IT standards committee of the executive committee assists in the review, update, and approval of the policy as outlined in the executive committee handbook.
2.0 Communications: The entity communicates its defined system security policies to responsible parties and authorized users.	
2.1 The entity has prepared an objective description of the system and its boundaries and communicated such description to authorized users.	<p>For its e-commerce system, the entity has posted a system description on its Web site. <i>(For an example of a system description for an e-commerce system, refer to appendix A [paragraph .45].)</i></p> <p>For its non-e-commerce system, the entity has provided a system description to authorized users. <i>(For an example of a system description for a non-e-commerce based system, refer to appendix B [paragraph .46].)</i></p>

(continued)

<i>Criteria</i>	<i>Illustrative Controls</i> ⁷
2.2 The security obligations of users and the entity's security commitments to users are communicated to authorized users.	<p>The entity's security commitments and required security obligations to its customers and other external users are posted on the entity's Web site and as part of the entity's standard services agreement.</p> <p>For its internal users (employees and contractors), the entity's policies relating to security are reviewed with new employees and contractors as part of their orientation, and the key elements of the policies and their impact on the employee are discussed.</p> <p>New employees must sign a statement signifying that they have read, understand, and will follow these policies.</p> <p>Each year, employees must reconfirm their understanding of and compliance with the entity's security policies. Security obligations of contractors are detailed in their contracts.</p> <p>A security awareness program has been implemented to communicate the entity's IT security policies to employees.</p>
2.3 Responsibility and accountability for the entity's system security policies and changes and updates to those policies are communicated to entity personnel responsible for implementing them.	<p>The entity publishes its IT security policies on its corporate intranet.</p> <p>The security administration team has custody of and is responsible for the day-to-day maintenance of the entity's security policies, and recommends changes to the CIO and the IT steering committee.</p> <p>Written job descriptions have been defined and are communicated to the security administration team.</p> <p>Written process and procedure manuals for all defined security processes are provided to security administration team personnel. The security officer updates the processes and procedures manuals based on changes to the security policy.</p>
2.4 The process for informing the entity about breaches of the system security and for submitting complaints is communicated to authorized users.	<p>The entity publishes its IT security policies on its corporate intranet.</p> <p>The security administration team has custody of and is responsible for the day-to-day maintenance of the entity's security policies, and recommends changes to the CIO and the IT steering committee.</p> <p>Written job descriptions have been defined and are communicated to the security administration team.</p> <p>Written process and procedure manuals for all defined security processes are provided to security administration team personnel. The security officer updates the processes and procedures manuals based on changes to the security policy.</p> <p>The process for customers and external users to inform the entity of possible security breaches and other incidents is posted on the entity's Web site and is provided as part of the new user welcome kit.</p> <p>The entity's security awareness program includes information concerning the identification of possible security breaches and the process for informing the security administration team.</p>

<i>Criteria</i>	<i>Illustrative Controls</i> ⁷
2.5 Changes that may affect system security are communicated to management and users who will be affected.	<p>Documented procedures exist for the identification and escalation of security breaches and other incidents.</p> <p>Planned changes to system components and the scheduling of those changes are reviewed as part of the monthly IT steering committee meetings.</p> <p>Changes to system components, including those that may affect system security, require the approval of the security administrator before implementation.</p> <p>Changes that may affect customers and users and their security obligations or the entity's security commitments are highlighted on the entity's Web site.</p> <p>Changes that may affect system security and confidentiality are communicated in writing to affected customers for review and approval under the provisions of the standard services agreement before implementation of the proposed change.</p> <p>There is periodic communication of changes, including changes that affect system security.</p> <p>Changes that affect system security are incorporated into the entity's ongoing security awareness program.</p>
3.0 Procedures: The entity placed in operation procedures to achieve its documented system security objectives in accordance with its defined policies.	
3.1 Procedures exist to (1) identify potential threats of disruption to systems operation that would impair system security commitments and (2) assess the risks associated with the identified threats.	<p>A risk assessment is performed periodically. As part of this process, threats to security are identified and the risk from these threats is formally assessed.</p> <p>Security processes and procedures are revised by the security officer based on the assessed threats.</p>
3.2 Procedures exist to restrict logical access to the defined system including, but not limited to, the following matters:	
<p>a. Logical access security measures to restrict access to information resources not deemed to be public.</p>	<ul style="list-style-type: none"> • Logical access to nonpublic information resources is protected through the use of native operating system security, native application and resource security, and add-on security software.

(continued)

<i>Criteria</i>	<i>Illustrative Controls</i> ⁷
<p>b. Identification and authentication of users.</p>	<ul style="list-style-type: none"> • Resource specific or default access rules have been defined for all non-public resources. • Access to resources is granted to an authenticated user based on the user's identity. • Users must establish their identity to the entity's network and application systems when accessing nonpublic resources through the use of a valid user ID that is authenticated by an associated password. • Unique user IDs are assigned to individual users. • Use of group or shared IDs is permitted only after completion of an assessment of the risk of the shared ID and written approval of the manager of the requesting business unit. • Passwords are case sensitive and must contain at least 8 characters, one of which is nonalphanumeric. • Security configuration parameters force passwords to be changed every 90 days. • Login sessions are terminated after 3 unsuccessful login attempts.
<p>c. Registration and authorization of new users.</p>	<ul style="list-style-type: none"> • Customers can self-register on the entity's Web site, under a secure session in which they provide new user information and select appropriate user ID and password. Privileges and authorizations associated with self-registered customer accounts provide specific limited system functionality. • The line-of-business supervisor authorizes access privilege change requests for employees and contractors. Access to restricted resources is authorized by the resource owner. • Customer access privileges beyond the default privileges granted during self-registration are approved by the customer account manager or the resource owner. • Proper segregation of incompatible duties is considered in granting privileges based on the user's job description or role. • The ability to create or modify users and user access privileges (other than the limited functionality "customer accounts") is limited to the security administration team.
<p>d. The process to make changes and updates to user profiles.</p>	<ul style="list-style-type: none"> • Changes and updates to self-registered customer accounts can be done by the individual user at any

<i>Criteria</i>	<i>Illustrative Controls</i> ⁷
	<p>time on the entity's Web site after the user has successfully logged onto the system. Changes are reflected immediately.</p> <ul style="list-style-type: none"> • Unused customer accounts (no activity for six months) are purged by the system. • Changes to other accounts and profiles are made by the security administration team and require the written approval of the appropriate line-of-business supervisor or customer account manager and the resource owner. • The human resource management system provides the human resources team with a list of newly terminated employees on a weekly basis. This listing is sent to the security administration team for deactivation.
e. Distribution of output restricted to authorized users.	<ul style="list-style-type: none"> • Access to computer processing output is provided to authorized individuals based on the classification of the information. • Processing output is stored in an area that reflects the classification of the information. • Processing output is distributed in accordance with the security policy based on classification of the information.
f. Restriction of access to offline storage, backup data, systems, and media.	<ul style="list-style-type: none"> • Access to offline storage, backup data, systems, and media is limited to computer operations staff through the use of physical and logical access controls.
g. Restriction of access to system configurations, superuser functionality, master passwords, powerful utilities, and security devices (for example, firewalls).	<ul style="list-style-type: none"> • Hardware and operating system configuration tables are restricted to appropriate personnel through physical access controls, native operating system security, and add-on security software. • Application software configuration tables are restricted to authorized users and under the control of application change management software. • Utility programs that can read, add, change, or delete data or programs are restricted to authorized technical services staff. Usage is logged and monitored by the manager of computer operations. • The information security team, under the direction of the CIO, maintains access to firewall and other logs, as well as access to any storage media.

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<i>Criteria</i>	<i>Illustrative Controls</i> ⁷
3.3 Procedures exist to restrict physical access to the defined system including, but not limited to, facilities, backup media, and other system components such as firewalls, routers, and servers.	<p>Any access is logged and reviewed in accordance with the company's IT policies.</p> <ul style="list-style-type: none"> • A listing of all master passwords is stored in an encrypted database, and an additional copy is maintained in a sealed envelope in the entity safe. <p>Physical access to the computer rooms, which house the entity's IT resources, servers, and related hardware such as firewalls and routers, is restricted to authorized individuals by card key systems and monitored by video surveillance.</p> <p>Physical access cards are managed by building security staff. Access card usage is logged. Logs are maintained and reviewed by building security staff.</p> <p>Requests for physical access privileges to the entity's computer facilities require the approval of the manager of computer operations.</p>
3.4 Procedures exist to protect against unauthorized access to system resources.	<p>Documented procedures exist for the identification and escalation of potential physical security breaches.</p> <p>Offsite media are stored in locked containers in secured facilities. Physical access to these containers is restricted to facilities personnel and employees authorized by the manager of computer operations.</p> <p>Login sessions are terminated after three unsuccessful login attempts. Virtual private networking (VPN) software is used to permit remote access by authorized users. Users are authenticated by the VPN server through specific "client" software and user ID and passwords.</p> <p>Firewalls are used and configured to prevent unauthorized access. Firewall events are logged and reviewed daily by the security administrator.</p> <p>Unneeded network services (for example, telnet, ftp, and http) are deactivated on the entity's servers. A listing of the required and authorized services is maintained by the IT department. This list is reviewed by entity management on a routine basis for its appropriateness for the current operating conditions.</p>

<i>Criteria</i>	<i>Illustrative Controls</i> ⁷
3.5 Procedures exist to protect against infection by computer viruses, malicious code, and unauthorized software.	<p>Intrusion detection systems are used to provide continuous monitoring of the entity's network and early identification of potential security breaches.</p> <p>The entity contracts with third parties to conduct periodic security reviews and vulnerability assessments. Results and recommendations for improvement are reported to management.</p> <p>In connection with other security monitoring, the security administration team participates in user groups and subscribes to services relating to computer viruses.</p> <p>Antivirus software is in place, including virus scans of incoming e-mail messages. Virus signatures are updated promptly.</p> <p>Any viruses discovered are reported to the security team, and an alert is created for all users notifying them of a potential virus threat.</p>
3.6 Encryption or other equivalent security techniques are used to protect user authentication information and the corresponding session transmitted over the Internet or other public networks.	<p>The ability to install, modify, and replace operating system and other system programs is restricted to authorized personnel.</p> <p>Access to superuser functionality and sensitive system functions is restricted to authorized personnel.</p> <p>The entity uses industry standard encryption technology, VPN software, or other secure communication systems (consistent with its periodic IT risk assessment) for the transmission of private or confidential information over public networks, including user IDs and passwords. Users are required to upgrade their browsers to the most current version tested and approved for use by the security administration team to avoid possible security problems.</p> <p>Account activities, subsequent to successful login, are encrypted through industry standard encryption technology, VPN software, or other secure communication systems (consistent with its periodic IT risk assessment). Users are logged out on request (by selecting the "Sign-out" button on the Web site) or after 10 minutes of inactivity.</p>

(continued)

<i>Criteria</i>	<i>Illustrative Controls</i> ⁷
Criteria related to execution and incident management used to achieve objectives	
3.7	<p>Procedures exist to identify, report, and act upon system security breaches and other incidents.</p> <p>Users are provided instructions for communicating potential security breaches to the information security team. The information security team logs incidents reported through customer hotlines and e-mail.</p> <p>Intrusion detection systems and other tools are used to identify, log, and report potential security breaches and other incidents. The system notifies the security administration team or the network administrator via e-mail and text of potential incidents in progress.</p> <p>Incident logs are monitored and evaluated by the information security team daily.</p> <p>When an incident is detected or reported, a defined incident management process is initiated by authorized personnel. Corrective actions are implemented in accordance with defined policies and procedures.</p> <p>Procedures include a defined incident escalation process and notification mechanisms.</p> <p>All incidents are tracked by management until resolved.</p> <p>Closed incidents are reviewed by management for appropriate resolution.</p> <p>Resolution of incidents not related to security includes consideration of the effect of the incident and its resolution on security requirements.</p>
Criteria related to the system components used to achieve the objectives	
3.8	<p>Procedures exist to classify data in accordance with classification policies and periodically monitor and update such classifications as necessary</p> <p>Data owners periodically review data access rules and request modifications based on defined security requirements and risk assessments.</p> <p>Whenever new data are captured or created, the data are classified based on security policies,</p> <p>Propriety of data classification is considered as part of the change management process.</p>
3.9	<p>Procedures exist to provide that issues of noncompliance with security policies are</p> <p>All incidents are tracked by management until resolved.</p>

<i>Criteria</i>	<i>Illustrative Controls⁷</i>
promptly addressed and that corrective measures are taken on a timely basis.	Closed incidents are reviewed by management for appropriate resolution.
3.10 Design, acquisition, implementation, configuration, modification, and management of infrastructure and software are consistent with defined system security policies to enable authorized access and to prevent unauthorized access.	The internal audit process includes the development of management actions plans for findings and the tracking of action plans until closed.
	The entity has adopted a formal systems development life cycle (SDLC) methodology that governs the development, acquisition, implementation, and maintenance of computerized information systems and related technology.
	The SDLC methodology includes a framework for classifying data and creating standard user profiles that are established based on an assessment of the business impact of the loss of security. Users are assigned standard profiles based on needs and functional responsibilities.
	The security administration team reviews and approves the architecture and design specifications for new systems development and acquisition to help ensure consistency with the entity's security objectives, policies, and standards.
	Changes to system components that may affect security require the approval of the security administration team.
3.11 Procedures exist to provide that personnel responsible for the design, development, implementation, and operation of systems affecting security have the qualifications and resources to fulfill their responsibilities.	The entity has written job descriptions specifying the responsibilities and academic and professional requirements for key job positions.
	Hiring procedures include a comprehensive screening of candidates for key positions and consideration of whether the verified credentials are commensurate with the proposed position. New personnel are offered employment subject to background checks and reference validation.
	Candidates, including internal transfers, are approved by the line-of-business manager before the employment position is offered.
	Periodic performance appraisals are performed by employee supervisors and include the assessment and review of professional development activities.

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<i>Criteria</i>	<i>Illustrative Controls</i> ⁷
	<p>Personnel receive training and development in system security concepts and issues.</p> <p>Procedures are in place to provide alternate personnel for key system security functions in case of absence or departure.</p>
Change management-related criteria applicable to the system's security	
3.12	<p>Procedures exist to maintain system components, including configurations consistent with the defined system security policies.</p> <p>Entity management receives a third-party opinion on the adequacy of security controls and routinely evaluates the level of performance it receives (in accordance with its contractual service-level agreement) from the service provider that hosts the entity's systems and Web site.</p> <p>The IT department maintains an up-to-date listing of all software and the respective level, version, and patches that have been applied.</p> <p>Requests for changes, system maintenance, and supplier maintenance are standardized and subject to documented change management procedures. Changes are categorized and ranked according to priority, and procedures are in place to handle urgent matters. Change requestors are kept informed about the status of their requests.</p> <p>System configurations are tested annually and evaluated against the entity's security policies and current service-level agreements. An exception report is prepared and remediation plans are developed and tracked.</p>
3.13	<p>Procedures exist to provide that only authorized, tested, and documented changes are made to the system.</p> <p>The responsibilities for authorizing, testing, developing, and implementing changes have been segregated.</p> <p>The entity's documented systems development methodology describes the change initiation, software development and maintenance, and approval processes, as well as the standards and controls that are embedded in the processes. These include programming, documentation, and testing standards.</p> <p>Requests for changes, system maintenance, and supplier maintenance are standardized and subject to documented change management procedures. Changes are categorized and ranked according to priority, and</p>

<i>Criteria</i>	<i>Illustrative Controls</i> ⁷	
3.14	<p>Procedures exist to provide that emergency changes are documented and authorized timely.</p>	<p>procedures are in place to handle urgent matters. Change requestors are kept informed about the status of their outstanding and closed requests.</p> <p>Changes to system infrastructure and software are developed and tested in a separate development or test environment before implementation into production.</p> <p>As part of the change control policies and procedures, there is a “promotion” process (for example, from “test” to “staging” to “production”). Promotion to production requires the approval of the business owner who sponsored the change and the manager of computer operations.</p> <p>When changes are made to key systems components, there is a “backout” plan developed for use in the event of major interruption(s).</p> <p>Requests for changes, system maintenance, and supplier maintenance are standardized and subject to documented change management procedures. Changes are categorized and ranked according to priority, and procedures are in place to handle urgent matters. Change requestors are kept informed about the status of their requests.</p> <p>Emergency changes that require deviations from standard procedures are logged and reviewed by IT management daily and reported to the affected line-of-business manager. Permanent corrective measures follow the entity’s change management process, including line-of-business approvals.</p>
4.0 Monitoring: The entity monitors the system and takes action to maintain compliance with its defined system security policies.		
4.1	<p>The entity’s system security is periodically reviewed and compared with the defined system security policies.</p>	<p>The information security team monitors the system and assesses the system vulnerabilities using proprietary and publicly available tools. Potential risks are evaluated and compared to service-level agreements and other obligations of the entity. Remediation plans are proposed and implementations are monitored.</p> <p>The entity contracts with third parties to conduct periodic security reviews and vulnerability assessments. The internal audit function conducts system security reviews as part of its annual audit plan.</p>

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<i>Criteria</i>	<i>Illustrative Controls</i> ⁷
	Results and recommendations for improvement are reported to management.
4.2 There is a process to identify and address potential impairments to the entity's ongoing ability to achieve its objectives in accordance with its defined system security policies.	<p>Logs are analyzed either manually or by automated tools to identify trends that may have a potential impact on the entity's ability to achieve its system security objectives.</p> <p>Monthly IT staff meetings are held to address system security concerns and trends; findings are discussed at quarterly management meetings.</p>
4.3 Environmental, regulatory, and technological changes are monitored and their effect on system security is assessed on a timely basis and policies are updated for that assessment.	<p>Senior management, as part of its annual IT planning process, considers developments in technology and the impact of applicable laws or regulations on the entity's security policies.</p> <p>The entity's IT security group monitors the security impact of emerging technologies.</p> <p>Users are proactively invited to contribute to initiatives to improve system security through the use of new technologies.</p>

Availability Principle and Criteria

.21 The *availability principle* refers to the accessibility to the system, products, or services as advertised or committed by contract, service-level, or other agreements. It should be noted that this principle does not, in itself, set a minimum acceptable performance level for system availability. The minimum performance level is established through commitments made by mutual agreement (contract) between the parties.

.22 Although there is a connection between system availability, system functionality, and system usability, the availability principle does not address system functionality (the specific functions a system performs) and system usability (the ability of users to apply system functions to specific tasks or problems). It does address system availability, which relates to whether the system is accessible for processing, monitoring, and maintenance.

Availability Principle and Criteria Table

.23 The system is available for operation and use as committed or agreed.

<i>Criteria</i>	<i>Illustrative Controls</i>
1.0 Policies: The entity defines and documents its policies for the availability of its system.	
1.1 The entity's system availability and related security policies are established and periodically reviewed and approved by a designated individual or group.	<p>A written availability policy has been approved by the IT standards committee and is implemented throughout the company.</p> <p>The entity's documented systems development and acquisition process includes procedures to identify and document authorized users of the system and their availability and related security requirements.</p> <p>User requirements are documented in service-level agreements or other documents.</p>
<p>1.2 The entity's system availability and related security policies include, but may not be limited to, the following matters:</p> <ul style="list-style-type: none"> a. Identifying and documenting the system availability and related security requirements of authorized users. b. Classifying data based on its criticality and sensitivity and that classification is used to define protection requirements, access rights and access restrictions, and retention and destruction requirements c. Assessing risks on a periodic basis d. Preventing unauthorized access. e. Adding new users, modifying the access levels of existing users, and removing users who no longer need access. f. Assigning responsibility and accountability for system availability and related security. 	<p><i>An example of an illustrative control for this criterion would be an entity's documented availability policy and related security policy addressing the elements set out in criterion 1.2. Illustrative availability and securities policies have been omitted for brevity.</i></p>

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<i>Criteria</i>	<i>Illustrative Controls</i>
<ul style="list-style-type: none"> <li data-bbox="198 152 510 248">g. Assigning responsibility and accountability for system changes and maintenance. <li data-bbox="198 262 510 357">h. Testing, evaluating, and authorizing system components before implementation. <li data-bbox="198 371 510 484">i. Addressing how complaints and requests relating to system availability and related security issues are resolved. <li data-bbox="198 498 510 593">j. Identifying and mitigating system availability and related security breaches and other incidents. <li data-bbox="198 607 510 703">k. Providing for training and other resources to support its system availability and related security policies. <li data-bbox="198 716 510 864">l. Providing for the handling of exceptions and situations not specifically addressed in its system availability and related security policies. <li data-bbox="198 878 510 1069">m. Providing for the identification of and consistency with, applicable laws and regulations, defined commitments, service-level agreements, and other contractual requirements. <li data-bbox="198 1083 510 1197">n. Recovering and continuing service in accordance with documented customer commitments or other agreements. <li data-bbox="198 1211 510 1341">o. Monitoring system capacity to achieve customer commitments or other agreements regarding availability 	
<p data-bbox="127 1359 510 1524">1.3 Responsibility and accountability for developing and maintaining the entity's system availability and related security policies, and changes and updates to those policies, are assigned.</p>	<p data-bbox="568 1359 989 1550">Management has assigned responsibilities for the maintenance and enforcement of the entity's availability policies to the CIO. The IT standards committee of the executive committee assists in the review, update, and approval of these policies as outlined in the executive committee handbook.</p>

<i>Criteria</i>	<i>Illustrative Controls</i>
<p>Ownership and custody of significant information resources (for example, data, programs, and transactions) and responsibility for establishing and maintaining the system availability of and related security over such resources are defined.</p>	
2.0 Communications: The entity communicates the defined system availability policies to responsible parties and authorized users.	
2.1	<p>The entity has prepared an objective description of the system and its boundaries and communicated such description to authorized users.</p> <p>For its e-commerce system, the entity has posted a system description on its Web site. <i>(For an example of a system description for an e-commerce system, refer to appendix A [paragraph .45].)</i></p> <p>For its non-e-commerce system, the entity has provided a system description to authorized users. <i>(For an example of a system description for a non-e-commerce based system, refer to appendix B [paragraph .46].)</i></p>
2.2	<p>The availability and related security obligations of users and the entity's availability and related security commitments to users are communicated to authorized users.</p> <p>The entity's system availability and related security commitments and required system availability and related security obligations of its customers and other external users are posted on the entity's Web site or as part of the entity's standard services agreement. Service-level agreements are reviewed with the customer annually.</p> <p>For its internal users (employees and contractors), the entity's policies relating to system security are reviewed with new employees and contractors as part of their orientation, and the key elements of the policies and their impact on the employee are discussed. New employees must sign a statement signifying that they have read, understand, and will follow these policies. Each year, as part of their performance review, employees must reconfirm their understanding of and compliance with the entity's policies. Obligations of contractors are detailed in their contract.</p> <p>A security awareness program has been implemented to communicate the entity's IT security policies to employees.</p> <p>The entity publishes its IT security policies on its corporate intranet.</p>
2.3	<p>Responsibility and accountability for the entity's system availability and related security policies and changes</p> <p>The network operations team is responsible for implementing the entity's availability policies under the direction of the CIO. The security administration</p>

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<i>Criteria</i>	<i>Illustrative Controls</i>
and updates to those policies are communicated to entity personnel responsible for implementing them.	<p>team is responsible for implementing the related security policies.</p> <p>The network operations team has custody of and is responsible for the day-to-day maintenance of the entity's availability policies and recommends changes to the CIO and the IT steering committee. The security administration team is responsible for the related security policies.</p>
2.4 The process for informing the entity about system availability issues and breaches of system security and for submitting complaints is communicated to authorized users.	<p>Written job descriptions have been defined and are communicated to the network operations team and the security administration team.</p> <p>Written processes and procedures manuals for all operations and security processes are provided to personnel. Designated personnel update the processes and procedures manuals based on changes to availability requirements and security policies.</p> <p>The process for customers and external users to inform the entity of system availability issues, possible security breaches, and other incidents is posted on the entity's Web site and is provided as part of the new user welcome kit.</p> <p>The entity's user training program includes modules dealing with the identification and reporting of system availability issues, security breaches, and other incidents.</p> <p>The entity's security awareness program includes information concerning the identification of possible security breaches and the process for informing the security administration team.</p>
2.5 Changes that may affect system availability and system security are communicated to management and users who will be affected.	<p>Documented procedures exist for the identification and escalation of system availability issues, security breaches, and other incidents.</p> <p>Changes that may affect system availability, customers and users and their security obligations, or the entity's security commitments are highlighted on the entity's Web site.</p> <p>Changes that may affect system availability and related system security are communicated in writing to affected customers for review and approval under the provisions of the standard services agreement before implementation of the proposed change.</p>

<i>Criteria</i>	<i>Illustrative Controls</i>
	<p>Planned changes to system components and the scheduling of those changes are reviewed as part of the monthly IT steering committee meetings.</p> <p>Changes to system components, including those that may affect system security, require the approval of the manager of network operations or the security administration team before implementation.</p> <p>There is periodic communication of system changes to users and customers, including changes that affect availability and system security.</p>
3.0	Procedures: The entity placed in operation procedures to achieve its documented system availability objectives in accordance with its defined policies.
3.1	<p>Procedures exist to (1) identify potential threats of disruptions to systems operation that would impair system availability commitments and (2) assess the risks associated with the identified threats.</p> <p>A threat identification risk assessment is prepared and reviewed on a periodic basis or when a significant change occurs in either the internal or external physical environment. Threats such as fire, flood, dust, power failure, excessive heat and humidity, and labor problems have been considered.</p>
3.2	<p>Measures to prevent or mitigate threats have been implemented consistent with the risk assessment when commercially practicable.</p> <p>Management maintains measures to protect against environmental factors (for example, fire, flood, dust, power failure, and excessive heat and humidity) based on its periodic risk assessment. The entity's controlled areas are protected against fire using both smoke detectors and a fire suppression system. Water detectors are installed within the raised floor areas.</p> <p>The entity site is protected against a disruption in power supply to the processing environment by both uninterruptible power supplies and emergency power supplies. This equipment is tested semiannually.</p> <p>Preventive maintenance agreements and scheduled maintenance procedures are in place for key system hardware components.</p> <p>Vendor warranty specifications are complied with and tested to determine if the system is properly configured.</p> <p>Procedures to address minor processing errors, outages, and destruction of records are documented.</p>

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<i>Criteria</i>	<i>Illustrative Controls</i>
	<p>Procedures exist for the identification, documentation, escalation, resolution, and review of problems.</p> <p>Physical and logical security controls are implemented to reduce the opportunity for unauthorized actions that could impair system availability.</p>
3.3 Procedures exist to provide for backup, offsite storage, restoration, and disaster recovery consistent with the entity's defined system availability and related security policies.	<p>Management has implemented a comprehensive strategy for backup and restoration based on a review of business requirements. Backup procedures for the entity are documented and include redundant servers, daily incremental backups of each server, and a complete backup of the entire week's changes on a weekly basis. Daily and weekly backups are stored offsite in accordance with the entity's system availability policies.</p> <p>Disaster recovery and contingency plans are documented.</p> <p>The disaster recovery plan defines the roles and responsibilities and identifies the critical IT application programs, operating systems, personnel, data files, and time frames needed to ensure high availability and system reliability based on a business impact analysis.</p> <p>The business continuity planning coordinator reviews and updates the business impact analysis with the lines of business annually.</p> <p>Disaster recovery and contingency plans are tested annually in accordance with the entity's system availability policies. Testing results and change recommendations are reported to the entity's management committee.</p> <p>The entity's management committee reviews and approves changes to the disaster recovery plan.</p> <p>Contracted capacity at resumption facilities is compared to documented processing requirements on an annual basis and modified as necessary.</p> <p>All critical personnel identified in the business continuity plan hold current versions of the plan, both onsite and offsite. An electronic version is stored offsite.</p>
3.4 Procedures exist to provide for the integrity of backup data and systems maintained to	<p>Automated backup processes include procedures for testing the integrity of the backup data.</p>

<i>Criteria</i>	<i>Illustrative Controls</i>
support the entity's defined system availability and related security policies.	<p>Backups are performed in accordance with the entity's defined backup strategy, and usability of backups is verified at least annually.</p> <p>An inventory of available backups and the physical location of the backups are maintained by operations personnel.</p> <p>Backup systems and data are stored offsite at the facilities of a third-party service provider.</p> <p>Under the terms of its service provider agreement, the entity performs an annual verification of media stored at the offsite storage facility. As part of the verification, media at the offsite location are matched to the appropriate media management system. The storage site is reviewed biannually for physical access security and security of data files and other items.</p> <p>Backup systems and data are tested as part of the annual disaster recovery test.</p>

Security-related criteria relevant to the system's availability

<p>3.5 Procedures exist to restrict logical access to the defined system including, but not limited to, the following matters:</p> <p>a. Logical access security measures to restrict access to information resources not deemed to be public.</p> <p>b. Identification and authentication of users.</p>	<ul style="list-style-type: none"> • Logical access to nonpublic information resources is protected through the use of native operating system security, native application or resource security, and add-on security software. • Resource specific or default access rules have been defined for all nonpublic resources. • Access to resources granted to authenticated users based on their user profiles. • Users must establish their identity to the entity's network and application systems when accessing nonpublic resources through the use of a valid user ID that is authenticated by an associated password. • Unique user IDs are assigned to individual users. • Use of group or shared IDs is permitted only after completion of an assessment of the risk of the shared ID and written approval of the manager of the requesting business unit.
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<i>Criteria</i>	<i>Illustrative Controls</i>
c. Registration and authorization of new users.	<ul style="list-style-type: none"> • Passwords are case sensitive must contain at least 8 characters, one of which is nonalphanumeric. • Security configuration parameters force passwords to be changed every 90 days. • Login sessions are terminated after 3 unsuccessful login attempts. • Customers can self-register on the entity's Web site, under a secure session in which they provide new user information and select appropriate user ID and password. Privileges and authorizations associated with self-registered customer accounts provide specific limited system functionality. • The ability to create or modify users and user access privileges (other than the limited functionality "customer accounts") is limited to the security administration team. • The line-of-business supervisor authorizes access privilege change requests for employees and contractors. Access to restricted resources is authorized by the resource owner. • Customer access privileges beyond the default privileges granted during self-registration are approved by the customer account manager. Proper segregation of duties is considered in granting privileges.
d. The process to make changes and updates to user profiles.	<ul style="list-style-type: none"> • Changes and updates to self-registered customer accounts can be done by the individual user at any time on the entity's Web site after the user has successfully logged onto the system. Changes are reflected immediately. • Unused customer accounts (no activity for six months) are purged by the system. • Changes to other accounts and profiles are restricted to the security administration team and require the approval of the appropriate line-of-business supervisor or customer account manager. • The human resource management system provides the human resources team with a list of newly terminated employees on a weekly basis. This listing is sent to the security administration team for deactivation.
e. Restriction of access to offline storage, backup data, systems and media.	<ul style="list-style-type: none"> • Access to offline storage, backup data, systems, and media is limited to computer operations staff through the

<i>Criteria</i>	<i>Illustrative Controls</i>
<p>f. Restriction of access to system configurations, superuser functionality, master passwords, powerful utilities, and security devices (for example, firewalls).</p>	<p>use of physical and logical access controls.</p> <ul style="list-style-type: none"> • Hardware and operating system configuration tables are restricted to appropriate personnel. • Application software configuration tables are restricted to authorized users and under the control of application change management software. • Utility programs that can read, add, change, or delete data or programs are restricted to authorized technical services staff. Usage is logged and monitored by the manager of computer operations. • The information security team, under the direction of the CIO, maintains access to firewall and other logs, as well as access to any storage media. Any access is logged and reviewed in accordance with the company's IT policies. • A listing of all master passwords is stored in an encrypted database and an additional copy is maintained in a sealed envelope in the entity safe.
<p>3.6 Procedures exist to restrict physical access to the defined system including, but not limited to, facilities, backup media, and other system components such as firewalls, routers, and servers.</p>	<p>Physical access to the computer rooms, which house the entity's IT resources, servers, and related hardware such as firewalls and routers, is restricted to authorized individuals by card key systems and monitored by video surveillance.</p> <p>Physical access cards are managed by building security staff. Access card usage is logged. Logs are maintained and reviewed by building security staff.</p> <p>Requests for physical access privileges to the entity's computer facilities require the approval of the manager of computer operations.</p> <p>Documented procedures exist for the identification and escalation of potential physical security breaches.</p> <p>Offsite backup data and media are stored at service provider facilities. Access to offsite data and media requires the approval of the manager of computer operations.</p>
<p>3.7 Procedures exist to protect against unauthorized access to system resources.</p>	<p>Login sessions are terminated after three unsuccessful login attempts.</p> <p>Virtual private networking (VPN) software is used to permit remote access</p>

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<i>Criteria</i>	<i>Illustrative Controls</i>
	<p>by authorized users. Users are authenticated by the VPN server through specific “client” software and user ID and passwords.</p> <p>Firewalls are used and configured to prevent unauthorized access. Firewall events are logged and reviewed daily by the security administrator.</p> <p>Unneeded network services (for example, telnet, ftp, and http) are deactivated on the entity’s servers. A listing of the required and authorized services is maintained by the IT department. This list is reviewed by entity management on a routine basis for its appropriateness for the current operating conditions.</p> <p>Intrusion detection systems are used to provide continuous monitoring of the entity’s network and early identification of potential security breaches.</p> <p>The entity contracts with third parties to conduct periodic security reviews and vulnerability assessments. Results and recommendations for improvement are reported to management.</p>
3.8 Procedures exist to protect against infection by computer viruses, malicious codes, and unauthorized software.	<p>In connection with other security monitoring, the security administration team participates in user groups and subscribes to services relating to computer viruses.</p> <p>Antivirus software is in place, including virus scans of incoming e-mail messages. Virus signatures are updated promptly.</p> <p>Any viruses discovered are reported to the security team and an alert is created for all users notifying them of a potential virus threat.</p> <p>The ability to install, modify, and replace operating system and other system programs is restricted to authorized personnel</p> <p>Access to superuser functionality and sensitive system functions is restricted to authorized personnel.</p>
3.9 Encryption or other equivalent security techniques are used to protect user authentication information and the corresponding session transmitted over the Internet or other public networks.	<p>The entity uses industry standard encryption technology, VPN software or other secure communication systems (consistent with its periodic IT risk assessment) for the transmission of private or confidential information over public networks, including user IDs and passwords. Users are required to upgrade</p>

<i>Criteria</i>	<i>Illustrative Controls</i>
	<p>their browsers to the most current versions tested and approved for use by the security administration team to avoid possible security problems.</p> <p>Account activities, subsequent to successful login, are encrypted through industry standard encryption technology, VPN software, or other secure communication systems (consistent with its periodic IT risk assessment). Users are logged out on request (by selecting the “Sign-out” button on the Web site) or after 10 minutes of inactivity.</p>
Criteria related to execution and incident management used to achieve objectives	
3.10	<p>Procedures exist to identify, report, and act upon system availability issues and related security breaches and other incidents.</p> <p>Users are provided instructions for communicating system availability issues, potential security breaches, and other issues to the help desk or customer service center.</p> <p>Documented procedures exist for the escalation of system availability issues and potential security breaches that cannot be resolved by the help desk.</p> <p>Network performance and system processing are monitored using system monitoring tools by onsite operations staff 24 hours a day, 7 days a week. Documented procedures exist for the escalation and resolution of performance and processing availability issues.</p> <p>Intrusion detection system and other tools are used to identify, log, and report potential security breaches and other incidents. The system notifies the security administration team and the network administrator via e-mail and text of potential incidents in progress.</p> <p>Incident logs are monitored and evaluated by the information security team daily.</p> <p>Documented incident identification and escalation procedures are approved by management and include a defined incident escalation process and notification mechanisms.</p> <p>Network performance, system availability, and security incident statistics and comparisons to approved targets are accumulated and reported to the IT steering committee monthly.</p>

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<i>Criteria</i>	<i>Illustrative Controls</i>
	<p>System performance and capacity analysis and projections are completed annually as part of the IT planning and budgeting process.</p> <p>System and network operations are actively monitored by operations personnel.</p> <p>When a system disruption is detected or reported, a defined incident management process is initiated by systems and network operations personnel. Corrective actions are implemented in accordance with defined policies and procedures.</p> <p>All incidents are tracked by operations management until resolved.</p> <p>Closed incidents are reviewed by operations personnel for appropriate resolution.</p>

Criteria related to the system components used to achieve the objectives

3.11	<p>Procedures exist to classify data in accordance with classification policies and periodically monitor and update such classifications as necessary.</p>	<p>Data owners periodically review data access rules and request modifications based on defined security and availability requirements and risk assessments</p> <p>Whenever new data are captured or created, the data are classified based on security and availability policies.</p> <p>Propriety of data classification is considered as part of the change management process.</p>
3.12	<p>Procedures exist to provide that issues of noncompliance with system availability and related security policies are promptly addressed and that corrective measures are taken on a timely basis.</p>	<p>All incidents are tracked by management until resolved.</p> <p>Closed incidents are reviewed by management for appropriate resolution.</p> <p>The internal audit process includes the development of management actions plans for findings and the tracking of action plans until closed.</p>
3.13	<p>Design, acquisition, implementation, configuration, modification, and management of infrastructure and software are consistent with defined system availability and related security policies.</p>	<p>The entity has adopted a formal systems development life cycle (SDLC) methodology that governs the development, acquisition, implementation, and maintenance of computerized information systems and related technology.</p> <p>The SDLC methodology includes a framework for</p> <ul style="list-style-type: none"> • establishing performance level and system availability requirements based on user needs.

<i>Criteria</i>	<i>Illustrative Controls</i>
3.14 Procedures exist to provide that personnel responsible for the design, development, implementation, and operation of systems affecting availability and security have the qualifications and resources to fulfill their responsibilities.	<ul style="list-style-type: none"> • maintaining the entity’s backup and disaster recovery planning processes in accordance with user requirements. • classifying data and creating standard user profiles that are established based on an assessment of the business impact of the loss of security; assigning standard profiles to users based on needs and functional responsibilities. • testing changes to system components to minimize the risk of an adverse impact to system performance and availability. • developing “backout” plans before implementation of changes. <p>The security administration team reviews and approves the architecture and design specifications for new systems development and acquisition to ensure consistency with the entity’s related security policies.</p> <p>Changes to system components that may affect systems processing performance, availability, and security require the approval of the security administration team.</p> <p>The entity contracts with third parties to conduct periodic security reviews and vulnerability assessments. Results and recommendations for improvement are reported to management.</p> <p>The entity has written job descriptions specifying the responsibilities and academic and professional requirements for key job positions.</p> <p>Hiring procedures include a comprehensive screening of candidates for key positions and consideration of whether the verified credentials are commensurate with the proposed position. New personnel are offered employment subject to background checks and reference validation.</p> <p>Candidates, including internal transfers, are approved by the line-of-business manager before the employment position is offered.</p> <p>Periodic performance appraisals are performed by employee supervisors and include the assessment and review of professional development activities.</p>

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<i>Criteria</i>	<i>Illustrative Controls</i>
	<p>Personnel receive training and development in system availability concepts and issues.</p> <p>Procedures are in place to provide alternate personnel for key system availability and security functions in case of absence or departure.</p>
Change management-related criteria applicable to the system's availability	
3.15	<p>Procedures exist to maintain system components, including configurations consistent with the defined system availability and related security policies.</p> <p>Entity management receives a third-party opinion on the adequacy of security controls and routinely evaluates the level of performance it receives (in accordance with its contractual service-level agreement) from the service provider that hosts the entity's systems and Web site.</p> <p>The IT department maintains an up-to-date listing of all software and the respective level, version, and patches that have been applied.</p> <p>Requests for changes, system maintenance, and supplier maintenance are standardized and subject to documented change management procedures. Changes are categorized and ranked according to priority, and procedures are in place to handle urgent matters. Change requestors are kept informed about the status of their requests.</p> <p>Staffing, infrastructure, and software requirements are periodically evaluated, and resources are allocated consistent with the entity's availability and related security policies.</p> <p>System configurations are tested annually and evaluated against the entity's processing performance, availability, security policies, and current service-level agreements. An exception report is prepared, and remediation plans are developed and tracked.</p>
3.16	<p>Procedures exist to provide that only authorized, tested, and documented changes are made to the system.</p> <p>The responsibilities for authorizing, testing, developing, and implementing changes have been segregated.</p> <p>The entity's documented systems development methodology describes the change initiation, software development and maintenance, and approval processes, as well as the standards and controls that are embedded in the processes. These include programming, documentation, and testing standards.</p>

<i>Criteria</i>	<i>Illustrative Controls</i>
	<p>Requests for changes, system maintenance, and supplier maintenance are standardized and subject to documented change management procedures. Changes are categorized and ranked according to priority, and procedures are in place to handle urgent matters. Change requestors are kept informed about the status of their outstanding and closed requests.</p> <p>Changes to system infrastructure and software are developed and tested in a separate development or test environment before implementation into production.</p> <p>As part of the change control policies and procedures, there is a “promotion” process (for example, from “test” to “staging” to “production”). Promotion to production requires the approval of the business owner who sponsored the change and the manager of computer operations.</p> <p>When changes are made to key systems components, there is a “backout” plan developed for use in the event of major interruption(s).</p>
3.17 Procedures exist to provide that emergency changes are documented and authorized (including after-the-fact approval).	<p>Requests for changes, system maintenance, and supplier maintenance are standardized and subject to documented change management procedures. Changes are categorized and ranked according to priority, and procedures are in place to handle urgent matters. Change requestors are kept informed about the status of their requests.</p> <p>Emergency changes that require deviations from standard procedures are logged and reviewed by IT management daily and reported to the affected line-of-business manager. Permanent corrective measures follow the entity’s change management process, including line-of-business approvals.</p>
4.0	Monitoring: The entity monitors the system and takes action to maintain compliance with its defined system availability policies.
4.1 The entity’s system availability and security performance is periodically reviewed and compared with the defined system availability and related security policies.	<p>Network performance and system processing are monitored using system monitoring tools by onsite operations staff 24 hours a day, 7 days a week. Network performance, system availability, and security incident statistics and comparisons to approved targets are accumulated and reported to the IT</p>

(continued)

<i>Criteria</i>	<i>Illustrative Controls</i>
	<p>steering committee monthly.</p> <p>The customer service group monitors system availability and related customer complaints. It provides a monthly report of such matters together with recommendations for improvement, which are considered and acted on at the monthly IT steering committee meetings.</p> <p>The information security team monitors the system and assesses the system vulnerabilities using proprietary and publicly available tools. Potential risks are evaluated and compared to service-level agreements and other obligations of the entity. Remediation plans are proposed, and implementations are monitored.</p> <p>The entity contracts with third parties to conduct periodic security reviews and vulnerability assessments. The internal audit function conducts system availability and system security reviews as part of its annual audit plan. Results and recommendations for improvement are reported to management.</p>
4.2	<p>There is a process to identify and address potential impairments to the entity's ongoing ability to achieve its objectives in accordance with its defined system availability and related security policies.</p> <p>Network performance and system processing are monitored using system monitoring tools by onsite operations staff 24 hours a day, 7 days a week. Network performance, system availability, and security incident statistics and comparisons to approved targets are accumulated and reported to the IT steering committee monthly.</p> <p>Future system performance, availability, and capacity requirements are projected and analyzed as part of the annual IT planning and budgeting process.</p> <p>Logs are analyzed either manually or by automated tools to identify trends that may have a potential impact on the entity's ability to achieve its system availability and related security objectives.</p> <p>Monthly IT staff meetings are held to address system performance, availability, capacity, and security concerns and trends; findings are discussed at quarterly management meetings.</p>
4.3	<p>Environmental, regulatory, and technological changes are monitored, and their effect on system availability and security is assessed on a timely</p> <p>The entity's data center facilities include climate and environmental monitoring devices. Deviations from optimal performance ranges are escalated and resolved.</p>

<i>Criteria</i>	<i>Illustrative Controls</i>
basis; policies are updated for that assessment.	<p>Senior management, as part of its annual IT planning process, considers developments in technology and the impact of applicable laws or regulations on the entity's availability and related security policies.</p> <p>The entity's customer service group monitors the impact of emerging technologies, customer requirements, and competitive activities.</p>

Processing Integrity Principle and Criteria

.24 The *processing integrity principle* refers to the completeness, accuracy, validity, timeliness, and authorization of system processing. Processing integrity exists if a system performs its intended function in an unimpaired manner, free from unauthorized or inadvertent manipulation. Completeness generally indicates that all transactions are processed or all services are performed without exception. Validity means that transactions and services are not processed more than once and that they are in accordance with business values and expectations. Accuracy means that key information associated with the submitted transaction remains accurate throughout the processing of the transaction and that the transaction or service is processed or performed as intended. The timeliness of the provision of services or the delivery of goods is addressed in the context of commitments made for such delivery. Authorization means that processing is performed in accordance with the required approvals and privileges defined by policies governing system processing.

.25 The risks associated with processing integrity are that the party initiating the transaction will not have the transaction completed or the service provided correctly and in accordance with the desired or specified request. Without appropriate and effective processing integrity controls, the user may not receive the information, goods, or services requested. For example, a buyer may not receive the goods or services ordered, receive more than requested, or receive the wrong goods or services altogether. However, if appropriate processing integrity controls exist and operate effectively, there is a greater likelihood that the user will receive the information, goods, or services requested in the correct quantity, at the correct price, and when promised. Processing integrity addresses all of the system components including procedures to initiate, record, process, and report the information related to the product or service that is the subject of the engagement. The nature of data input in e-commerce systems typically involves the user entering data directly over Web-enabled input screens or forms, whereas in other systems, the nature of data input can vary significantly. Because of this difference in data input processes, the nature of controls over the completeness and accuracy of data input in e-commerce systems may be somewhat different than for other systems. The illustrative controls outlined in paragraph .27 identify some of these differences.

.26 Processing integrity differs from data integrity. Processing integrity does not automatically imply that the information stored by the system is complete, accurate, current, and authorized. If a system processes information inputs from sources outside of the system's boundaries, an entity can establish only limited controls over the completeness, accuracy, authorization, and timeliness of the information submitted for processing. Errors that may have been

introduced into the information and the control procedures at external sites are typically beyond the entity's control. Even in a case when the information stored by the system is explicitly included in the description of the system that defines the engagement, it is still possible that the system exhibits high processing integrity without exhibiting high data integrity. For example, an address stored in the system may have passed all appropriate edit checks and other processing controls when it was added to the system, but it may no longer be current (if a person or company relocated) or it may be incomplete (if an apartment number or mailing location is omitted from the address).

Processing Integrity Principle and Criteria Table

.27 System processing is complete, accurate, timely, and authorized.

<i>Criteria</i>	<i>Illustrative Controls</i>
1.0 Policies: The entity defines and documents its policies for the processing integrity of its system.	
1.1 The entity's processing integrity and related security policies are established and periodically reviewed and approved by a designated individual or group.	<p>Written policies addressing processing integrity have been approved by the executive committee and are implemented throughout the company.</p> <p>As part of the periodic corporate risk assessment process, management identifies changes to the risk assessment based on: new applications and infrastructure, significant changes to applications and infrastructure, new environmental risks, changes to regulations and standards, and changes to user requirements as identified in service level agreements and other documents. Management then updates the policies based on the risk assessment.</p> <p>User requirements are documented in service-level agreements or other documents.</p> <p>Changes to policies are approved by leadership prior to implementation</p>
1.2 The entity's system processing integrity and related security policies include, but may not be limited to, the following matters:	<p><i>An example of an illustrative control for this criterion would be an entity's documented processing integrity policy and security policy addressing the elements set out in criterion 1.2. Illustrative process integrity and security policies have been omitted for brevity.</i></p>
<p>a. Identifying and documenting the system processing integrity and related security requirements of authorized users</p> <p>b. Classifying data based on their criticality and sensitivity; that</p>	

<i>Criteria</i>	<i>Illustrative Controls</i>
	classification is used to define protection requirements, access rights and access restrictions, and retention and destruction requirements
<i>c.</i>	Assessing risks on a periodic basis
<i>d.</i>	Preventing unauthorized access
<i>e.</i>	Adding new users, modifying the access levels of existing users, and removing users who no longer need access
<i>f.</i>	Assigning responsibility and accountability for system processing integrity and related security
<i>g.</i>	Assigning responsibility and accountability for system changes and maintenance
<i>h.</i>	Testing, evaluating, and authorizing system components before implementation
<i>i.</i>	Addressing how complaints and requests relating to system processing integrity and related security issues are resolved
<i>j.</i>	Identifying and mitigating errors and omissions and other system processing integrity and related security breaches and other incidents
<i>k.</i>	Providing for training and other resources to support its system processing integrity and related system security policies
<i>l.</i>	Providing for the handling of exceptions and situations not specifically addressed in its system processing integrity and related system security policies
<i>m.</i>	Providing for the identification of and consistency with applicable

(continued)

<i>Criteria</i>	<i>Illustrative Controls</i>
<p>laws and regulations, defined commitments, service-level agreements, and other contractual requirements</p>	
<p>1.3 Responsibility and accountability for developing and maintaining entity's system processing integrity and related system security policies; changes, updates, and exceptions to those policies are assigned.</p>	<p>Management has assigned responsibilities for the implementation of the entity's processing integrity and related security policies to individual members of management. Others on the executive committee assist in the review, update, and approval of the policies as outlined in the executive committee handbook.</p>
<p>2.0 Communications: The entity communicates its documented system processing integrity policies to responsible parties and authorized users.</p>	
<p>2.1 The entity has prepared an objective description of the system and its boundaries and communicated such description to authorized users.</p> <p>If the system is an e-commerce system, additional information provided on its Web-site includes, but may not be limited to, the following matters:</p> <p><i>a.</i> Descriptive information about the nature of the goods or services that will be provided, including, where appropriate,</p> <ul style="list-style-type: none"> — condition of goods (whether they are new, used, or reconditioned). — description of services (or service contract). — sources of information (where it was obtained and how it was compiled). <p><i>b.</i> The terms and conditions by which it conducts its e-commerce transactions including, but not limited to, the following matters:</p> <ul style="list-style-type: none"> — Time frame for completion of transactions (<i>transaction</i> means fulfillment of orders where goods are being sold and delivery of service where a service is being provided) 	<p>For its e-commerce system, the entity has posted a system description including the elements set out in criterion 2.1 on its Web site. (<i>For an example of a system description and additional disclosures for an e-commerce system, refer to appendix A [paragraph .45].</i>)</p> <p>For its non-e-commerce system, the entity has provided a system description to authorized users. (<i>For an example of a system description for a non-e-commerce based system, refer to appendix B [paragraph .46].</i>)</p>

<i>Criteria</i>	<i>Illustrative Controls</i>
<ul style="list-style-type: none"> — Time frame and process for informing customers of exceptions to normal processing of orders or service requests — Normal method of delivery of goods or services, including customer options, where applicable — Payment terms, including customer options, if any — Electronic settlement practices and related charges to customers — How customers may cancel recurring charges, if any — Product return policies and limited liability, where applicable <p>c. Where customers can obtain warranty, repair service, and support related to the goods and services purchased on its Web site.</p> <p>d. Procedures for resolution of issues regarding processing integrity. These may relate to any part of a customer's e-commerce transaction, including complaints related to the quality of services and products, accuracy, completeness, and the consequences for failure to resolve such complaints.</p>	
<p>2.2 The processing integrity and related security obligations of users and the entity's processing integrity and related security commitments to users are communicated to authorized users.</p>	<p>The entity's processing integrity and related security commitments and required processing integrity and related security obligations of its customers and other external users are posted on the entity's Web site, as part of the entity's standard services agreement, or in both places.</p> <p>For its internal users (employees and contractors), the entity's policies relating to processing integrity and security are reviewed with new employees and contractors as part of their orientation, and the key elements of the policies and their impact on the employee are discussed. New employees must sign a statement signifying that they have read,</p>

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<i>Criteria</i>	<i>Illustrative Controls</i>
	<p>understand, and will follow these policies. Each year, as part of their performance review, employees must reconfirm their understanding of and compliance with the entity's processing integrity and security policies. Obligations of contractors are detailed in their contracts.</p> <p>A security awareness program has been implemented to communicate the entity's processing integrity and related security policies to employees.</p> <p>The entity publishes its IT security policies on its corporate intranet.</p>
2.3 Responsibility and accountability for the entity's system processing integrity and related security policies, and changes and updates to those policies, are communicated to entity personnel responsible for implementing them.	<p>Management has assigned responsibilities for the enforcement of the entity's processing integrity policies to the COO.</p> <p>The security administration team has custody of and is responsible for the day-to-day maintenance of the entity's security policies, and recommends changes to the CIO and the IT steering committee.</p> <p>Processing integrity and related security commitments are reviewed with the customer account managers as part of the annual IT planning process.</p> <p>Written job descriptions have been defined and are communicated to the security administration team.</p> <p>Written process and procedure manuals for all defined security processes are provided to security administration team personnel. The security officer updates the processes and procedures manuals based on changes to the security policy.</p>
2.4 The process for obtaining support and informing the entity about system processing integrity issues, errors and omissions, and breaches of systems security and for submitting complaints is communicated to authorized users.	<p>The process for customers and external users to inform the entity of possible processing integrity issues, security breaches, and other incidents is posted on the entity's Web site, is provided as part of the new user welcome kit, or is in both places.</p> <p>The entity's user training and security awareness programs include information concerning the identification of processing integrity issues and possible security breaches and the process for informing the security administration team.</p> <p>Documented procedures exist for the identification and escalation of system processing integrity issues, security breaches, and other incidents.</p>

<i>Criteria</i>	<i>Illustrative Controls</i>	
2.5	<p>Changes that may affect system processing integrity and system security are communicated to management and users who will be affected.</p>	<p>Planned changes to system components and the scheduling of those changes are reviewed as part of the monthly IT steering committee meetings.</p> <p>Changes to system components, including those that may affect system security, require the approval of the security administrator and the sponsor of the change before implementation.</p> <p>Changes that may affect customers and users and their processing integrity and related security obligations or the entity's processing integrity and related security commitments are highlighted on the entity's Web site.</p> <p>Changes that may affect processing integrity and related system security are communicated in writing to affected customers for review and approval by affected customers under the provisions of the standard services agreement before implementation of the proposed change.</p> <p>There is periodic communication of changes that affect system security, including changes to users and customers.</p> <p>Changes are incorporated into the entity's ongoing user training and security awareness programs.</p>
3.0 Procedures: The entity placed in operation procedures to achieve its documented system processing integrity objectives in accordance with its defined policies.		
3.1	<p>Procedures exist to (1) identify potential threats of disruptions to systems operations that would impair processing integrity commitments and (2) assess the risks associated with the identified threats.</p>	<p>A risk assessment is performed periodically. As part of this process, threats to processing integrity are identified and the risks from these threats are formally assessed.</p> <p>Processes and procedures are revised by management based on the assessed threats.</p>
3.2	<p>The procedures related to completeness, accuracy, timeliness, and authorization of inputs are consistent with the documented system processing integrity policies.</p> <p>If the system is an e-commerce system, the entity's procedures include, but may not be limited to, the following matters:</p>	<p>The entity has established data preparation procedures to be followed by user departments.</p> <p>Data entry screens contain field edits and range checks, and input forms are designed to reduce errors and omissions.</p> <p>Source documents are reviewed for appropriate authorizations before input.</p> <p>Error handling procedures are followed during data origination to ensure that</p>

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<i>Criteria</i>	<i>Illustrative Controls</i>
	errors and irregularities are detected, reported, and corrected.
a. The entity checks each request or transaction for accuracy and completeness.	Original source documents are retained on image management systems for a minimum of seven years, to facilitate the retrieval or reconstruction of data as well as to satisfy legal requirements.
b. Positive acknowledgment is received from the customer before the transaction is processed.	<p>Logical access controls restrict data entry capability to authorized personnel. (See item 3.6 in this table.)</p> <p>The customer account manager performs a regular review of customer complaints, back-order logs, and other transactional analysis. This information is compared to customer service agreements.</p> <p>The entity protects information from unauthorized access, modification, and misaddressing during transmission and transport using a variety of methods including</p> <ul style="list-style-type: none"> • encryption of transmission information. • batch header and control total reconciliations. • message authentication codes and hash totals. • private leased lines or virtual private networking connections with authorized users. • bonded couriers and tamper-resistant packaging. <p>Because of the Web-based nature of the input process, the nature of the controls to achieve the criterion set out in item 3.1 may take somewhat different forms, such as</p> <ul style="list-style-type: none"> • account activity, subsequent to successful login, is encrypted through industry standard encryption software. • Web scripts contain error checking for invalid inputs. • the entity's order processing system contains edits, validity, and range checks, which are applied to each order to check for accuracy and completeness of information before processing. • before a transaction is processed by the entity, the customer is presented with a request to confirm the intended transaction and the customer is required to click on the "Yes, please process this order" button before the transaction is processed.

<i>Criteria</i>	<i>Illustrative Controls</i>
<p>3.3 The procedures related to completeness, accuracy, timeliness, and authorization of system processing, including error correction and database management, are consistent with documented system processing integrity policies.</p> <p>If the system is an e-commerce system, the entity's procedures include, but are not necessarily limited to, the following matters:</p> <ol style="list-style-type: none"> a. The correct goods are shipped in the correct quantities in the time frame agreed upon, or services and information are provided to the customer as requested. b. Transaction exceptions are promptly communicated to the customer. c. Incoming messages are processed and delivered accurately and completely to the correct IP address. d. Outgoing messages are processed and delivered accurately and completely to the service provider's (SP's) Internet access point. e. Messages remain intact while in transit within the confines of the SP's network. 	<p>The entity e-mails an order confirmation to the customer-supplied e-mail address. The order confirmation contains order details, shipping and delivery information, and a link to an online customer order tracking service. Returned e-mails are investigated by customer service.</p> <p>Responsibilities for order processing, application of credits and cash receipts, custody of inventory, user account management, and database management have been segregated.</p> <p>The entity's documented systems development life cycle (SDLC) methodology is used in the development of new applications and the maintenance of existing applications. The methodology contains required procedures for user involvement, testing, conversion, and management approvals of system processing integrity features.</p> <p>Computer operations and job scheduling procedures exist, are documented, and contain procedures and instructions for operations personnel regarding system processing integrity objectives, policies, and standards. Exceptions require the approval of the manager of computer operations.</p> <p>The entity's application systems contain edit and validation routines to check for incomplete or inaccurate data. Errors are logged, investigated, corrected, and resubmitted for input. Management reviews error logs daily to ensure that errors are corrected on a timely basis.</p> <p>End-of-day reconciliation procedures include the reconciliation of the number of records accepted to the number of records processed to the number of records output.</p> <p>The following additional controls are included in the entity's e-commerce system:</p> <ul style="list-style-type: none"> • Packing slips are created from the customer sales order and checked by warehouse staff as the order is packed. • Commercial delivery methods are used that reliably meet expected delivery schedules. Vendor performance is monitored and assessed periodically.

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<i>Criteria</i>	<i>Illustrative Controls</i>
<p>3.4 The procedures related to completeness, accuracy, timeliness, and authorization of outputs are consistent with the documented system processing integrity policies.</p> <p>If the system is an e-commerce system, the entity's procedures include, but are not necessarily limited to, the following matters:</p> <ul style="list-style-type: none"> • The entity displays sales prices and all other costs and fees to the customer before processing the transaction. • Transactions are billed and electronically settled as agreed. • Billing or settlement errors are promptly corrected. 	<ul style="list-style-type: none"> • Service delivery targets are maintained, and actual services provided are monitored against such targets. • The entity uses a feedback questionnaire to confirm customer satisfaction with completion of service or delivery of information to the customer. • Computerized back-order records are maintained and are designed to notify customers of back orders within 24 hours. Customers are given the option to cancel a back order or have an alternate item delivered. • Monitoring tools are used to continuously monitor latency, packet loss, hops, and network performance. • The organization maintains network integrity software and has documented network management policies. • Appropriately documented escalation procedures are in place to initiate corrective actions to unfavorable network performance. <p>Written procedures exist for the distribution of output reports that conform to the system processing integrity objectives, policies, and standards.</p> <p>Control clerks reconcile control totals of transaction input to output reports daily, on both a system-wide and an individual customer basis. Exceptions are logged, investigated, and resolved.</p> <p>The customer service department logs calls and customer complaints. An analysis of customer calls, complaints, back-order logs, and other transactional analysis and comparison to the entity's processing integrity policies are reviewed at monthly management meetings, and action plans are developed and implemented as necessary.</p> <p>The following additional controls are included in the entity's e-commerce system:</p> <ul style="list-style-type: none"> • All costs, including taxes, shipping, and duty costs, and the currency used, are displayed to the customer. Customer accepts the order, by clicking on the "yes" button, before the order is processed. • Customers have the option of printing, before an online order is processed, an "order confirmation" for

<i>Criteria</i>	<i>Illustrative Controls</i>
3.5 There are procedures to enable tracing of information inputs from their source to their final disposition and vice versa.	<p>future verification with payment records (such as credit card statement) detailing information about the order (such as item(s) ordered, sales prices, costs, sales taxes, and shipping charges).</p> <ul style="list-style-type: none"> • All foreign exchange rates are displayed to the customer before performing a transaction involving foreign currency. • Billing or settlement errors are followed up and corrected within 24 hours of reporting by the customer. <p>Input transactions are date and time stamped by the system and identified with the submitting source (user, terminal, IP address). Each order has a unique identifier that can be used to access order and related shipment and payment settlement information. This information can also be accessed by customer name and dates of order, shipping, or billing.</p> <p>The entity maintains transaction histories for a minimum of 10 years. Order history information is maintained online for 3 years and is available for immediate access by customer service representatives. After 3 years, this information is maintained in offline storage.</p> <p>Original source documents are retained on image management systems for a minimum of 7 years, to facilitate the retrieval or reconstruction of data as well as to satisfy legal requirements.</p> <p>The entity performs an annual audit of tapes stored at the offsite storage facility. As part of the audit, tapes at the offsite location are matched to the appropriate tape management system.</p>

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<i>Criteria</i>	<i>Illustrative Controls</i>
Security-related criteria relevant to the system's processing integrity	
3.6 Procedures exist to restrict logical access to the defined system including, but not limited to, the following matters:	
<p>a. Logical access security measures to access information not deemed to be public</p>	<ul style="list-style-type: none"> • Logical access to nonpublic information resources is protected through the use of native operating system security, native application and resource security, and add-on security software. • Resource specific or default access rules have been defined for all non-public resources. • Access to resources is granted to an authenticated user based on the user's identity.
<p>b. Identification and authentication of authorized users</p>	<ul style="list-style-type: none"> • Users must establish their identity to the entity's network and application systems when accessing nonpublic resources through the use of a valid user ID that is authenticated by an associated password. • Unique user IDs are assigned to individual users. • Use of group or shared IDs is permitted only after completion of an assessment of the risk of the shared ID and written approval of the manager of the requesting business unit. • Passwords are case sensitive must contain at least 8 characters, one of which is nonalphanumeric. • Security configuration parameters force passwords to be changed every 90 days. • The login sessions are terminated after 3 unsuccessful login attempts.
<p>c. Registration and authorization of new users</p>	<ul style="list-style-type: none"> • Customers can self-register on the entity's Web site, under a secure session in which they provide new user information and select appropriate user ID and password. Privileges and authorizations associated with self-registered customer accounts provide specific limited system functionality. • The ability to create or modify users and user access privileges (other than the limited functionality "customer accounts") is limited to the security administration team. • The line-of-business supervisor authorizes access privilege change requests for employees and contractors. Access to restricted resources is authorized by the resource owner.

<i>Criteria</i>	<i>Illustrative Controls</i>
<p>d. The process to make changes and updates to user profiles</p>	<ul style="list-style-type: none"> • Customer access privileges beyond the default privileges granted during self-registration are approved by the customer account manager. • Proper segregation of duties is considered in granting privileges. • Changes and updates to self-registered customer accounts can be done by the individual user at any time on the entity's Web site after the user has successfully logged onto the system. Changes are reflected immediately. • Unused customer accounts (no activity for six months) are purged by the system. • Changes to other accounts and profiles are restricted to the security administration team and require the approval of the appropriate line-of-business supervisor or customer account manager. • The human resource management system provides the human resources team with a list of newly terminated employees on a weekly basis. This listing is sent to the security administration team for deactivation.
<p>e. Distribution of output restricted to authorized users</p>	<ul style="list-style-type: none"> • Access to computer processing output is provided to authorized individuals based on the classification of the information. • Processing outputs are stored in an area that reflects the classification of the information.
<p>f. Restriction of access to offline storage, backup data, systems, and media</p>	<ul style="list-style-type: none"> • Access to offline storage, backup data, systems, and media is limited to computer operations staff.
<p>g. Restriction of access to system configurations, superuser functionality, master passwords, powerful utilities, and security devices (for example, firewalls)</p>	<ul style="list-style-type: none"> • Hardware and operating system configuration tables are restricted to appropriate personnel. • Application software configuration tables are restricted to authorized users and under the control of application change management software. • Utility programs that can read, add, change, or delete data or programs are restricted to authorized technical services staff. Usage is logged and monitored by the manager of computer operations. • The information security team, under the direction of the CIO, maintains access to firewall and other logs, as well as access to any storage media.

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<i>Criteria</i>	<i>Illustrative Controls</i>	
3.7	<p>Procedures exist to restrict physical access to the defined system including, but not limited to, facilities, offline storage media, backup media and systems, and other system components such as firewalls, routers, and servers.</p>	<p>Any access is logged and reviewed in accordance with the company's IT policies.</p> <ul style="list-style-type: none"> • A listing of all master passwords is stored in an encrypted database, and an additional copy is maintained in a sealed envelope in the entity safe. <p>Physical access to the computer rooms, which house the entity's IT resources, servers, and related hardware such as firewalls and routers, is restricted to authorized individuals by card key systems and is monitored by video surveillance.</p> <p>Physical access cards are managed by building security staff. Access card usage is logged. Logs are maintained and reviewed by building security staff.</p> <p>Requests for physical access privileges to the entity's computer facilities require the approval of the manager of computer operations.</p> <p>Documented procedures exist for the identification and escalation of potential physical security breaches.</p> <p>Offsite backup data and media are stored at service provider facilities. Access to offsite data and media requires the approval of the manager of computer operations.</p>
3.8	<p>Procedures exist to protect against unauthorized access to system resources.</p>	<p>Login sessions are terminated after three unsuccessful login attempts.</p> <p>Virtual private networking (VPN) software is used to permit remote access by authorized users. Users are authenticated by the VPN server through specific "client" software and user ID and passwords.</p> <p>Firewalls are used and configured to prevent unauthorized access. Firewall events are logged and reviewed daily by the security administrator.</p> <p>Unneeded network services (for example, telnet, ftp, and http) are deactivated on the entity's servers. A listing of the required and authorized services is maintained by the IT department. This list is reviewed by entity management on a routine basis for its appropriateness for the current operating conditions.</p>

<i>Criteria</i>	<i>Illustrative Controls</i>
3.9 Procedures exist to protect against infection by computer viruses, malicious code, and unauthorized software.	<p>Intrusion detection systems are used to provide continuous monitoring of the entity's network and early identification of potential security breaches.</p> <p>The entity contracts with third parties to conduct periodic security reviews and vulnerability assessments. Results and recommendations for improvement are reported to management.</p> <p>In connection with other security monitoring, the security administration team participates in user groups and subscribes to services relating to computer viruses.</p> <p>Antivirus software is in place, including virus scans of incoming e-mail messages. Virus signatures are updated promptly.</p> <p>Any viruses discovered are reported to the security team, and an alert is created for all users notifying them of a potential virus threat.</p> <p>The ability to install, modify, and replace operating systems and other system programs is restricted to authorized personnel.</p>
3.10 Encryption or other equivalent security techniques are used to protect user authentication information and the corresponding session transmitted over the Internet or other public networks.	<p>Access to superuser functionality and sensitive system functions is restricted to authorized personnel.</p> <p>The entity uses industry standard encryption technology, VPN software, or other secure communication systems (consistent with its periodic IT risk assessment) for the transmission of private or confidential information over public networks, including user IDs and passwords. Users are required to upgrade their browsers to the most current version tested and approved for use by the security administration team to avoid possible security problems.</p> <p>Account activity, subsequent to successful login, is encrypted through industry standard encryption technology, VPN software, or other secure communication systems (consistent with its periodic IT risk assessment). Users are logged out on request (by selecting the "Sign-out" button on the Web site) or after 10 minutes of inactivity.</p>

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<i>Criteria</i>	<i>Illustrative Controls</i>
Criteria related to execution and incident management used to achieve objectives	
3.11 Procedures exist to identify, report, and act upon system processing integrity issues and related security breaches and other incidents.	<p>Users are provided instructions for communicating system processing integrity issues and potential security breaches to the IT hotline. Processing integrity issues are escalated to the manager of computer operations. The information security team investigates security-related incidents reported through customer hotlines and e-mail.</p> <p>Production run and automated batch job scheduler logs are reviewed each morning, and processing issues are identified, escalated, and resolved.</p> <p>Intrusion detection systems and other tools are used to identify, log, and report potential security breaches and other incidents. The system notifies the security administration team, the network administrator, or both via e-mail and text of potential incidents in progress.</p> <p>Incident logs are monitored and evaluated by the information security team daily.</p> <p>When an incident is detected or reported, a defined incident management process is initiated by authorized personnel. Corrective actions are implemented in accordance with defined policies and procedures.</p> <p>Procedures include a defined incident escalation process and notification mechanisms.</p> <p>All incidents are tracked by management until resolved.</p> <p>Closed incidents are reviewed by management for appropriate resolution.</p> <p>Resolution of incidents not related to security includes consideration of the impact of the incident and its resolution on security requirements.</p>
Criteria related to the system components used to achieve the objectives	
3.12 Procedures exist to classify data in accordance with classification policies and periodically monitor and update such classifications as necessary	<p>The entity has a data quality assurance function.</p> <p>The data quality assurance group reviews data usage and ensures that metadata is documented, including, but not limited to, the following matters:</p>

<i>Criteria</i>	<i>Illustrative Controls</i>
	<ul style="list-style-type: none"> a. Purpose b. Origin/Ownership, both internal and external c. Used by d. Custodian/Steward e. Standards governing f. Classification for security/privacy g. Access privileges h. Location (for searchability) i. Version j. Timestamp k. Retention/Disposal Requirements l. Source; Owner/responsible party/Lineage/Audit trail m. Assurance
	<p>Whenever new data are captured or created, the data are classified based on security and process integrity policies.</p> <p>Propriety of data classification is considered as part of the change management process.</p>
3.13 Procedures exist to provide that issues of noncompliance with system processing integrity and related security policies are promptly addressed and that corrective measures are taken on a timely basis.	<p>The entity requires procedures to be consistent with policies and there is a process to check that procedures are consistent with policies.</p> <p>The entity monitors changes to policies and promptly updates procedures affected by those changes.</p> <p>Computer operations team meetings are held each morning to review the previous day's processing. Processing issues are discussed, remedial action is taken, and additional action plans are developed, where necessary, and implemented.</p> <p>Standard procedures exist for the review, documentation, escalation, and resolution of system processing problems.</p> <p>Entity management routinely evaluates the level of performance it receives from the Internet service provider (ISP) which hosts the entity's Web site. This includes evaluating the security controls the ISP has in place by an independent third party as well as following up with the ISP management on any open items or causes for concern.</p> <p>Processing integrity and related security issues are recorded and accumulated in a problem report. Corrective action is noted and monitored by management.</p>

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<i>Criteria</i>	<i>Illustrative Controls</i>
3.14 Design, acquisition, implementation, configuration, modification, and management of infrastructure and software are consistent with defined processing integrity and related security policies.	<p>On a routine basis, processing integrity and related security policies, controls, and procedures are audited by the internal audit department. Results of such examinations are reviewed by management, a response is prepared, and a remediation plan is put in place.</p> <p>The entity has adopted a formal systems development life cycle (SDLC) methodology that governs the development, acquisition, implementation, and maintenance of computerized information systems and related technology.</p> <p>The SDLC methodology includes a framework for assigning ownership of systems and classifying data. Process owners are involved in development of user specifications, solution selection, testing, conversion, and implementation.</p> <p>The security administration team reviews and approves the architecture and design specifications for new systems development and/or acquisition to ensure consistency with the entity's processing integrity and related security objectives, policies, and standards.</p> <p>Process owner review, approval of test results, and authorization are required for implementation of changes.</p>
3.15 Procedures exist to provide that personnel responsible for the design, development, implementation, and operation of systems affecting processing integrity and security have qualifications and resources to fulfill their responsibilities.	<p>Changes to system components that may affect security require the approval of the security administration team.</p> <p>A separate systems quality assurance group reporting to the CIO has been established.</p> <p>The entity has written job descriptions specifying the responsibilities and academic and professional requirements for key job positions.</p> <p>Hiring procedures include a comprehensive screening of candidates for key positions and consideration of whether the verified credentials are commensurate with the proposed position. New personnel are offered employment subject to background checks and reference validation.</p> <p>Candidates, including internal transfers, are approved by the line-of-business manager before the employment position is offered.</p>

<i>Criteria</i>	<i>Illustrative Controls</i>
	<p>Outsourced activities are included in assessments of personnel qualifications and resource adequacy.</p> <p>Periodic performance appraisals are performed by employee supervisors and include the assessment and review of professional development activities.</p> <p>Personnel receive training and development in computer operations, system design and development, testing, and security concepts and issues.</p> <p>Procedures are in place to provide alternate personnel for key system processing functions in case of absence or departure.</p> <p>Procedures are in place for allocating the number of personnel and other resources commensurate with the processing integrity and related security requirements.</p>
Change management-related criteria applicable to the system's processing integrity	
3.16 Procedures exist to maintain system components, including configurations consistent with the defined system processing integrity and related security policies.	<p>Entity management receives a third-party opinion on the adequacy of security controls, and routinely evaluates the level of performance it receives (in accordance with its contractual service-level agreement) from the service provider that hosts the entity's systems and Web site.</p> <p>The IT department maintains an up-to-date listing of all software and the respective level, version, and patches that have been applied.</p> <p>Requests for changes, system maintenance, and supplier maintenance are standardized and subject to documented change management procedures. Changes are categorized and ranked according to priority, and procedures are in place to handle urgent matters. Change requestors are kept informed about the status of their requests.</p> <p>System configurations are tested annually and evaluated against the entity's processing integrity and security policies and current service-level agreements. An exception report is prepared and remediation plans are developed and tracked.</p>

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<i>Criteria</i>	<i>Illustrative Controls</i>
3.17 Procedures exist to provide that only authorized, tested, and documented changes are made to the system.	<p>The entity monitors changes to policies and promptly updates procedures affected by those changes.</p> <p>The entity's documented systems development methodology describes the change initiation, software development and maintenance, and testing and approval processes, as well as the standards and controls that are embedded in the processes. These include programming, documentation, and testing standards.</p> <p>Requests for changes, system maintenance, and supplier maintenance are standardized and subject to documented change management procedures. Changes are categorized and ranked according to priority, and procedures are in place to handle urgent matters. Change requestors are kept informed about the status of their outstanding and closed requests.</p> <p>Changes to system infrastructure and software are developed and tested in a separate development and test environment before implementation into production.</p> <p>As part of the change control policies and procedures, there is a "promotion" process (for example, from "test" to "staging" to "production"). Promotion to production requires the approval of the business owner who sponsored the change and the manager of computer operations.</p> <p>When changes are made to key systems components, there is a "backout" plan developed for use in the event of major interruption(s).</p>
3.18 Procedures exist to provide that emergency changes are documented and authorized (including after-the-fact approval).	<p>Requests for changes, system maintenance, and supplier maintenance are standardized and subject to documented change management procedures. Changes are categorized and ranked according to priority, and procedures are in place to handle urgent matters. Change requestors are kept informed about the status of their requests.</p>

<i>Criteria</i>	<i>Illustrative Controls</i>
Availability-related criteria applicable to the system's processing integrity	
3.19 Procedures exist to protect the system against potential risks (for example, environmental risks, natural disasters, and routine operational errors and omissions) that might impair system processing integrity.	<p>Emergency changes that require deviations from standard procedures are logged and reviewed by IT management daily and reported to the affected line-of-business manager. Permanent corrective measures follow the entity's change management process, including line-of-business approvals.</p> <p>A risk assessment is prepared and reviewed on a periodic basis or when a significant change occurs in either the internal or external physical environment. Threats such as fire, flood, dust, power failure, excessive heat and humidity, and labor problems have been considered.</p> <p>Management maintains measures to protect against environmental factors (for example, fire, dust, power failure, and excessive heat and humidity) based on its periodic risk assessment. The entity's controlled areas are protected against fire using both smoke detectors and a fire suppression system. Water detectors are installed within the raised floor areas.</p> <p>The entity site is protected against a disruption in power supply to the processing environment by both uninterruptible power supplies and emergency power supplies. This equipment is tested semiannually.</p> <p>Preventive maintenance agreements and scheduled maintenance procedures are in place for key system hardware components.</p> <p>Vendor warranty specifications are complied with and tested to determine if the system is properly configured.</p> <p>Procedures to address minor processing errors, outages, and destruction of records are documented.</p> <p>Procedures exist for the identification, documentation, escalation, resolution, and review of problems.</p> <p>Physical and logical security controls are implemented to reduce the opportunity for unauthorized actions that could impair system processing integrity.</p>

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<i>Criteria</i>	<i>Illustrative Controls</i>
3.20 Procedures exist to provide for restoration and disaster recovery consistent with the entity's defined processing integrity policies.	<p>Management has implemented a comprehensive strategy for backup and restoration based on a review of business requirements. Backup procedures for the entity are documented and include redundant servers, daily incremental backups of each server, and a complete backup of the entire week's changes on a weekly basis. Daily and weekly backups are stored offsite in accordance with the entity's system policies.</p> <p>Disaster recovery and contingency plans are documented.</p> <p>The disaster recovery plan defines the roles and responsibilities and identifies the critical IT application programs, operating systems, personnel, data files, and time frames needed to ensure high availability and system reliability based on the business impact analysis.</p> <p>The business continuity planning coordinator reviews and updates the business impact analysis with the lines of business annually.</p> <p>Disaster recovery and contingency plans are tested annually in accordance with the entity's system policies. Testing results and change recommendations are reported to the entity's management committee.</p> <p>The entity's management committee reviews and approves changes to the disaster recovery plan.</p> <p>All critical personnel identified in the business continuity plan hold current versions of the plan, both onsite and offsite. An electronic version is stored offsite.</p>

<i>Criteria</i>	<i>Illustrative Controls</i>
3.21 Procedures exist to provide for the completeness, accuracy, and timeliness of backup data and systems.	<p>Automated backup processes include procedures for testing the integrity of the backup data.</p> <p>Backups are performed in accordance with the entity's defined backup strategy, and usability of backups is verified at least annually.</p> <p>Backup systems and data are stored offsite at the facilities of a third-party service provider.</p> <p>Under the terms of its service provider agreement, the entity performs an annual verification of media stored at the offsite storage facility. As part of the verification, media at the offsite location are matched to the appropriate media management system. The storage site is reviewed biannually for physical access security and security of data files and other items.</p> <p>Backup systems and data are tested as part of the annual disaster recovery test.</p>
4.0 Monitoring: The entity monitors the system and takes action to maintain compliance with the defined system processing integrity policies.	
4.1 System processing integrity and security performance are periodically reviewed and compared with the defined system processing integrity and related security policies.	<p>System processing is monitored using system monitoring tools by onsite operations staff 24 hours a day, 7 days a week. Processing logs, performance and security incident statistics, and comparisons to approved targets are reviewed by the operations team daily and are accumulated and reported to the IT steering committee monthly.</p> <p>The customer service group monitors system processing and related customer complaints. It provides a monthly report of such matters together with recommendations for improvement, which are considered and acted on at the monthly IT steering committee meetings.</p> <p>The information security team monitors the system and assesses the system vulnerabilities using proprietary and publicly available tools. Potential risks are evaluated and compared to service-level agreements and other obligations of the entity. Remediation plans are proposed and implementations are monitored.</p> <p>The entity contracts with third parties to conduct periodic security reviews and vulnerability assessments. The internal</p>

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<i>Criteria</i>	<i>Illustrative Controls</i>	
4.2	<p>There is a process to identify and address potential impairments to the entity's ongoing ability to achieve its objectives in accordance with its defined system processing integrity and related security policies.</p>	<p>audit function conducts processing integrity and system security reviews as part of its annual audit plan. Results and recommendations for improvement are reported to management.</p> <p>System processing is monitored using system monitoring tools by onsite operations staff 24 hours a day, 7 days a week. Processing logs and performance and security incident statistics and comparisons to approved targets are reviewed by the operations team daily and are accumulated and reported to the IT steering committee monthly.</p> <p>Future system processing performance and capacity requirements are projected and analyzed as part of the annual IT planning and budgeting process.</p> <p>Logs are analyzed either manually or by automated tools to identify trends that may have a potential impact on the entity's ability to achieve its system processing integrity and related security objectives.</p> <p>Monthly IT staff meetings are held to address system processing, capacity, and security concerns and trends; findings are discussed at quarterly management meetings.</p>
4.3	<p>Environmental, regulatory, and technological changes are monitored, their impact on system processing integrity and security is assessed on a timely basis, and policies are updated for that assessment.</p>	<p>The entity's data center facilities include climate and environmental monitoring devices. Deviations from optimal performance ranges are escalated and resolved.</p> <p>Senior management, as part of its annual IT planning process, considers developments in technology and the impact of applicable laws or regulations on the entity's processing integrity and related security policies.</p> <p>The entity's customer service group monitors the impact of emerging technologies, customer requirements, and competitive activities.</p>

Confidentiality Principle and Criteria

.28 The *confidentiality principle* refers to the system's ability to protect the information designated as confidential, as committed or agreed. Unlike personal information, which is defined by regulation in a number of countries worldwide and is subject to the privacy principles (see paragraph .33), there is no widely recognized definition of what constitutes confidential information. In the course of communicating and transacting business, partners often exchange information they require to be maintained on a confidential basis. In most

instances, the respective parties wish to ensure that the information they provide is available only to those individuals who need access to that information to complete the transaction or to resolve any questions that may arise. To enhance business partner confidence, it is important that the business partner be informed about the entity's system and information confidentiality policies, procedures, and practices. The entity needs to disclose its system and information confidentiality policies, procedures, and practices relating to the manner in which it provides for authorized access to its system and uses and shares information designated as confidential.

.29 Examples of the kinds of information that may be subject to confidentiality include

- transaction details,
- engineering drawings,
- business plans,
- banking information about businesses,
- intellectual property,
- inventory availability,
- bid or ask prices,
- price lists,
- legal documents,
- client and customer lists, and
- revenue by client and industry.

.30 What is considered to be confidential information can vary significantly from business to business and is determined by contractual arrangements or regulations. It is important to understand and agree upon what information is to be maintained in the system on a confidential basis and what, if any, rights of access will be provided.

.31 Confidential information that is provided to another party is susceptible to unauthorized access during transmission and while it is stored on the other party's computer systems. For example, an unauthorized party may intercept business partner profile information and transaction and settlement instructions while the information is being transmitted. Controls such as encryption can be used to protect the confidentiality of this information during its transmission. Firewalls and rigorous access controls can also be used to help protect the information while it is processed or stored on computer systems.

Confidentiality Principle and Criteria Table

.32 Information designated as confidential is protected by the system as committed or agreed.

<i>Criteria</i>	<i>Illustrative Controls</i>
1.0 Policies: The entity defines and documents its policies related to the system protecting confidential information, as committed or agreed.	
1.1 The entity's system confidentiality and related security policies are established	Written system confidentiality and security policies, addressing both IT and physical security, have been approved by the IT

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<i>Criteria</i>	<i>Illustrative Controls</i>
<p>and periodically reviewed and approved by a designated individual or group.</p>	<p>standards committee and are implemented throughout the company.</p> <p>As part of the periodic corporate risk assessment process, the security officer identifies changes to the IT risk assessment based on</p> <ul style="list-style-type: none"> • new applications and infrastructure changes, • significant changes to applications and infrastructure components, • new environmental based confidentiality and security risks, • changes to regulations and standards, and • changes to user requirements as identified in service level agreements and other documents. <p>The security officer then updates the confidentiality and security policies based on the IT risk assessment.</p> <p>Changes to the IT security policy are approved by the IT standards committee prior to implementation.</p> <p>User confidentiality requirements are documented in service-level agreements, nondisclosure agreements, or other documents.</p>
<p>1.2 The entity's policies related to the system's protection of confidential information and security include, but are not limited to, the following matters:</p> <ol style="list-style-type: none"> a. Identifying and documenting the confidentiality and related security requirements of authorized users b. Classifying data based on its criticality and sensitivity that is used to define protection requirements, access rights and access restrictions, and retention and destruction requirements c. Assessing risk on a periodic basis d. Preventing unauthorized access e. Adding new users, modifying the access levels 	<p><i>An example of an illustrative control for this criterion would be an entity's documented confidentiality policy and related security policy addressing the elements set out in criterion 1.2. Illustrative confidentiality policies and security policies have been omitted for brevity.</i></p>

<i>Criteria</i>	<i>Illustrative Controls</i>
<p>of existing users, and removing users who no longer need access</p> <p><i>f.</i> Assigning responsibility and accountability for confidentiality and related security</p> <p><i>g.</i> Assigning responsibility and accountability for system changes and maintenance</p> <p><i>h.</i> Testing, evaluating, and authorizing system components before implementation</p> <p><i>i.</i> Addressing how complaints and requests relating to confidentiality and related security issues are resolved</p> <p><i>j.</i> Handling confidentiality and related security breaches and other incidents</p> <p><i>k.</i> Providing for training and other resources to support its system confidentiality and related security policies</p> <p><i>l.</i> Providing for the handling of exceptions and situations not specifically addressed in its system confidentiality and related security policies</p> <p><i>m.</i> Providing for the identification of and consistency with, applicable laws and regulations, defined commitments, service-level agreements, and other contractual requirements</p> <p><i>n.</i> Sharing information with third parties</p>	
<p>1.3 Responsibility and accountability for developing and maintaining the entity's system confidentiality and related security policies, and changes and updates to those policies, are assigned.</p>	<p>Management has assigned responsibilities for implementation of the entity's confidentiality policies to the human resources team. Responsibility for implementation of the entity's security policies has been assigned to the security officer under the direction of the CIO. The IT standards committee of the executive committee assists in the review, update, and approval of the policies as outlined in the executive committee handbook.</p>

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<i>Criteria</i>	<i>Illustrative Controls</i>
2.0	Communications: The entity communicates its defined policies related to the system's protection of confidential information to responsible parties and authorized users.
2.1	<p>The entity has prepared an objective description of the system and its boundaries and communicated such description to authorized users.</p> <p>For its e-commerce system, the entity has posted a system description on its Web site. <i>(For an example of a system description for an e-commerce system, refer to appendix A [paragraph .45].)</i></p> <p>For its non-e-commerce system, the entity has provided a system description to authorized users. <i>(For an example of a system description for a non-e-commerce based system, refer to appendix B [paragraph .46].)</i></p>
2.2	<p>The system confidentiality and related security obligations of users and the entity's confidentiality and related security commitments to users are communicated to authorized users before the confidential information is provided. This communication includes, but is not limited to, the following matters:</p> <p><i>a.</i> How information is designated as confidential and ceases to be confidential. The handling, destruction, maintenance, storage, back-up, and distribution or transmission of confidential information.</p> <p><i>b.</i> How access to confidential information is authorized and how such authorization is rescinded.</p> <p><i>c.</i> How confidential information is used.</p> <p>The entity's confidentiality and related security commitments and required confidentiality and security obligations of its customers and other external users are posted on the entity's Web site. The entity's confidentiality policies and practices can also be outlined in its customer contracts, service-level agreements, vendor contract terms and conditions, and standard nondisclosure agreement.</p> <p>Signed nondisclosure agreements are required before sharing information designated as confidential with third parties. Customer contracts, service-level agreements, and vendor contracts are negotiated before performance or receipt of service. Changes to the standard confidentiality provisions in these contracts require the approval of executive management.</p> <p>For its internal users (employees and contractors), the entity's policies relating to confidentiality and security are reviewed with new employees and contractors as part of their orientation, and the key elements of the policies and their impact on the employee are discussed. New employees must sign a statement signifying that they have read, understand, and will follow these policies. Each year, as part of their performance review, employees must reconfirm their understanding of and compliance with the entity's security policies. Confidentiality and security obligations of contractors are detailed in their contract.</p> <p>A security awareness program has been implemented to communicate the entity's confidentiality and security policies to employees.</p>

<i>Criteria</i>	<i>Illustrative Controls</i>
<p>d. How confidential information is shared.</p> <p>e. If information is provided to third parties, disclosures include any limitations on reliance on the third party's confidentiality practices and controls. Lack of such disclosure indicates that the entity is relying on the third party's confidentiality practices and controls that meet or exceed those of the entity.</p> <p>f. Practices to comply with applicable laws and regulations addressing confidentiality.</p>	<p>The entity publishes its confidentiality and related security policies on its corporate intranet.</p> <p>Signed nondisclosure agreements are required before sharing information designated as confidential with third parties.</p>
<p>2.3 Responsibility and accountability for the entity's system confidentiality and related security policies and changes and updates to those policies are communicated to entity personnel responsible for implementing them.</p>	<p>The security administration team has custody of and is responsible for the day-to-day maintenance of the entity's confidentiality and related security policies and recommends changes to the CIO and the IT steering committee.</p> <p>Confidentiality and related security commitments are reviewed with the customer account managers and legal department representatives as part of the annual IT planning process.</p> <p>Written job descriptions have been defined and are communicated to the responsible personnel.</p> <p>Written process and procedure manuals for defined confidentiality processes are provided to responsible personnel. The security officer updates the processes and procedures manuals based on changes to the confidentiality policy.</p>
<p>2.4 The process for informing the entity about breaches of confidentiality and system security and for submitting complaints is communicated to authorized users.</p>	<p>The process for customers and external users to inform the entity of possible confidentiality or security breaches and other incidents is posted on the entity's Web site, provided as part of the new user welcome kit, or both.</p> <p>The entity's security awareness program includes information concerning the identification of possible confidentiality and security breaches and the process for informing the security administration team.</p> <p>Documented procedures exist for the identification and escalation of possible</p>

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<i>Criteria</i>	<i>Illustrative Controls</i>
2.5 Changes that may affect confidentiality and system security are communicated to management and users who will be affected.	<p>confidentiality or security breaches and other incidents.</p> <p>Planned changes to system components and the scheduling of those changes are reviewed as part of monthly IT steering committee meetings.</p> <p>Changes to system components, including those that may affect system security, require the approval of the security administrator before implementation.</p> <p>Changes that may affect customers and users and their confidentiality and related security obligations or the entity's confidentiality and security commitments are highlighted on the entity's Web site.</p> <p>Changes that may affect confidentiality and system security are communicated in writing to affected customers for review and approval under the provisions of the standard services agreement before implementation of the proposed change.</p> <p>There is periodic communication of changes, including changes that may affect confidentiality and system security.</p> <p>Changes that affect confidentiality or system security are incorporated into the entity's ongoing security awareness program.</p>
3.0 Procedures: The entity placed in operation procedures to achieve its documented system confidentiality objectives in accordance with its defined policies.	
3.1 Procedures exist to (1) identify potential threats of disruptions to systems operations that would impair system confidentiality commitments and (2) assess the risks associated with the identified threats.	<p>A risk assessment is performed periodically. As part of this process, threats to confidentiality are identified, and the risk from these threats is formally assessed.</p> <p>Confidentiality processes and procedures are revised by the security officer based on the assessed threats.</p>
3.2 The system procedures related to confidentiality of inputs are consistent with the documented confidentiality policies.	<p>Confidentiality processes are established to help ensure that all inputs have been authorized, have been accepted for processing, and are accounted for. Any missing or unaccounted source documents or input files have been identified and investigated. These processes require that exceptions be resolved within a specified time period but before data processing occurs or is completed.</p> <p>Confidentiality processes are implemented to limit access to input routines and physical input media (blank and completed) to authorized individuals.</p>

<i>Criteria</i>	<i>Illustrative Controls</i>
	<p>Confidentiality processes exist to restrict the capability to input information to only authorized individuals. This should include limitations based on specific operational or project roles and responsibilities.</p> <p>Error messages are revealed to authorized personnel. Error messages do not reveal potentially harmful information that could be used by others, and sensitive information (for example, e-mail content and financial data) is not listed in error logs or associated administrative messages.</p>
3.3 The system procedures related to confidentiality of data processing are consistent with the documented confidentiality policies.	<p>Confidentiality processes use transaction logs to reasonably ensure that all transactions are processed and to identify transactions that were not completely processed. Processes are in place to identify and review the incomplete execution of transactions, analyze them, and take appropriate action.</p> <p>Confidentiality processes exist to monitor, in a timely manner, unauthorized attempts to access data for any purposes, or for purposes beyond the authorization level of the person accessing the data, including inappropriate or unusual actions, overrides, or bypasses applied to data and transaction processing.</p>
3.4 The system procedures related to confidentiality of outputs are consistent with the documented confidentiality policies.	<p>Management has developed a reporting strategy that includes the sensitivity and confidentiality of data and appropriateness of user access to output data.</p> <p>Management has processes in place to monitor the replication or production of confidential output data used in reports or other communications within or outside the entity.</p> <p>User access to output data is appropriately aligned with the user's role and confidentiality of information.</p> <p>Access to reports is restricted to those users with a legitimate business need for the information.</p> <p>Users should have appropriate authorization for accessing reports containing confidential information.</p>
3.5 The system procedures provide that confidential information is disclosed to parties only in accordance with the entity's defined confidentiality and related security policies.	<p>Employees are required to sign a confidentiality agreement as a routine part of their employment. This agreement prohibits any disclosures of information and other data to which the employee has been granted access.</p>

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<i>Criteria</i>	<i>Illustrative Controls</i>
	<p>Logical access controls are in place that limit access to confidential information based on job function and need. Requests for access privileges to confidential data require the approval of the data owner.</p> <p>Business partners are subject to nondisclosure agreements or other contractual confidentiality provisions.</p>
3.6 The entity has procedures to obtain assurance or representation that the confidentiality policies of third parties to whom information is transferred and upon which the entity relies are in conformity with the entity's defined system confidentiality and related security policies and that the third party is in compliance with its policies.	<p>The entity outsources technology support or service and transfers data to an outsource provider. The requirements of the service provider with respect to confidentiality of information provided by the entity are included in the service contract. Legal counsel reviews third-party service contracts to assess conformity of the service provider's confidentiality provisions with the entity's confidentiality policies.</p> <p>The entity obtains representations and assurances about the controls that are followed by the outsource provider and obtains a report on the effectiveness of such controls from the outsource provider's independent auditor.</p>
3.7 In the event that a disclosed confidentiality practice is discontinued or changed to be less restrictive, the entity has procedures to protect confidential information in accordance with the system confidentiality practices in place when such information was received, or obtains customer consent to follow the new confidentiality practice with respect to the customer's confidential information.	<p>Changes to confidentiality provisions in business partner contracts are renegotiated with the business partner.</p> <p>When changes resulting in less restrictive policy are made, the entity attempts to obtain the agreement of its customers to the new policy. Confidential information for those customers who do not agree to the new policy is either removed from the system and destroyed or isolated to receive continued protection under the old policy.</p>

System security-related criteria relevant to confidentiality

3.8 Procedures exist to restrict logical access to the system and the confidential information resources maintained in the system including, but not limited to, the following matters:	
<p>a. Logical access security measures to restrict access to information resources not deemed to be public</p>	<ul style="list-style-type: none"> • Logical access to nonpublic confidential information resources is protected through the use of native operating system security, native application and resource security, and add-on security software. • Resource specific or default access rules have been defined for all nonpublic resources.

<i>Criteria</i>	<i>Illustrative Controls</i>
<p>b. Identification and authentication of all users.</p>	<ul style="list-style-type: none"> • Access to resources is granted to an authenticated user based on the user's identity. • Users must establish their identity to the entity's network and application systems when accessing nonpublic confidential information resources through the use of a valid user ID that is authenticated by an associated password. • Unique user IDs are assigned to individual users. • Use of group or shared IDs is permitted only after completion of an assessment of the risk of the shared ID and written approval of the manager of the requesting business unit. • Passwords are case sensitive and must contain at least 8 characters, one of which is nonalphanumeric. • Security configuration parameters force passwords to be changed every 90 days. • Login sessions are terminated after 3 unsuccessful login attempts.
<p>c. Registration and authorization of new users.</p>	<ul style="list-style-type: none"> • Customers can self-register on the entity's Web site, under a secure session in which they provide new user information and select appropriate user ID or user account and password. Privileges and authorizations associated with self-registered customer accounts provide access to specific limited system functionalities. • The ability to create or modify users and user access privileges (other than the limited functionality "customer accounts") is limited to the security administration team. • The line-of-business supervisor authorizes access privilege change requests for employees and contractors. Access to restricted resources is authorized by the resource owner. • Customer access privileges beyond the default privileges granted during self-registration are approved by the customer account manager. • Confidentiality and proper segregation of duties are considered in granting privileges.
<p>d. The process to make changes and updates to user profiles.</p>	<ul style="list-style-type: none"> • Changes and updates to self-registered customer accounts can be done by the individual user at any time on the entity's Web site after the user has successfully logged onto the system. Changes are reflected immediately.

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<i>Criteria</i>	<i>Illustrative Controls</i>
	<ul style="list-style-type: none"> • Unused customer accounts (no activity for six months) are purged by the system. • Changes to other accounts and profiles are restricted to the security administration team and require the approval of the appropriate line-of-business supervisor or customer account manager • The human resource management system provides the human resources team with a list of newly terminated employees on a weekly basis. This listing is sent to the security administration team for deactivation.
e. Procedures to prevent customers, groups of individuals, or other entities from accessing confidential information other than their own.	<ul style="list-style-type: none"> • Corporate customers are assigned a unique company identifier that is required as part of the login process. Access software is used to restrict user access based on the company identifier used at login. • Individual customers have their access restricted to their own confidential information resources based on their unique user IDs.
f. Procedures to limit access to confidential information to only authorized employees based upon their assigned roles and responsibilities.	<ul style="list-style-type: none"> • Requests for privileges to access confidential customer information resources require the approval of the customer account manager. • Simulated customer data are used for system development and testing purposes. Confidential customer information is not used for this purpose.
g. Distribution of output containing confidential information restricted to authorized users.	<ul style="list-style-type: none"> • Access to computer processing output is provided to authorized individuals based on the classification of the information. • Processing outputs are stored in an area that reflects the classification of the information.
h. Restriction of access to offline storage, backup data, systems, and media.	<ul style="list-style-type: none"> • Access to offline storage, backup data, systems, and media is limited to computer operations staff through the use of physical and logical access controls.
i. Restriction of access to system configurations, superuser functionality, master passwords, powerful utilities, and security devices (for example, firewalls).	<ul style="list-style-type: none"> • Hardware and operating system configuration tables are restricted to appropriate personnel. • Application software configuration tables are restricted to authorized users and under the control of application change management software. • Utility programs that can read, add, change, or delete data or other programs are restricted to authorized technical services staff. Usage of such programs are logged and monitored by the manager of computer operations.

<i>Criteria</i>	<i>Illustrative Controls</i>
3.9 Procedures exist to restrict physical access to the defined system including, but not limited to, facilities, backup media, and other system components such as firewalls, routers, and servers.	<ul style="list-style-type: none"> • The information security team, under the direction of the CIO, maintains access controls over firewall and other logs, as well as access to any storage media. Such access is logged and reviewed in accordance with the entity's IT policies. • The listing of all master passwords is stored in an encrypted database, and an additional copy is maintained in a sealed envelope in the entity safe. <p>Physical access to the computer rooms, which house the entity's IT resources, servers, and related hardware such as firewalls and routers, is restricted to authorized individuals by card key systems and monitored by video surveillance. Physical access cards are managed by building security staff. Access card usage is logged. Logs are maintained and reviewed by building security staff.</p> <p>Requests for physical access privileges to the entity's computer facilities require the approval of the manager of computer operations.</p> <p>Documented procedures exist for the identification and escalation of potential physical security breaches.</p> <p>Offsite backup data and media are stored at service provider facilities. Access to offsite data and media requires the approval of the manager of computer operations.</p>
3.10 Procedures exist to protect against unauthorized access to system resources.	<p>Login sessions are terminated after three unsuccessful login attempts.</p> <p>Virtual private networking (VPN) software is used to permit remote access by authorized users. Users are authenticated by the VPN server through specific "client" software and user ID and passwords.</p> <p>Firewalls are used and configured to prevent unauthorized access. Firewall events are logged and reviewed daily by the security administrator.</p> <p>Unneeded network services (for example, telnet, ftp, and http) are deactivated on the entity's servers. A listing of the required and authorized services is maintained by the IT department. This list is reviewed by entity management on a routine basis for its appropriateness for the current operating conditions.</p>

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<i>Criteria</i>	<i>Illustrative Controls</i>
3.11 Procedures exist to protect against infection by computer viruses, malicious code, and unauthorized software.	<p>Intrusion detection systems are used to provide continuous monitoring of the entity's network and the early identification of potential security breaches.</p> <p>The entity contracts with third parties to conduct periodic security reviews and vulnerability assessments. Results and recommendations for improvement are reported to management.</p> <p>In connection with other security monitoring, the security administration team participates in user groups and subscribes to services relating to computer viruses.</p> <p>Antivirus software is in place, including virus scans of incoming e-mail messages. Virus signatures are updated promptly.</p> <p>Any viruses discovered are reported to the security team, and an alert is created for all users notifying them of a potential virus threat.</p>
3.12 Encryption or other equivalent security techniques are used to protect transmissions of user authentication and other confidential information passed over the Internet or other public networks.	<p>The entity employs industry standard encryption technology, VPN software, or other secure communication systems (consistent with its periodic IT risk assessment) for the transmission of private or confidential information over public networks, including user IDs and passwords. Users are required to upgrade their browsers to the most current version tested and approved for use by the security administration team to avoid possible security problems.</p> <p>Account activities, subsequent to successful login, are encrypted through industry standard encryption technology, VPN software, or other secure communication systems (consistent with the entity's periodic IT risk assessment). Users are logged out on request (by selecting the "Sign-out" button on the Web site) or after 10 minutes of inactivity.</p> <p>Confidential information submitted to the entity over its trading partner extranet is encrypted.</p> <p>Transmission of confidential customer information to third-party service providers is done over leased lines.</p>

<i>Criteria</i>	<i>Illustrative Controls</i>
Criteria related to execution and incident management used to achieve the objectives	
3.13 Procedures exist to identify, report, and act upon system confidentiality and security breaches and other incidents.	<p>Users are provided instructions for communicating potential confidentiality and security breaches to the information security team. The information security team logs incidents reported through customer hotlines and e-mail.</p> <p>Intrusion detection and other tools are used to identify, log, and report potential security breaches and other incidents. The system notifies the security administration team, the network administrator, or both via e-mail and pager of potential incidents in progress.</p> <p>Incident logs are monitored and evaluated by the information security team daily.</p> <p>When an incident is detected or reported, a defined incident management process is initiated by authorized personnel. Corrective actions are implemented in accordance with defined policies and procedures.</p> <p>Procedures include a defined incident escalation process and notification mechanisms.</p> <p>All incidents are tracked by management until resolved.</p> <p>Closed incidents are reviewed by management for appropriate resolution.</p> <p>Resolution of incidents not related to security includes consideration of the impact of the incident and its resolution on security requirements.</p>
Criteria related to the system components used to achieve the objectives	
3.14 Procedures exist to provide that system data are classified in accordance with the defined confidentiality and related security policies.	<p>Data owners periodically review data access rules and request modifications based on defined security requirements and risk assessments.</p> <p>Whenever new data are captured or created, the data are classified based on security and confidentiality policies.</p> <p>Propriety of data classification is considered as part of change management process.</p>
3.15 Procedures exist to provide that issues of noncompliance with defined confidentiality and related security policies are	<p>All incidents are tracked by management until resolved.</p> <p>Closed incidents are reviewed by management for appropriate resolution.</p>

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<i>Criteria</i>	<i>Illustrative Controls</i>
<p>promptly addressed and that corrective measures are taken on a timely basis.</p> <p>3.16 Design, acquisition, implementation, configuration, modification, and management of infrastructure and software are consistent with defined confidentiality and related security policies.</p>	<p>The internal audit process includes the development of management actions plans for findings and the tracking of action plans until closed.</p> <p>The entity has adopted a formal systems development life cycle (SDLC) methodology that governs the development, acquisition, implementation, and maintenance of computerized information systems and related technology.</p> <p>The SDLC methodology includes a framework for classifying data, including customer confidentiality requirements. Standard user profiles are established based on customer confidentiality requirements and an assessment of the business impact of the loss of security. Users are assigned standard profiles based on needs and functional responsibilities.</p> <p>Internal information is assigned to an owner based on its classification and use. Customer account managers are assigned as custodians of customer data. Owners of internal information and custodians of customer information and data classify its sensitivity and determine the protection mechanisms required to maintain an appropriate level of confidentiality and security.</p> <p>The security administration team reviews and approves the architecture and design specifications for new systems development or acquisition to help ensure consistency with the entity's confidentiality and related security policies.</p> <p>Changes to system components that may affect security or the confidentiality of information require the approval of the security administration team.</p> <p>The access control and operating system facilities have been installed, including the implementation of options and parameters, to restrict access in accordance with the entity's confidentiality and related security policies.</p> <p>The entity contracts with third parties to conduct periodic security reviews and vulnerability assessments. Results and recommendations for improvement are reported to management.</p>

<i>Criteria</i>	<i>Illustrative Controls</i>
3.17 Procedures exist to help ensure that personnel responsible for the design, development, implementation, and operation of systems affecting confidentiality and security have the qualifications and resources to fulfill their responsibilities.	<p>The entity has written job descriptions specifying the responsibilities and academic and professional requirements for key job positions.</p> <p>Hiring procedures include a comprehensive screening of candidates for key positions and consideration of whether the candidates' verified credentials are commensurate with the proposed position. New personnel are offered conditional employment subject to background checks and reference validation.</p> <p>Candidates, including internal transfers, are approved by the line-of-business manager before the employment position is offered.</p> <p>Periodic performance appraisals are performed by employee supervisors and include the assessment and review of professional development activities.</p> <p>Personnel receive training and development in system confidentiality and security concepts and issues.</p> <p>Procedures are in place to provide alternate personnel for key system confidentiality and security functions in case of absence or departure.</p>

Change management-related criteria relevant to confidentiality

3.18 Procedures exist to maintain system components, including configurations consistent with the defined system confidentiality and related security policies.	<p>Entity management receives a third-party opinion on the adequacy of security controls, and routinely evaluates the level of performance it receives (in accordance with its contractual service-level agreement) from the service provider that hosts the entity's systems and Web site.</p> <p>The IT department maintains an up-to-date listing of all software and the respective level, version, and patches that have been applied.</p> <p>Requests for changes, system maintenance, and supplier maintenance are standardized and subject to documented change management procedures. Changes are categorized and ranked according to priority, and procedures are in place to handle urgent matters. Change requestors are kept informed about the status of their outstanding and closed requests.</p>
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<i>Criteria</i>	<i>Illustrative Controls</i>
3.19 Procedures exist to provide that only authorized, tested, and documented changes are made to the system.	<p>System configurations are tested annually and evaluated against the entity's security policies and current service-level agreements. An exception report is prepared, and remediation plans are developed and tracked.</p> <p>The responsibilities for authorizing, testing, developing, and implementing changes have been segregated. The entity's documented systems development methodology describes the change initiation, software development and maintenance, and approval processes, as well as the standards and controls that are embedded in the processes. These include programming, documentation, and testing standards.</p> <p>Requests for changes, system maintenance, and supplier maintenance are standardized and subject to documented change management procedures. Changes are categorized and ranked according to priority, and procedures are in place to handle urgent matters. Change requestors are kept informed about the status of their outstanding and closed requests.</p> <p>Changes to system infrastructure and software are developed and tested in a separate development or test environment before implementation into production.</p> <p>As part of the change control policies and procedures, there is a "promotion" process (for example, from "test" to "staging" to "production"). Promotion to production requires the approval of the business owner who sponsored the change and the manager of computer operations.</p> <p>When changes are made to key systems components, there is a "backout" plan developed for use in the event of major interruption(s).</p>
3.20 Procedures exist to provide that emergency changes are documented and authorized (including after-the-fact approval).	<p>Requests for changes, system maintenance, and supplier maintenance are standardized and subject to documented change management procedures. Changes are categorized and ranked according to priority, and procedures are in place to handle urgent matters. Change requestors are kept informed about the status of their requests.</p> <p>Emergency changes that require deviations from standard procedures are logged and reviewed by IT management daily and reported to the affected line-of-business manager. Permanent corrective measures</p>

<i>Criteria</i>	<i>Illustrative Controls</i>
	follow the entity's change management process, including the requirements for obtaining line-of-business approvals.
3.21 Procedures exist to provide that confidential information is protected during the system development, testing, and change processes in accordance with defined system confidentiality and related security policies.	<p>Information designated as confidential is not stored, processed, or maintained in test or development systems and environments.</p> <p>Test or development systems and environments that must contain information designated as confidential use data encryption, masking, and sanitization techniques to protect the confidentiality of the information.</p>
4.0 Monitoring: The entity monitors the system and takes action to maintain compliance with its defined confidentiality policies.	
4.1 The entity's system confidentiality and security performance is periodically reviewed and compared with the defined system confidentiality and related security policies.	<p>The information security team monitors the system and assesses the systems vulnerabilities using proprietary and publicly available tools. Potential risks are evaluated and compared to service-level agreements and other obligations of the entity. Remediation plans are proposed, and implementations are monitored.</p> <p>The entity contracts with third parties to conduct periodic security reviews and vulnerability assessments. The internal audit function conducts system security reviews as part of its annual audit plan. Results and recommendations for improvement are reported to management.</p>
4.2 There is a process to identify and address potential impairments to the entity's ongoing ability to achieve its objectives in accordance with its system confidentiality and related security policies.	<p>Logs are analyzed, either manually or by automated tools, to identify trends that may have a potential impact on the entity's ability to achieve its system confidentiality and related security objectives.</p> <p>Monthly IT staff meetings are held to address system security concerns and trends; findings are discussed at quarterly management meetings.</p>
4.3 Environmental, regulatory, and technological changes are monitored, and their impact on system confidentiality and security is assessed on a timely basis. System confidentiality policies and procedures are updated for such changes as required.	<p>Trends and emerging technologies and their potential impact on customer confidentiality requirements are reviewed with corporate customers as part of the annual performance review meeting.</p> <p>Senior management, as part of its annual IT planning process, considers developments in technology and the impact of applicable laws or regulations on the entity's confidentiality and related security policies.</p> <p>The entity's customer service group monitors the impact of emerging technologies, customer requirements, and competitive activities.</p>

Privacy Principles and Criteria

.33 This section provides a brief overview of privacy concepts, objectives, and principles. The complete set of privacy principles is contained in generally accepted privacy principles (GAPP) found in appendix D (paragraph .48).

.34 The *privacy principles*, which are included in GAPP, focus on protecting the personal information an organization may collect about its customers, employees, and other individuals. GAPP have been developed from a business perspective, referencing significant domestic and international privacy regulations. GAPP operationalizes complex privacy requirements into a single privacy objective that is supported by 10 privacy principles.

Privacy Concepts

.35 *Privacy* is defined in GAPP as the rights and obligations of individuals and organizations with respect to the collection, use, retention, disclosure, and destruction of personal information.

.36 *Personal information* is information that is about or can be related to an identifiable individual. It includes any information that can be linked to an individual or used to directly or indirectly identify an individual. Most information collected by an organization about an individual is likely to be considered personal information if it can be attributed to an identified individual. Some examples of personal information are

- name,
- home or e-mail address,
- identification number (for example, a Social Security or Social Insurance Number),
- physical characteristics, and
- consumer purchase history.

.37 Some personal information is considered *sensitive*. Some laws and regulations define the following to be sensitive personal information:

- Information on medical or health conditions
- Financial information
- Racial or ethnic origin
- Political opinions
- Religious or philosophical beliefs
- Trade union membership
- Sexual preferences
- Information related to offenses or criminal convictions

.38 Sensitive personal information generally requires an extra level of protection and a higher duty of care. For example, the use of sensitive information may require explicit consent rather than implicit consent.

.39 Some information about or related to people cannot be associated with specific individuals. Such information is referred to as *nonpersonal information*. This includes statistical or summarized personal information for which the identity of the individual is unknown or linkage to the individual has been removed. In such cases, the individual's identity cannot be determined from the

information that remains because the information is “de-identified” or “anonymized.” Nonpersonal information ordinarily is not subject to privacy protection because it cannot be linked to an individual.

.40 *Privacy or Confidentiality?* As discussed in the confidentiality principle, personal information is different from confidential information. Unlike personally identifiable information, which is often defined by regulation in a number of countries worldwide, there is no single definition of confidential information that is widely recognized. In the course of communicating and transacting business, partners often exchange information or data that one or the other party requires be maintained on a “need to know” basis.

Generally Accepted Privacy Principles

.41 *Overall Privacy Objective.* GAPP are founded on the following privacy objective:

Personal information is collected, used, retained, disclosed, and destroyed in conformity with the commitments in the entity’s privacy notice and with criteria set forth in generally accepted privacy principles issued by the AICPA and CICA.

.42 *The Privacy Principles.* GAPP are essential to the proper protection and management of personal information. They are based on internationally known fair information practices included in many privacy laws and regulations of various jurisdictions around the world and recognized good privacy practices. The following are the 10 GAPP:

1. *Management.* The entity defines, documents, communicates, and assigns accountability for its privacy policies and procedures.
2. *Notice.* The entity provides notice about its privacy policies and procedures and identifies the purposes for which personal information is collected, used, retained, and disclosed.
3. *Choice and consent.* The entity describes the choices available to the individual and obtains implicit or explicit consent with respect to the collection, use, and disclosure of personal information.
4. *Collection.* The entity collects personal information only for the purposes identified in the notice.
5. *Use and retention.* The entity limits the use of personal information to the purposes identified in the notice and for which the individual has provided implicit or explicit consent. The entity retains personal information for only as long as necessary to fulfill the stated purposes.
6. *Access.* The entity provides individuals with access to their personal information for review and update.
7. *Disclosure to third parties.* The entity discloses personal information to third parties only for the purposes identified in the notice and with the implicit or explicit consent of the individual.
8. *Security for privacy.* The entity protects personal information against unauthorized access (both physical and logical).
9. *Quality.* The entity maintains accurate, complete, and relevant personal information for the purposes identified in the notice.
10. *Monitoring and enforcement.* The entity monitors compliance with its privacy policies and procedures and has procedures to address privacy-related complaints and disputes.

For each of the 10 privacy principles, relevant, objective, complete, and measurable criteria have been developed for evaluating an entity's privacy policies, communications, procedures, and controls.

.43 These criteria are set forth in the separate publication *Generally Accepted Privacy Principles*.

Online Privacy Engagements

.44 When the privacy engagement relates to an online segment, an entity may choose to display a privacy seal. For these engagements, the scope needs to include, as a minimum, an online business segment of the entity. For additional considerations, see appendix C of *Generally Accepted Privacy Principles*.

Appendix A

Illustrative Disclosures for E-Commerce Systems

This appendix sets out illustrative disclosures for e-commerce systems that are required to meet the trust services principles and criteria. The required disclosures are identified separately in the trust services principles (security, availability, processing integrity, and confidentiality). The following disclosures are illustrative only and should be tailored to the particular organization's system.

System Description

Rather than addressing the components of a system (used for describing non-e-commerce systems), an organization may describe the functionality of the system as follows:

Illustrative System Description

Our site (abc-xyz.org) enables entrepreneurs and small business owners to create and manage their own online store (myABC-xyz.org) using the abc-xyz.org suite of business services. It also covers the fulfillment and settlement systems that integrate with abc-xyz.org to facilitate ordering from these online stores and the use of third-party service providers with which we have contracted to provide various services related to our site.

The description covers the functionality in our abc-xyz.org site that allows users to create and manage their own online store. It also covers the fulfillment and settlement systems that integrate with abc-xyz.org to facilitate ordering from customer sites created on abc-xyz.org.

Disclosures Related to Specific Principles and Criteria

The following tables set out illustrative disclosures for e-commerce systems.

<i>Criteria Reference</i>	<i>Illustrative Disclosures</i>
Security	
2.2 The security obligations of users and the entity's security commitments to users are communicated to authorized users.	<p>Even though we strive to protect the information you provide through ABC.com, no data transmission over the Internet can be guaranteed to be 100 percent secure. As a result, even though we strive to protect your information, we cannot guarantee or warrant the security of any information you transmit to or receive from us through our Web site and online services.</p> <p>We review our security policies on a regular basis, and changes are made as necessary. They undergo an intense review on an annual basis by the IT department. These defined security policies detail access privileges, information collection needs, accountability, and other such matters. Documented system security objectives, policies, and standards are consistent with</p>

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<i>Criteria Reference</i>	<i>Illustrative Disclosures</i>
	<p>system security requirements defined in contractual, legal, and other service-level agreements. For example, only a select group of authorized individuals within ABC has access to user information. A complete policy with details regarding access, scripting, updates, and remote access is available for review by qualified personnel within the organization. This document is not available to the general public for study.</p> <p>ABC.com operates secure data networks that are password-protected and are not available to the public. When transmitting information between you and ABC.com, data security is handled through a security protocol called secured sockets layer (SSL). SSL is an Internet security standard using data encryption and Web server authentication.</p> <p>Encryption strength is measured by the length of the key used to encrypt the data; that is, the longer the key, the more effective the encryption. Using the SSL protocol, data transmission between you and the ABC.com server is performed at industry standard encryption strength.</p>
2.4	<p>The process for informing the entity about breaches of the system security and for submitting complaints is communicated to authorized users.</p> <p>If you feel that there has been a breach to the security of this site, please contact us <i>immediately</i> at (800) XXX-XXXX.</p>
2.5	<p>Changes that may affect system security are communicated to management and users who will be affected.</p> <p>Any changes that affect the security of our Web site as it affects you as a site user will be communicated to you by posting the highlight of the change to the Web page that summarizes our security policies and significant controls.</p>

Availability

2.2	<p>The availability and related security obligations of users and the entity's availability and related security commitments to users are communicated to authorized users.</p> <p>To allow sufficient time for file maintenance and backup, the maximum number of hours per day that our network will be made available is 22 hours per day, 7 days a week. In the event of a disaster or other prolonged service interruption, the entity has arranged for the use of alternative service sites to allow for full business resumption within 24 hours.</p> <p>Our company's defined security policies detail access privileges, information collection needs, accountability, and other such matters. They are reviewed and updated at quarterly management meetings and undergo an intense review on an annual basis by the IT department.</p>
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<i>Criteria Reference</i>	<i>Illustrative Disclosures</i>
	Documented system security objectives, policies, and standards are consistent with system security requirements defined in contractual, legal, and other service-level agreements. For example, current policy prohibits shared IDs; each support person has his or her own unique ID to log on and maintain network equipment. A complete policy with details regarding access, scripting, updates, and remote access is available for review by qualified personnel. This document will not be released to the general public for study.
2.4 The process for informing the entity about system availability issues and breaches of system security and for submitting complaints is communicated to authorized users.	Management has in place a consumer hotline to allow customers to telephone in any comments, complaints, or concerns regarding the security of the site and availability of the system. If you are unable to obtain access to this site, please contact our customer support personnel at (800) XXX-XXXX. If you believe that there has been a breach to the security of this site, please contact us <i>immediately</i> at (800) XXX-XXXX.
2.5 Changes that may affect system availability and system security are communicated to management and users who will be affected.	Highlights of any changes that affect the security of our Web site and availability of the system as it affects you as a site user will be communicated to you by e-mail seven days in advance of the anticipated change. The highlights of the change will be posted to the Web page that summarizes our availability and security policies.

Processing Integrity

2.1 The entity has prepared an objective description of the system and its boundaries and communicated such description to authorized users. If the system is an e-commerce system, additional information provided on its Web site includes, but may not be limited to, the following matters:	You can purchase new and used books on our site; used books are clearly labeled as such. The mortgage rate information we obtain for your brokerage transaction is gathered from 12 different lending institutions on a daily basis. A complete listing of these lending institutions can be obtained by clicking here [<i>insert hot link/URL</i>]. ABC's Online RFQ Brokerage is the online clearing house for requests for quotes (RFQ) on custom-made parts. Through our unique service, Original Equipment Manufacturers (OEM) looking for parts will be connected to contract manufacturers looking for work.
a. Descriptive information about the nature of the goods or services that will be provided, including, where appropriate	RFQs published on our online brokerage undergo an intensive review process to ensure that contract manufacturers get all the information needed to compose a quote. ABC's trained personnel will work closely with OEM manufacturers new to the outsourcing market to ease their fears.

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<i>Criteria Reference</i>	<i>Illustrative Disclosures</i>
<ul style="list-style-type: none"> condition of goods (whether they are new, used, or reconditioned). 	Contract manufacturers participating in the RFQ bidding process are members of ABC's BizTrust program. New members are subjected to an assortment of checks such as credit checks and reference checks to ensure that they are qualified to bid on RFQs. The results from these checks are organized into an easy-to-read BizTrust Report accessible by all members of ABC.
<ul style="list-style-type: none"> description of services (or service contract). 	The nationwide survey, conducted by the compensation-research firm of Dowden & Co., presents data on 20X2 compensation that was gathered from among more than 900 employers of information systems professionals, including corporations of all sizes, in every industry group, and from every U.S. region. The survey was completed July 20X1.
<ul style="list-style-type: none"> sources of information (where it was obtained and how it was compiled). 	Our policy is to ship orders within 1 week of receipt of a customer-approved order. Our experience is that over 90 percent of our orders are shipped within 48 hours; the remainder is shipped within 1 week.
<p>b. The terms and conditions by which it conducts its e-commerce transactions including, but not limited to, the following matters:</p>	We will notify you by e-mail within 24 hours if we cannot fulfill your order as specified at the time you placed it and will provide you the option of canceling the order without further obligation. You will not be billed until the order is shipped.
<ul style="list-style-type: none"> Time frame for completion of transactions (<i>transaction</i> means fulfillment of orders where goods are being sold and delivery of service where a service is being provided) 	You have the option of downloading the requested information now, or we will send it to you on CD-ROM by UPS 2-day or Federal Express overnight delivery. Credit approval is required before shipment. All goods will be invoiced on shipment according to either our normal terms of settlement (net 30 days), or where alternative contractual arrangements are in place, those arrangements shall prevail.
<ul style="list-style-type: none"> Time frame and process for informing customers of exceptions to normal processing of orders or service requests 	We require an electronic funds transfer of fees and costs at the end of the transaction. For new customers, a deposit may be required. To cancel your monthly service fee, send us an e-mail at Subscriber@ABC.com or call us at (800) XXX-XXXX. Be sure to include your account number or have it ready when you call.
<ul style="list-style-type: none"> Normal method of delivery of goods or services, including customer options, where applicable 	Purchases can be returned for a full refund within 30 days of receipt of shipment. Call our toll-free number or e-mail us for a return authorization number, which should be written clearly on the outside of the return package.

<i>Criteria Reference</i>	<i>Illustrative Disclosures</i>
<ul style="list-style-type: none"> • Payment terms, including customer options, if any • Electronic settlement practices and related charges to customers • How customers may cancel recurring charges, if any • Product return policies and limited liability, where applicable 	<p>Warranty and other service can be obtained at any one of our 249 locations worldwide that are listed on this Web site. A list of these locations is also provided with delivery of all of our products.</p> <p>Transactions at this site are covered by binding arbitration conducted through our designated arbitrator [<i>name of arbitrator</i>]. They can be reached at www.name.org or by calling toll-free (800) XXX-XXXX. For the details of the terms and conditions of arbitration, click here [<i>insert hot link/URL</i>].</p> <p>Our process for consumer dispute resolution requires that you contact our customer toll-free hotline at (800) XXX-XXXX or contact us via e-mail at custhelp@ourcompany.com.</p> <p>If your problem has not been resolved to your satisfaction, you may contact the Cyber Complaint Dispute Resolution Association, which can be reached at (877) XXX-XXXX during normal business hours (8:00 a.m. to 5:00 p.m. central time) or via their Web site at www.ccomplaint.com.</p>
c. Where customers can obtain warranty, repair service, and support related to the goods and services purchased on its Web site.	For the details of the terms and conditions of arbitration, click here [<i>insert hot link/URL</i>].
d. Procedures for resolution of issues regarding processing integrity. These may relate to any part of a customer's e-commerce transaction, including complaints related to the quality of services and products, accuracy, completeness, and the consequences for failure to resolve such complaints.	If you, our customer, require follow-up or response to your questions or complaints regarding transactions at this site, you may contact us at www.xxxquestions.org . If your follow-up or your complaint is not handled to your satisfaction, you should contact the e-commerce ombudsman who handles consumer complaints for e-commerce in this country. He or she can be reached at www.ecommercombud.org or by calling toll-free at (800) XXX-XXXX.
2.2 The processing integrity and related security obligations of users and the entity's processing integrity and related security commitments to users are communicated to authorized users.	Our company's defined processing integrity policies and related security policies are communicated to all authorized users of the company. The security policies detail access privileges, information collection needs, accountability, and other such matters. They are reviewed and updated at quarterly management meetings and undergo an intense review on an annual basis by the IT department. Documented system security objectives, policies, and standards are consistent with system security requirements defined in contractual, legal, and other service-level agreements. For example, current policy prohibits shared IDs; each support person has his or her own

(continued)

<i>Criteria Reference</i>	<i>Illustrative Disclosures</i>	
2.4	<p>The process for obtaining support and informing the entity about system processing integrity issues, errors and omissions, and breaches of systems security and for submitting complaints is communicated to authorized users.</p>	<p>unique ID to log on and maintain network equipment. A complete policy with details regarding access, scripting, updates, and remote access is available for review by qualified personnel. This document will not be released to the general public for study.</p> <p>For service and other information, contact one of our customer service representatives at (800) XXX-XXXX between 7:00 a.m. and 8:00 p.m. (central standard time), or you can write to us at CustServ@ABC.com or at the following address:</p> <p style="padding-left: 40px;">Customer Service Department ABC Company 1234 Anystreet Anytown, Illinois 60000</p>
2.5	<p>Changes that may affect system processing integrity and system security are communicated to management and users who will be affected.</p>	<p>If you believe that there has been a breach to the integrity or security of this site, please contact us <i>immediately</i> at (800) 123-1234.</p> <p>Highlights of any changes that affect the security of our Web site and processing integrity of the system as it affects you as a site user will be communicated to you by e-mail seven days in advance of the anticipated change. The highlights of the change will be posted to the Web page that summarizes our processing integrity and security policies.</p>

Confidentiality

2.2	<p>The confidentiality and related security obligations of users and the entity's confidentiality and related security commitments to users are communicated to authorized users before the confidential information is provided. This communication includes, but is not limited to, the following matters:</p> <p>a. How information is designated as confidential and ceases to be confidential; the handling, destruction, back-up, and distribution or transmission of confidential information.</p> <p>b. How access to confidential information is authorized</p>	<p>XYZ manufacturing.com is a high quality custom manufacturer of electronic components. Customers and potential customers can submit engineering drawings, specifications, and requests for manufacturing price quotes through our Web site or e-mail.</p> <p>Access to your information is limited to our employees and any third-party subcontractors we may elect to use in preparing our quote. We will not use any information you provide for any purpose other than a price quote and subsequent manufacturing and order fulfillment on your behalf. However, access may need to be provided in response to subpoenas, court orders, legal process, or other needs to comply with applicable laws and regulations.</p> <p>Using our encryption software, you may designate information as confidential by</p>
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<i>Criteria Reference</i>	<i>Illustrative Disclosures</i>
and how such authorization is rescinded.	checking the “Confidential Treatment” box. This software can be downloaded from our site and will accept information in most formats. Such information will automatically be encrypted using our public key before transmission over the Internet. You may transmit such information to us through our Web site or by e-mail.
c. How confidential information is used.	Access to information designated as confidential will be restricted only to our employees with a need to know. We will not provide such information to third parties without your prior permission.
d. How confidential information is shared.	When we provide information to third parties, we do not provide your company name. However, we make no representation regarding third-party confidential treatment of such information.
e. If information is provided to third parties, disclosures include any limitations on reliance on the third party’s confidentiality practices and controls. Lack of such disclosure indicates that the entity is relying on the third party’s confidentiality practices and controls that meet or exceed those of the entity.	Our confidentiality protection is for a period of two years, after which any confidential information will be returned to you, upon request, or destroyed.
f. Practices to comply with applicable laws and regulations addressing confidentiality.	If you are not a customer at the time of submitting such information, you will be provided with an account number and password. You may use this account number and password to access the information you have submitted in addition to any related price quote information provided by us. You may also set up an additional 10 sub-accounts and passwords so others in your organization can also access this information. Our services and the protection of confidential information are subject to third-party dispute resolution. This process is described under “Arbitration Process” elsewhere on our Web site.
2.4 The process for informing the entity about breaches of confidentiality and system security and for submitting complaints is communicated to authorized users.	If you have any questions about our organization or our policies on confidentiality as stated at this site, please contact CustServ@XYZ-manufacturing.com. If you feel that there has been a breach to the security of this site, please contact us immediately at (800) XXX-XXXX.

(continued)

	<i>Criteria Reference</i>	<i>Illustrative Disclosures</i>
2.5	Changes that may affect confidentiality and system security are communicated to management and users who will be affected.	Effective January 200X, we eliminated our “secret” category of information. Information submitted under the secret category will continue to be protected in accordance with our commitments at that time.
<hr/> <i>Privacy</i> <hr/>		
See generally accepted privacy principles in appendix D (paragraph .48) for related criteria.		

Appendix B

Illustrative System Description of a Non-E-Commerce System

The purpose of a system description is to delineate the boundaries of the system covered by management's assertion or the subject matter of the practitioner's report (in this example, a pension processing service). The system description should be an integrated part of the entity's communication of policies related to the specific principles subject to the practitioner's attestation. In all cases, the system description should accompany the practitioner's report.

Background

XYZ Co. Pension Services (XPS), based in New York, New York, with offices across North America, manages and operates the Pension Administration System (PAS) on behalf of pension plan sponsors who are XPS's customers. The plan members are the employees of XPS's customers who are enrolled in the pension plan. XPS uses PAS for recordkeeping of pension-related activities.

Infrastructure

PAS uses a three-tier architecture, including proprietary client software, application servers, and database servers.

Various peripheral devices, such as tape cartridge silos, disk drives, and laser and impact printers, are also used.

Software

The PAS application was developed by programming staff in XYZ Co.'s Information Technology Department (XITD) Systems Development and Application Support area. PAS enables the processing of contributions to members' pension plans and withdrawals at retirement, based on plan rules. PAS generates all the required reports for members, plan sponsors, and tax authorities. PAS also provides a facility to record investments and related transactions (purchases, sales, dividends, interest, and other miscellaneous transactions). Batch processing of transactions is performed nightly.

PAS provides a facility for online data input and report requests. In addition, PAS accepts input from plan sponsors in the form of digital or magnetic media or files transmitted via the telecommunications infrastructure.

People

XPS has a staff of approximately 200 employees organized in the following functional areas:

- Pension administration includes a team of specialists that set up pension rules, maintain master files, process contributions to PAS, report to plan sponsors and members, and assist with inquiries from plan members.
- Financial operations is responsible for processing withdrawals, depositing contributions, and investment accounting.
- Trust accounting is responsible for bank reconciliation.

- Investment services is responsible for processing purchases of stocks, bonds, certificates of deposits, and other financial instruments.

XITD has a staff of approximately 50 employees who are dedicated to PAS and its related infrastructure and are organized in the following functional areas:

- The help desk provides technical assistance to users of PAS and other infrastructure as well as plan sponsors.
- Systems development and application support provides application software development and testing for enhancements and modifications to PAS.
- Product support specialists prepare documentation manuals and training material.
- Quality assurance monitors compliance with standards and manages and controls the change migration process.
- Information security and risk is responsible for security administration, intrusion detection, security monitoring, and business-recovery planning.
- Operational services performs day-to-day operation of servers and related peripherals.
- System software services installs and tests system software releases, monitors daily system performance, and resolves system software problems.
- Technical delivery services maintains job scheduling and report distribution software, manages security administration, and maintains policies and procedures manuals for the PAS processing environment.
- Voice and data communications maintains the communication environment, monitors the network, and provides assistance to users and plan sponsors in resolving communication problems and network planning.

Procedures

The pension administration services covered by this system description include

- pension master file maintenance,
- contributions,
- withdrawals,
- investment accounting, and
- reporting to members.

These services are supported by XITD, which supports PAS 24 hours a day, 7 days a week. The key support services provided by XITD include

- systems development and maintenance,
- security administration and auditing,
- intrusion detection and incident response,

- data center operations and performance monitoring,
- change controls, and
- business recovery planning.

Data

PAS data consist of the following:

- Master file data
- Transaction data
- Error and suspense logs
- Output reports
- Transmission records
- System and security files

Transaction processing is initiated by the receipt of paper documents, electronic media, or calls to XYZ Co.'s call center. Transaction data are processed by PAS in either online or batch modes of processing and are used to update master files. Output reports are available either in hard copy or through a report-viewing facility to authorized users based on their job functions. Pension statement and transaction notices are mailed to plan sponsors and members.

Appendix C

Practitioner Guidance on Scoping and Reporting Issues

This appendix deals with issues related to engagement planning, performance, and reporting using the trust services principles and criteria. This section deals with

- engagement components,
- the practitioner's report,
- review engagements,
- agreed-upon procedures engagements, and
- other matters.

Trust services engagements are attest engagements performed under the AICPA Statements of Standards for Attestation Engagements.

Engagement Components

Trust Services Principles

Trust services provides for a modular approach using five different principles—security, availability, processing integrity, confidentiality, and privacy. A practitioner may perform a trust services examination that covers only one or any combination of the principles. Each principle describes an attribute of a system (for example, availability) and is followed by criteria for evaluating the system with respect to that attribute.

Trust Services Criteria

Criteria are the benchmarks used to measure and present the subject matter. The practitioner evaluates the subject matter against these criteria.

AT section 101, *Attest Engagements* (AICPA, *Professional Standards*), of the attestation standards,¹ states that suitable criteria must have each of the following attributes:

- *Objectivity.* Criteria should be free from bias.
- *Measurability.* Criteria should permit reasonably consistent measurements, qualitative or quantitative, of subject matter.
- *Completeness.* Criteria should be sufficiently complete so that those relevant factors that would alter a conclusion about subject matter are not omitted.
- *Relevance.* Criteria should be relevant to the subject matter.

The trust services criteria meet the requirement for being suitable criteria and are the result of a public exposure and comment process.

Management's Assertion

AT section 101 states that the practitioner should ordinarily obtain a written assertion² from management, or the practitioner will be required to modify his

¹ See AT section 101, *Attest Engagements* (AICPA, *Professional Standards*), paragraph .24.

² See AT section 101 paragraph .09.

or her report.³ Specifically, management asserts that, during the period covered by the report and based on the AICPA and CICA trust services criteria, it maintained effective controls over the system under examination to satisfy the stated trust services principle(s) and criteria. For engagements covering only certain principles, management's assertion should only address the principles covered by the engagement. In addition, for engagements covering an entity's compliance with its commitments, those commitments covered by the report should be indentified in management's assertion.

Under AT section 101, the practitioner may report on either management's assertion or on the subject matter of the engagement. When the practitioner reports on the assertion, the assertion should accompany the practitioner's report or be included in the first paragraph of the practitioner's report.⁴ When the practitioner reports on the subject matter, the practitioner may want to request that management make its assertion available to the users of the practitioner's report. If one or more deviations from the criteria exist, the practitioner should modify the report. When issuing a modified report, the practitioner should report directly on the subject matter rather than on the assertion.⁵

Period of Coverage

AT section 101 provides that the practitioner's report and management's assertion should specify the time period covered by the report and the assertion, respectively. A practitioner may issue a report for a period of time or at a point in time. The determination of an appropriate period should be at the discretion of the practitioner and the entity.

The committee has identified the following factors that the practitioner may want to consider in establishing the reporting period:

- The anticipated users of the report and their needs
- The need for contiguous coverage between reports
- The degree and frequency of change in each of the system components
- The cyclical nature of processing within the system
- Historical information about the system

The Practitioner's Report

The committee has identified the following items that the practitioner may want to consider when reporting on trust services principles and criteria.

Reporting on Multiple Principles

In most cases, a practitioner will be asked to report on one or more trust services principles and related criteria, rather than on the entire set of five principles. In the introductory paragraph of the report, the practitioner should identify the principles included in the scope of the examination.

Individual or Combined Report

When engaged to perform a trust services examination for multiple principles, the practitioner can, depending on the needs of the client, issue either a combined report or individual reports for each of the principles. For the purpose

³ See AT section 101 paragraph .58 for a description of a practitioner's options if a written assertion is not obtained.

⁴ See AT section 101 paragraph .64.

⁵ See AT section 101 paragraph .66.

of this discussion, it is assumed that the practitioner has been asked to report on three principles and related criteria: security, privacy, and confidentiality.

The first issue is to decide whether this represents (1) one engagement to examine three principles or (2) three engagements to examine one principle each. This decision can affect, among other matters, the engagement letter, the content and number of representation letters, and whether one report or multiple reports will be issued. In either case, the practitioner's report(s) should clearly communicate the scope and nature of the engagement(s).

Failure to Meet Criteria

If one or more relevant criteria have not been met, the practitioner cannot issue an unqualified report. Under AT section 101, when issuing a modified report, the practitioner should report directly on the subject matter rather than on the assertion.⁶

Different Examination Periods

There may be situations in which the entity requests that more than one principle be examined, but due to various reasons, the principles will have different reporting periods (for example, differences in the length of the reporting period or the date that the various reporting periods begin). Ideally, it would be more efficient for the practitioner to have such periods coincide. When different reporting periods exist, the practitioner may consider whether to issue separate or combined reports. Separate reports covering the separate principles are less complex to prepare than a combined report. If a combined report is issued, the different reporting periods would need to be detailed in the introductory and opinion paragraphs of the report to ensure that the different examination periods are highlighted.

Use of Third-Party Service Providers

The practitioner may encounter situations in which the entity under examination uses a third-party service provider to accomplish some of the trust services criteria. The AICPA and CICA *Effects of a Third-Party Service Provider in a WebTrust or Similar Engagement* provides applicable guidance for these situations and is available for download at www.webtrust.org.

Responsibility for Communicating Departures From the Criteria Related to Other Principles

During a trust services examination, information about departures from the criteria, such as noncompliance or control deficiencies related to principles and criteria that are not within the scope of the engagement may come to the practitioner's attention. For example, while engaged only to report on controls related to the security principle, a practitioner may become aware that the entity is not complying with its privacy policy as stated on its Web site (for example, it is disclosing personal information to selected third parties). Although the practitioner is not responsible for detecting information about departures from the criteria that are outside the scope of his or her examination, the practitioner may want to evaluate whether such information that comes to his or her attention is significant (that is, whether the effects of such departures could materially mislead users of the system).

If the practitioner determines that the effects of such departures are significant, the committee believes that the practitioner should communicate in writing to management. Management should be asked either to correct the

⁶ See AT section 101 paragraph .66.

control deficiency or noncompliance (in this case, cease providing the information to third parties) or to properly disclose their actual practices publicly so that users are aware of actual policies (in this case, the privacy statement would be amended to reflect the fact that they do provide information to third parties).

If the practitioner concludes that omission of this information would be significant and if management is unwilling to either correct the departure or disclose the information, the practitioner may consider withdrawing from the engagement.

Subsequent Events

Events or transactions sometimes occur subsequent to the point in time or period of time covered by the practitioner's report but prior to the date of the practitioner's report that have a material effect on the subject matter or assertion and therefore require adjustment or disclosure in the presentation of the subject matter or assertion. These occurrences are referred to as subsequent events. In performing an attest engagement, a practitioner should consider information about subsequent events that comes to his or her attention. Two types of subsequent events require consideration by the practitioner.

The first type consists of events that provide additional information with respect to conditions that existed at the point in time or during the period of time covered by the practitioner's report. This information should be used by the practitioner in considering whether the subject matter or assertion is presented in conformity with the criteria and may affect the presentation of the subject matter, the assertion, or the practitioner's report.

The second type consists of those events that provide information with respect to conditions that arose subsequent to the point in time or period of time covered by the practitioner's report that are of such a nature and significance that their disclosure is necessary to keep the subject matter from being misleading. This type of information will not normally affect the practitioner's report if the information is appropriately disclosed.

Although the practitioner has no responsibility to detect subsequent events, the practitioner should inquire of the responsible party (and his or her client if the client is not the responsible party) as to whether they are aware of any subsequent events, through the date of the practitioner's report, that would have a material effect on the subject matter or assertion.⁷ The representation letter ordinarily would include a representation concerning subsequent events.

The practitioner has no responsibility to keep informed of events subsequent to the date of his or her report; however, the practitioner may later become aware of conditions that existed at that date that might have affected the practitioner's report had he or she been aware of them. In such circumstances, the practitioner may wish to consider the guidance in AU-C section 560, *Subsequent Events and Subsequently Discovered Facts* (AICPA, *Professional Standards*).⁸ [Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

Review Engagements

A review engagement performed in accordance with Statements on Standards for Attestation Engagements is a type of attestation engagement in which the practitioner reports on whether any information came to his or her attention

⁷ Certain attestation standards include requirements regarding the practitioner's consideration of subsequent events, for example, AT section 501 paragraphs .73-.76 and AT section 601 paragraphs .50-.52.

⁸ See AT section 101 paragraphs .95-.99.

on the basis of the work performed that indicates that the subject matter is not based on (or in conformity with) the criteria, or the assertion is not presented (or fairly stated) in all material respects based on the criteria. Such review engagements generally are limited to inquiry and analytical review procedures. Accordingly, the committee has determined that review engagements should not be performed when reporting on controls over a system in accordance with trust services principles and criteria.

Agreed-Upon Procedures Engagements

A client may request that a practitioner perform an agreed-upon procedures engagement related to the trust services principles and criteria. In such an engagement, the practitioner performs specified procedures agreed to by the specified parties,⁹ and reports his or her findings. Because the needs of the parties may vary widely, the nature, timing, and extent of the agreed-upon procedures may vary as well; consequently, the specified parties assume responsibility for the sufficiency of the procedures since they best understand their own needs. In an agreed-upon procedures engagement, the practitioner does not perform an examination of an assertion or subject matter or express an opinion about the assertion or subject matter. The practitioner's report on agreed-upon procedures is a presentation of procedures and findings.¹⁰ The use of an agreed-upon procedures report is restricted to the specified parties who agreed upon the procedures.

Illustrative Reports

The following are illustrative reports for trust services examination engagements. Illustrations 1, 2, and 3 are examples of reports in which the practitioner is reporting on management's assertion. Illustrations 4 and 5 are examples of reports in which the practitioner is reporting directly on the subject matter. The first paragraph of the practitioner's report will indicate whether the practitioner is reporting on management's assertion or directly on the subject matter.

The trust services principles and criteria for *system reliability* include availability, security, and processing integrity. There is also a fourth principle and set of criteria related to confidentiality that a practitioner may report on.

The trust services principles and criteria related to availability, processing integrity and confidentiality include criteria that refer to commitments the entity has made to customers. For those principles and criteria, the client may request that the practitioner (1) report on controls over commitments (in which case the report will make no special reference to commitments) or (2) report on controls over commitments *and* on whether the entity has complied with those commitments (in which case the report will make reference to the commitments, as shown in illustration 3).

A client may include a list of its controls over the system related to the principles and criteria being reported on. An illustrative report for that option is shown in illustration 5.

These reports are for illustrative purposes and should be modified in accordance with the applicable professional standards as the specific engagement facts and circumstances warrant.

⁹ The specified users and the practitioner agree upon the procedures to be performed by the practitioner.

¹⁰ See AT section 201, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*), for guidance on agreed-upon procedures engagements.

Illustration 1—Trust Services Report on Management’s Assertion about the Effectiveness of Controls Related to Four Principles (Availability, Security, Process Integrity, and Confidentiality) (Period-of-Time Report)

Independent Practitioner’s Trust Services Report

To the management of ABC Company, Inc.:

We have examined management’s assertion that during the period [month, day, and year] through [month, day, and year], ABC Company, Inc. (ABC Company) maintained effective controls over the _____ [type or name of system] system based on the AICPA and CICA trust services availability, security, processing integrity, and confidentiality criteria to provide reasonable assurance that

- the system was available for operation and use, as committed or agreed;
- the system was protected against unauthorized access (both physical and logical);
- the system processing was complete, accurate, timely, and authorized; and
- information designated as confidential was protected by the system as committed or agreed

based on the AICPA and CICA trust services security, availability, processing integrity, and confidentiality criteria.

ABC Company’s management is responsible for this assertion. Our responsibility is to express an opinion based on our examination. Management’s description of the aspects of the _____ [type or name of system] system covered by its assertion is attached. We did not examine this description, and accordingly, we do not express an opinion on it.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included (1) obtaining an understanding of ABC Company’s relevant controls over the availability, security, processing integrity, and confidentiality of the _____ [type or name of system] system; (2) testing and evaluating the operating effectiveness of the controls; and (3) 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 nature and inherent limitations of controls, ABC Company’s ability to meet the aforementioned criteria may be affected. For example, controls may not prevent or detect and correct error or fraud, unauthorized access to systems and information, or failure to comply with internal and external policies or requirements. Also, 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.

In our opinion, management’s assertion referred to above is fairly stated, in all material respects, based on the AICPA and CICA trust services security, availability, processing integrity, and confidentiality criteria.

[Name of CPA firm]

Certified Public Accountants

[City, State]

[Date]

[See notes to illustrative reports prepared under AICPA standards.]

Illustration 2—Trust Services Report on Management’s Assertion about the Effectiveness of Controls over System Reliability (Availability, Security, and Processing Integrity (Period-of-Time Report))

Independent Practitioner’s Trust Services Report on System Reliability

To the management of ABC Company, Inc.:

We have examined the assertion made by management of ABC Company, Inc. (ABC Company) about its controls over the reliability of the _____ [type or name of system] system during the period [month, day, year] through [month, day, year] based on the AICPA and CICA trust services availability, security, and processing integrity criteria for systems reliability. A reliable system is one that is capable of operating without material error, fault, or failure during a specified period in a specified environment. Management’s assertion is included in the accompanying document titled “ABC Company’s Assertion Regarding the Effectiveness of Its Controls Over the _____ [type or name of system] System” and states that:

During the period [month, day, year] through [month, day, year], ABC Company maintained effective controls over the availability, security and processing integrity of the _____ [type or name of system] system to provide reasonable assurance that

- the system was available for operation and use, as committed or agreed;
- the system was protected against unauthorized access (both physical and logical); and
- the system processing was complete, accurate, timely, and authorized

based on the AICPA and CICA trust services availability, security, and processing integrity criteria for systems reliability.

The attached system description of ABC Company’s _____ [type or name of system] system identifies the aspects of the _____ [type or name of system] system covered by the assertion.

ABC Company’s management is responsible for this assertion. Our responsibility is to express an opinion based on our examination. Management’s description of the aspects of the _____ [type or name of system] system covered by its assertion is attached. We did not examine this description, and accordingly, we do not express an opinion on it.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included (1) obtaining an understanding of ABC Company’s relevant controls over the availability, security, and processing integrity of the _____ [type or name of system] system; (2) testing and evaluating the operating effectiveness of the controls; and (3) 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 nature and inherent limitations of controls, ABC Company’s ability to meet the aforementioned criteria may be affected. For example, controls may not prevent or detect and correct error or fraud, unauthorized access to systems and information, and failure to comply with internal and external policies or requirements. Also, 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.

In our opinion, management's assertion referred to above is fairly stated in all material respects, based on the AICPA and CICA trust services availability, security, and processing integrity criteria for systems reliability.

[Name of CPA firm]

Certified Public Accountants

[City, State]

[Date]

[See notes to illustrative reports prepared under AICPA standards.]

Illustration 3—Trust Services Report on Management’s Assertion About the Effectiveness of Controls and Compliance With the Criteria for One Principle (Confidentiality) (Point-in-Time Report)

Independent Practitioner’s Trust Services Report

To the management of ABC Company, Inc.:

We have examined management’s assertion [*hot link to management’s assertion*] that as of [*month, day, year*] ABC Company, Inc. (ABC Company) maintained effective controls over the _____ [*type or name of system*] system to provide reasonable assurance that the _____ [*type or name of system*] system protected information designated as confidential, as committed or agreed upon and complied with its commitments regarding the protection of information designated as confidential [*hot link to management’s commitments*] based on the AICPA and CICA trust services confidentiality criteria.

ABC Company’s management is responsible for this assertion. Our responsibility is to express an opinion based on our examination. Management’s description of the aspects of the _____ [*type or name of system*] system covered by its assertion is attached. We did not examine this description, and accordingly, we do not express an opinion on it.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included (1) obtaining an understanding of the controls over the protection of information designated as confidential in ABC Company’s _____ [*type or name of system*] system; (2) testing and evaluating the operating effectiveness of those controls; (3) testing compliance with ABC Company’s commitments regarding the protection of information designated as confidential, and (4) 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 nature and inherent limitations of controls, ABC Company’s ability to meet the aforementioned criteria and its commitments may be affected. For example, controls may not prevent or detect and correct error or fraud, unauthorized access to systems and information, and failure to comply with internal and external policies or requirements. Also, 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.

In our opinion, ABC Company’s management’s assertion referred to above is fairly stated, in all material respects, based on the AICPA and CICA trust services confidentiality criteria.

[*Name of CPA firm*]

Certified Public Accountants

[*City, State*]

[*Date*]

[*See notes to illustrative reports prepared under AICPA standards.*]

Illustration 4—Trust Services Report on System Reliability (Availability, Security, and Processing Integrity)—Reporting Directly on the Subject Matter (Period-of-Time Report)

Independent Practitioner’s Trust Services Report on System Reliability

To the management of ABC Company, Inc.:

We have examined the effectiveness of ABC Company, Inc.’s (ABC Company) controls over the reliability of its _____ [*type or name of system*] system during the period [*month, day, year*] through [*month, day, year*] based on the AICPA and CICA trust services availability, security, and processing integrity criteria for systems reliability. A reliable system is one that is capable of operating without material error, fault, or failure during a specified period in a specified environment. ABC Company’s management is responsible for maintaining the effectiveness of these controls. Our responsibility is to express an opinion based on our examination.

Management’s description of the aspects of the _____ [*type or name of system*] system covered by its assertion is attached. We did not examine this description, and accordingly, we do not express an opinion on it.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included (1) obtaining an understanding of ABC Company’s relevant controls over availability, security, and processing integrity; (2) testing and evaluating the operating effectiveness of the controls; and (3) 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 nature and inherent limitations of controls, ABC Company’s ability to meet the aforementioned criteria may be affected. For example, controls may not prevent or detect and correct error or fraud, unauthorized access to systems and information, and failure to comply with internal and external policies or requirements. Also, 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.

In our opinion, ABC Company maintained, in all material respects, effective controls over the reliability of ABC Company’s _____ [*type or name of system*] system to provide reasonable assurance that

- the system was available for operation and use, as committed or agreed;
- the system was protected against unauthorized access (both physical and logical); and
- the system processing was complete, accurate, timely, and authorized during the period [*month, day, year*] through [*month, day, year*],

based on the AICPA and CICA trust services availability, security, and processing integrity criteria for systems reliability.

[*Name of CPA firm*]

Certified Public Accountants

[*City, State*]

[*Date*]

[*See notes to illustrative reports prepared under AICPA standards.*]

Illustration 5—Trust Services Report on the Effectiveness of Controls Related to One Principle (Security)—Reporting Directly on the Subject Matter (Period-of-Time Report Including Schedule Describing Controls)

Independent Practitioner’s Trust Services Report

To the management of ABC Company, Inc.:

We have examined the effectiveness of ABC Company, Inc.’s (ABC Company) controls, described in schedule X, over the security of its _____ [type or name of system] system during the period [month, day, year] through [month, day, year] based on the AICPA and CICA trust services security criteria. ABC Company’s management is responsible for maintaining the effectiveness of these controls. Our responsibility is to express an opinion based on our examination.

Management’s description of the aspects of the _____ [type or name of system] system covered by its assertion is attached. We did not examine this description, and accordingly, we do not express an opinion on it.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included (1) obtaining an understanding of the ABC Company’s controls over the security of _____ [type or name of system] system; (2) testing and evaluating the operating effectiveness of those controls; and (3) 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 nature and inherent limitations of controls, ABC Company’s ability to meet the aforementioned criteria may be affected. For example, controls may not prevent or detect and correct error or fraud, unauthorized access to systems and information, and failure to comply with internal and external policies or requirements. Also, 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.

In our opinion, ABC Company maintained, in all material respects, effective controls, described in schedule X, over the security of ABC Company’s _____ [type or name of system] system to provide reasonable assurance that the ABC Company’s _____ [type or name of system] system was protected against unauthorized access (both physical and logical) during the period [month, day, year] through [month, day, year], based on the AICPA and CICA trust services security criteria.

[Name of CPA firm]

Certified Public Accountants

[City, State]

[Date]

[See notes to illustrative reports prepared under AICPA standards.]

Schedule X—Controls Over the Security of ABC Company's _____ [type or name of system] System Supporting the AICPA and CICA Trust Services Security Criteria

The system is protected against unauthorized access (both physical and logical).

1.0	Policies: The entity defines and documents its policies for the security of its system.	Controls
1.1	The entity's security policies are established and periodically reviewed and approved by a designated individual or group.	<p>The company's documented systems development and acquisition process includes procedures to identify and document authorized users of the system and their security requirements.</p> <p>User requirements are documented in service-level agreements or other documents.</p> <p>The security officer reviews security policies annually and submits proposed changes for the approval by the IT standards committee.</p>
1.2	<p>The entity's security policies include, but may not be limited to, the following matters:</p> <ul style="list-style-type: none"> <li data-bbox="242 777 557 869">a. Identifying and documenting the security requirements of authorized users. <li data-bbox="242 887 557 1100">b. Classifying data based on its criticality and sensitivity and that classification is used to define protection requirements, access right and access restrictions, and retention and destruction requirements. <li data-bbox="242 1117 489 1159">c. Assessing risks on a periodic basis <li data-bbox="242 1177 534 1218">d. Preventing unauthorized access. <li data-bbox="242 1236 557 1352">e. Adding new users, modifying the access levels of existing users, and removing users who no longer need access. <li data-bbox="242 1369 523 1433">f. Assigning responsibility and accountability for system security. <li data-bbox="242 1451 523 1538">g. Assigning responsibility and accountability for system changes and maintenance. 	The company's documented security policies contain the elements set out in criterion 1.2.

(continued)

- h.* Testing, evaluating, and authorizing system components before implementation.
 - i.* Addressing how complaints and requests relating to security issues are resolved.
 - j.* Identifying and mitigating security breaches and other incidents.
 - k.* Providing for training and other resources to support its system security policies.
 - l.* Providing for the handling of exceptions and situations not specifically addressed in its system security policies.
 - m.* Providing for the identification of and consistency with, applicable laws and regulations, defined commitments, service-level agreements, and other contractual requirements.
 - n.* Providing for sharing information with third parties.
- 1.3 Responsibility and accountability for the entity's system security policies, and changes and updates to those policies, are assigned.

Management has assigned responsibilities for the maintenance and enforcement of the company security policy to the CIO. Others on the executive committee assist in the review, update, and approval of the policy as outlined in the executive committee handbook.

Ownership and custody of significant information resources (for example, data, programs, and transactions) and responsibility for establishing and maintaining security over such resources is defined.

This schedule is for illustrative purposes only and does not contain all of the criteria for the security principle. When the practitioner is reporting on more than one principle, a similar format would be used to detail the appropriate criteria and controls. The practitioner is not bound by this presentation format and may use other alternative presentation styles.

Appendix D

Generally Accepted Privacy Principles

August 2009

Acknowledgments

The AICPA and Canadian Institute of Chartered Accountants (CICA) appreciate the contribution of the volunteers who devoted significant time and effort to this project. The institutes also acknowledge the support that the following organizations have provided to the development of *Generally Accepted Privacy Principles*:

- ISACA
- The Institute of Internal Auditors

Notice to Readers

This CPA and CA practitioner version is identical to *Generally Accepted Privacy Principles* with the exception of appendix B, “CPA and CA Practitioner Services Using Generally Accepted Privacy Principles,” and appendix C, “Illustrative Privacy Examination and Audit Reports.” These additional appendixes are intended primarily to assist CPAs and CAs in public practice in providing privacy services to their clients. Effective October 30, 2009.

Foreword

The AICPA and the Canadian Institute of Chartered Accountants (CICA) strongly believe that privacy is a business issue. Considering what organizations face when trying to address privacy issues, we quickly concluded that businesses did not have a comprehensive framework to manage their privacy risks effectively. The institutes decided that they could provide a significant contribution by developing a privacy framework that would address the needs of all of the parties affected by privacy requirements or expectations. Therefore, the institutes developed a privacy framework called AICPA and CICA *Generally Accepted Privacy Principles*. The institutes are making these principles and criteria widely available to all parties interested in addressing privacy issues.

These principles and criteria were developed and updated by volunteers who considered both current international privacy regulatory requirements and best practices. These principles and criteria were issued following the due process procedures of both institutes, which included exposure for public comment. The adoption of these principles and criteria is voluntary.

An underlying premise to these principles is that good privacy is good business. Good privacy practices are a key component of corporate governance and accountability. One of today’s key business imperatives is maintaining the privacy of personal information collected and held by an organization. As business systems and processes become increasingly complex and sophisticated, growing amounts of personal information are being collected. Because more data is being collected and held, most often in electronic format, personal information may be at risk to a variety of vulnerabilities, including loss, misuse, unauthorized access, and unauthorized disclosure. Those vulnerabilities raise concerns for organizations, governments, individuals, and the public in general.

For organizations operating in a multijurisdictional environment, managing privacy risk can be an even more significant challenge. Adherence to generally accepted privacy principles does not guarantee compliance with all laws and regulations to which an organization is subject. Organizations need to be aware of the significant privacy requirements in all of the jurisdictions in which they do business. Although this framework provides guidance on privacy in general, organizations should consult their own legal counsel to obtain advice and guidance on particular laws and regulations governing an organization's specific situation.

With these issues in mind, the AICPA and CICA developed *Generally Accepted Privacy Principles* to be used as an operational framework to help management address privacy in a manner that takes into consideration many local, national, or international requirements. The primary objective is to facilitate privacy compliance and effective privacy management. The secondary objective is to provide suitable criteria against which a privacy attestation engagement (usually referred to as a privacy audit) can be performed.

Generally Accepted Privacy Principles represents the AICPA and CICA contribution to aid organizations in maintaining the effective management of privacy risk, recognizing the needs of organizations, and reflecting the public interest. Additional history about the development and additional privacy resources can be found online at www.aicpa.org/INTERESTAREAS/INFORMATIONTECHNOLOGY/RESOURCES/PRIVACY/Pages/default.aspx and www.cica.ca/privacy. *Generally Accepted Privacy Principles* can be downloaded from the AICPA and the CICA websites, at www.aicpa.org/INTERESTAREAS/INFORMATIONTECHNOLOGY/RESOURCES/PRIVACY/Pages/default.aspx and www.cica.ca/privacy, respectively.

Because the privacy environment is constantly changing, *Generally Accepted Privacy Principles* will need to be revised from time to time; accordingly, please forward any comments about this document by email to the AICPA (GAPP@aicpa.org) or the CICA (privacy@cica.ca).

AICPA

CICA

Privacy—An Introduction to Generally Accepted Privacy Principles

Introduction

Many organizations find challenges in managing privacy¹ on local, national, or international bases. Most are faced with a number of differing privacy laws and regulations whose requirements need to be operationalized.

Generally Accepted Privacy Principles (GAPP) has been developed from a business perspective, referencing some, but by no means all, significant local, national, and international privacy regulations. GAPP operationalizes complex privacy requirements into a single privacy objective that is supported by 10 privacy principles. Each principle is supported by objective, measurable criteria that form the basis for effective management of privacy risk and compliance in an organization. Illustrative policy requirements, communications, and controls, including monitoring controls, are provided as support for the criteria.

¹ The first occurrence of each word contained in the glossary is hyperlinked to the top of glossary.

GAPP can be used by any organization as part of its privacy program. GAPP has been developed to help management create an effective privacy program that addresses privacy risks and obligations, and business opportunities. It can also be a useful tool to boards and others charged with governance and providing oversight. This introduction includes a definition of privacy and an explanation of why privacy is a business issue and not solely a compliance issue. Also illustrated is how these principles can be applied to outsourcing scenarios and the potential types of privacy initiatives that can be undertaken for the benefit of organizations and their customers.

This introduction and the set of privacy principles and related criteria that follow will be useful to those who

- oversee and monitor privacy and security programs.
- implement and manage privacy in an organization.
- implement and manage security in an organization.
- oversee and manage risks and compliance in an organization.
- assess compliance and audit privacy and security programs.
- regulate privacy.

Why Privacy Is a Business Issue

Good privacy is good business. Good privacy practices are a key part of corporate governance and accountability. One of today's key business imperatives is maintaining the privacy of personal information. As business systems and processes become increasingly complex and sophisticated, organizations are collecting growing amounts of personal information. As a result, personal information is vulnerable to a variety of risks, including loss, misuse, unauthorized access, and unauthorized disclosure. Those vulnerabilities raise concerns for organizations, governments, and the public in general.

Organizations are trying to strike a balance between the proper collection and use of their customers' personal information. Governments are trying to protect the public interest and, at the same time, manage their cache of personal information gathered from citizens. Consumers are very concerned about their personal information, and many believe they have lost control of it. Furthermore, the public has a significant concern about identity theft and inappropriate access to personal information, especially financial and medical records, and information about children.

Individuals expect their privacy to be respected and their personal information to be protected by the organizations with which they do business. They are no longer willing to overlook an organization's failure to protect their privacy. Therefore, all businesses need to effectively address privacy as a risk management issue. The following are specific risks of having inadequate privacy policies and procedures:

- Damage to the organization's reputation, brand, or business relationships
- Legal liability and industry or regulatory sanctions
- Charges of deceptive business practices
- Customer or employee distrust
- Denial of consent by individuals to have their personal information used for business purposes
- Lost business and consequential reduction in revenue and market share

- Disruption of international business operations
- Liability resulting from identity theft

International Privacy Considerations

For organizations operating in more than one country, the management of their privacy risk can be a significant challenge.

For example, the global nature of the Internet and business means regulatory actions in one country may affect the rights and obligations of individual users and customers around the world. Many countries have laws regulating trans-border data flow, including the European Union's (EU) directives on data protection and privacy, with which an organization must comply if it wants to do business in those countries. Therefore, organizations need to comply with changing privacy requirements around the world. Further, different jurisdictions have different privacy philosophies, making international compliance a complex task. To illustrate this, some countries view personal information as belonging to the individual and take the position that the enterprise has a fiduciary-like relationship when collecting and maintaining such information. Alternatively, other countries view personal information as belonging to the enterprise that collects it.

In addition, organizations are challenged to try and stay up to date with the requirements for each country in which they do business. By adhering to a high global standard, such as those set out in this document, compliance with many regulations will be facilitated.

Even organizations with limited international exposure often face issues of compliance with privacy requirements in other countries. Many of these organizations are unsure how to address often stricter overseas regulations. This increases the risk that an organization inadvertently could commit a breach that becomes an example to be publicized by the offended host country.

Furthermore, many local jurisdictions (such as states or provinces) and certain industries, such as healthcare or banking, have specific requirements related to privacy.

Outsourcing and Privacy

Outsourcing increases the complexity for dealing with privacy. An organization may outsource a part of its business process and, with it, some responsibility for privacy; however, the organization cannot outsource its ultimate responsibility for privacy for its business processes. Complexity increases when the entity that performs the outsourced service is in a different country and may be subject to different privacy laws or perhaps no privacy requirements at all. In such circumstances, the organization that outsources a business process will need to ensure it manages its privacy responsibilities appropriately.

GAPP and its supporting criteria can assist an organization in completing assessments (including independent examinations) about the privacy policies, procedures, and practices of the third party providing the outsourced services.

The fact that these principles and criteria have global application can provide comfort to an outsourcer that privacy assessments can be undertaken using a consistent measurement based on internationally known fair information practices.

What Is Privacy?

Privacy Definition

Privacy is defined in Generally Accepted Privacy Principles as “the rights and obligations of individuals and organizations with respect to the collection, use, retention, disclosure, and disposal of personal information.”

Personal Information

Personal information (sometimes referred to as personally identifiable information) is information that is about, or can be related to, an identifiable individual. It includes any information that can be linked to an individual or used to directly or indirectly identify an individual. Individuals, for this purpose, include prospective, current, and former customers, employees, and others with whom the entity has a relationship. Most information collected by an organization about an individual is likely to be considered personal information if it can be attributed to an identified individual. Some examples of personal information are as follows:

- Name
- Home or e-mail address
- Identification number (for example, a Social Security or Social Insurance Number)
- Physical characteristics
- Consumer purchase history

Some personal information is considered sensitive. Some laws and regulations define the following to be sensitive personal information:

- Information on medical or health conditions
- Financial information
- Racial or ethnic origin
- Political opinions
- Religious or philosophical beliefs
- Trade union membership
- Sexual preferences
- Information related to offenses or criminal convictions

Sensitive personal information generally requires an extra level of protection and a higher duty of care. For example, some jurisdictions may require explicit consent rather than implicit consent for the collection and use of sensitive information.

Some information about or related to people cannot be associated with specific individuals. Such information is referred to as *nonpersonal information*. This includes statistical or summarized personal information for which the identity of the individual is unknown or linkage to the individual has been removed. In such cases, the individual’s identity cannot be determined from the information that remains because the information is deidentified or anonymized. Nonpersonal information ordinarily is not subject to privacy protection because it cannot be linked to an individual. However, some organizations may still have obligations over nonpersonal information due to other regulations and agreements (for example, clinical research and market research).

Privacy or Confidentiality?

Unlike personal information, which is often defined by law or regulation, no single definition of confidential information exists that is widely recognized. In the course of communicating and transacting business, partners often exchange information or data that one or the other party requires be maintained on a “need to know” basis. Examples of the kinds of information that may be subject to a confidentiality requirement include the following:

- Transaction details
- Engineering drawings
- Business plans
- Banking information about businesses
- Inventory availability
- Bid or ask prices
- Price lists
- Legal documents
- Revenue by client and industry

Also, unlike personal information, rights of access to confidential information to ensure its accuracy and completeness are not clearly defined. As a result, interpretations of what is considered to be confidential information can vary significantly from organization to organization and, in most cases, are driven by contractual arrangements. For additional information on criteria for confidentiality, refer to the AICPA and CICA *Trust Services Principles, Criteria, and Illustrations for Security, Availability, Processing Integrity, Confidentiality, and Privacy* (see www.aicpa.org/INTERESTAREAS/INFORMATIONTECHNOLOGY/RESOURCES/TRUSTSERVICES/Pages/default.aspx or www.webtrust.org).

Introducing Generally Accepted Privacy Principles

GAPP is designed to assist management in creating an effective privacy program that addresses their privacy obligations, risks, and business opportunities.

The privacy principles and criteria are founded on key concepts from significant local, national, and international privacy laws, regulations, guidelines,² and good business practices. By using GAPP, organizations can proactively address the significant challenges that they face in establishing and managing their privacy programs and risks from a business perspective. GAPP also facilitates the management of privacy risk on a multijurisdictional basis.

² For example, the Organisation for Economic Co-operation and Development has issued Guidelines on the Protection of Privacy and Transborder Flows of Personal Data and the European Union has issued Directive on Data Privacy (Directive 95/46/EC). In addition, the United States has enacted the Gramm-Leach-Bliley Act, the Health Insurance Portability and Accountability Act, and the Children’s Online Privacy Protection Act. Canada has enacted the Personal Information Protection and Electronic Documents Act and Australia has enacted the Australian Privacy Act of 1988, as amended in 2001. A chart comparing these international privacy concepts with generally accepted privacy principles can be found online at www.aicpa.org/INTERESTAREAS/INFORMATIONTECHNOLOGY/RESOURCES/PRIVACY/Pages/default.aspx. Compliance with this set of generally accepted privacy principles and criteria may not necessarily result in compliance with applicable privacy laws and regulations, and entities should seek appropriate legal advice regarding compliance with any laws and regulations.

Overall Privacy Objective

The privacy principles and criteria are founded on the following privacy objective.

Personal information is collected, used, retained, disclosed, and disposed of in conformity with the commitments in the entity's privacy notice and with criteria set forth in Generally Accepted Privacy Principles issued by the AICPA and CICA.

Generally Accepted Privacy Principles

The privacy principles are essential to the proper protection and management of personal information. They are based on internationally known fair information practices included in many privacy laws and regulations of various jurisdictions around the world and recognized good privacy practices.

The following are the 10 *generally accepted privacy principles*:

1. *Management.* The entity defines, documents, communicates, and assigns accountability for its privacy policies and procedures.
2. *Notice.* The entity provides notice about its privacy policies and procedures and identifies the purposes for which personal information is collected, used, retained, and disclosed.
3. *Choice and consent.* The entity describes the choices available to the individual and obtains implicit or explicit consent with respect to the collection, use, and disclosure of personal information.
4. *Collection.* The entity collects personal information only for the purposes identified in the notice.
5. *Use, retention, and disposal.* The entity limits the use of personal information to the purposes identified in the notice and for which the individual has provided implicit or explicit consent. The entity retains personal information for only as long as necessary to fulfill the stated purposes or as required by law or regulations and thereafter appropriately disposes of such information.
6. *Access.* The entity provides individuals with access to their personal information for review and update.
7. *Disclosure to third parties.* The entity discloses personal information to third parties only for the purposes identified in the notice and with the implicit or explicit consent of the individual.
8. *Security for privacy.* The entity protects personal information against unauthorized access (both physical and logical).
9. *Quality.* The entity maintains accurate, complete, and relevant personal information for the purposes identified in the notice.
10. *Monitoring and enforcement.* The entity monitors compliance with its privacy policies and procedures and has procedures to address privacy related complaints and disputes.

For each of the 10 privacy principles, relevant, objective, complete, and measurable criteria have been specified to guide the development and evaluation of an entity's privacy policies, communications, and procedures and controls. *Privacy policies* are written statements that convey management's intent,

objectives, requirements, responsibilities, and standards. *Communications* refers to the organization's communication to individuals, internal personnel, and third parties about its privacy notice and its commitments therein and other relevant information. *Procedures and controls* are the other actions the organization takes to achieve the criteria.

Using GAPP

GAPP can be used by organizations for the following:

- Designing, implementing, and communicating privacy policy
- Establishing and managing privacy programs
- Monitoring and auditing privacy programs
- Measuring performance and benchmarking

Establishing and managing a privacy program involves the following activities:

Strategizing. Performing privacy strategic and business planning.

Diagnosing. Performing privacy gap and risk analyses.

Implementing. Developing, documenting, introducing, and institutionalizing the program's action plan, including establishing controls over personal information.

Sustaining and managing. Monitoring activities of a privacy program.

Auditing. Internal or external auditors evaluating the organization's privacy program.

The following table summarizes and illustrates how GAPP can be used by an organization to address these business activities.

<i>Activity</i>	<i>General Discussion</i>	<i>Potential Use of Generally Accepted Privacy Principles</i>
Strategizing	<p>Vision. An entity's strategy is concerned with its long-term direction and prosperity. The vision identifies the entity's culture and helps shape and determine how the entity will interact with its external environment, including customers, competitors, and legal, social, and ethical issues.</p> <p>Strategic Planning. This is an entity's overall master plan, encompassing its strategic direction. Its objective is to ensure that the entity's efforts are all headed in a common direction. The strategic plan identifies the entity's long-term goals and major issues for becoming privacy compliant.</p>	<p>Vision. Within an entity's privacy effort, establishing the vision helps the entity integrate preferences and prioritize goals.</p> <p>Strategic Planning. Within an entity's privacy effort, <i>Generally Accepted Privacy Principles</i> (GAPP) can be used to assist the organization in identifying significant components that need to be addressed.</p> <p>Resource Allocation. Using GAPP, the entity would identify the people working with and responsible for areas that might include systems management, privacy and security concerns, and stipulate</p>

<i>Activity</i>	<i>General Discussion</i>	<i>Potential Use of Generally Accepted Privacy Principles</i>
Diagnosing	<p>Resource Allocation. This step identifies the human, financial, and other resources allocated to achieve the goals and objectives set forth in the strategic plan or business plan.</p> <p>This stage, often referred to as the assessment phase, encompasses a thorough analysis of the entity's environment, identifying opportunities where weaknesses, vulnerability, and threats exist. The most common initial project for an organization is a diagnostic assessment. The purpose of such an assessment is to evaluate the entity against its privacy goals and objectives and determine to what extent the organization is achieving those goals and objectives.</p>	<p>the resourcing for their activities.</p> <p>Overall Strategy. A strategic document describes expected or intended future development. GAPP can assist an entity in clarifying plans for the systems under consideration or for the business's privacy objectives. The plan identifies the process to achieve goals and milestones. It also provides a mechanism to communicate critical implementation elements, including details on services, budgets, development costs, promotion, and privacy advertising.</p> <p>GAPP can assist the entity in understanding its high-level risks, opportunities, needs, privacy policy and practices, competitive pressures, and the requirements of the relevant laws and regulations to which the entity is subject.</p> <p>GAPP provides a legislative neutral benchmark to allow the entity to assess the current state of privacy against the desired state.</p>
Implementing	<p>At this point, an action plan is mobilized or a diagnostic recommendation is put into effect, or both. Implementing involves developing and documenting a privacy program and action plan and the execution of all planned and other tasks necessary to make the action plan operational. It includes defining who will perform what tasks, assigning responsibilities, and establishing schedules and milestones. This involves the planning and implementation of a series of planned projects to provide guidance, direction, methodology, and tools to the organization in developing its initiatives.</p>	<p>GAPP can assist the entity in meeting its implementation goals. At the completion of the implementation phase, the entity should have developed the following deliverables:</p> <ul style="list-style-type: none"> • Systems, procedures, and processes to address the privacy requirements • Updated privacy compliant forms, brochures, and contracts • Internal and external privacy awareness programs
Sustaining and managing	<p>Sustaining and managing involves monitoring the work to</p>	<p>The entity can use GAPP to develop appropriate reporting</p>

(continued)

<i>Activity</i>	<i>General Discussion</i>	<i>Potential Use of Generally Accepted Privacy Principles</i>
	identify how progress differs from the action plan in time to initiate corrective action. Monitoring refers to the management policies, processes, and supporting technology to ensure compliance with organizational privacy policies and procedures and the ability to exhibit due diligence.	criteria for monitoring requests for information, the sources used to compile the information and the information actually disclosed. It can also be used for determining validation procedures to ensure that the parties to whom the information was disclosed are entitled to receive that information.
Internal privacy audit	Internal auditors provide objective assurance and consulting services designed to add value and improve an entity's operations. They help an entity accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.	Internal auditors can evaluate an entity's privacy program and controls using GAPP as a benchmark and provide useful information and reporting to management.
External privacy audit	External auditors, notably certified public accountants (CPAs) and chartered accountants (CAs), can perform attestation and assurance services. Generally, these services, whether performed on financial and nonfinancial information, build trust and confidence for individuals, management, customers, business partners, and other users.	An external auditor can evaluate an entity's privacy program and controls in accordance with GAPP and provide reports useful to individuals, management, customers, business partners, and other users.

Presentation of Generally Accepted Privacy Principles and Criteria

Under each principle, the criteria are presented in a three column format. The first column contains the measurement criteria. The second column contains illustrative controls and procedures, which are designed to provide examples and enhance the understanding of how the criteria might be applied. The illustrations are not intended to be comprehensive, nor are any of the illustrations required for an entity to have met the criteria. The third column contains additional considerations, including supplemental information such as good privacy practices and selected requirements of specific laws and regulations that may pertain to a certain industry or country.

Some of the criteria may not be directly applicable to some organizations or some processes. When a criterion is considered not applicable, the entity should consider justifying that decision to support future evaluation.

These principles and criteria provide a basis for designing, implementing, maintaining, evaluating, and auditing a privacy program to meet an entity's needs.

Generally Accepted Privacy Principles and Criteria Management

<i>Ref.</i>	<i>Management Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
1.0	The entity defines, documents, communicates, and assigns accountability for its privacy policies and procedures.		
1.1	Policies and Communications		
1.1.0	Privacy Policies The entity defines and documents its privacy policies with respect to the following: a. Notice (See 2.1.0) b. Choice and consent (See 3.1.0) c. Collection (See 4.1.0) d. Use, retention, and disposal (See 5.1.0) e. Access (See 6.1.0) f. Disclosure to third parties (See 7.1.0) g. Security for privacy (See 8.1.0) h. Quality (See 9.1.0) i. Monitoring and enforcement (See 10.1.0)	Privacy policies are documented in writing and made readily available to internal personnel and third parties who need them.	
1.1.1	Communication to Internal Personnel Privacy policies and the consequences of noncompliance with such policies are communicated, at least annually, to the entity's internal personnel responsible for collecting, using, retaining, and disclosing personal information. Changes in privacy policies are communicated to such personnel shortly after the changes are approved.	The entity <ul style="list-style-type: none"> periodically communicates to internal personnel (for example, on a network or a website) relevant information about the entity's privacy policies. Changes to its privacy policies are communicated shortly after approval. requires internal personnel to confirm (initially and periodically) their understanding of the entity's privacy policies and their agreement to comply with them. 	Privacy policies (as used herein) include security policies relevant to the protection of personal information.

(continued)

<i>Ref.</i>	<i>Management Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
1.1.2	<p>Responsibility and Accountability for Policies</p> <p>Responsibility and accountability are assigned to a person or group for developing, documenting, implementing, enforcing, monitoring, and updating the entity's privacy policies. The names of such person or group and their responsibilities are communicated to internal personnel.</p>	<p>The entity assigns responsibility for privacy policies to a designated person, such as a corporate privacy officer. (Those assigned responsibility for privacy policies may be different from those assigned for other policies, such as security).</p> <p>The responsibility, authority, and accountability of the designated person or group are clearly documented.</p> <p>Responsibilities include the following:</p> <ul style="list-style-type: none"> • Establishing with management the standards used to classify the sensitivity of personal information and to determine the level of protection required • Formulating and maintaining the entity's privacy policies • Monitoring and updating the entity's privacy policies • Delegating authority for enforcing the entity's privacy policies • Monitoring the degree of compliance and initiating action to improve the training or clarification of policies and practices <p>A committee of the board of directors includes privacy periodically in its regular review of overall corporate governance.</p>	<p>The individual identified as being accountable for privacy should be from within the entity.</p>

<i>Ref.</i>	<i>Management Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
1.2	Procedures and Controls		
1.2.1	<p>Review and Approval</p> <p>Privacy policies and procedures, and changes thereto, are reviewed and approved by management.</p>	<p>Privacy policies and procedures are</p> <ul style="list-style-type: none"> • reviewed and approved by senior management or a management committee. • reviewed at least annually and updated as needed. 	
1.2.2	<p>Consistency of Privacy Policies and Procedures With Laws and Regulations</p> <p>Policies and procedures are reviewed and compared to the requirements of applicable laws and regulations at least annually and whenever changes to such laws and regulations are made. Privacy policies and procedures are revised to conform with the requirements of applicable laws and regulations.</p>	<p>Corporate counsel or the legal department</p> <ul style="list-style-type: none"> • determines which privacy laws and regulations are applicable in the jurisdictions in which the entity operates. • identifies other standards applicable to the entity. • reviews the entity's privacy policies and procedures to ensure they are consistent with the applicable laws, regulations, and appropriate standards. 	<p>In addition to legal and regulatory requirements, some entities may elect to comply with certain standards, such as those published by International Organization for Standardization (ISO), or may be required to comply with certain standards, such as those published by the payment card industry, as a condition of doing business. Entities may include such standards as part of this process.</p>
1.2.3	<p>Personal Information Identification and Classification</p> <p>The types of personal information and sensitive personal information and the related processes, systems, and third parties involved in the handling of such information are identified. Such information is covered by the entity's privacy and related security policies and procedures.</p>	<p>The entity has both an information classification policy and process, which include the following:</p> <ul style="list-style-type: none"> • A classification process, which identifies and classifies information into one or more of the following categories: <ul style="list-style-type: none"> — Business confidential — Personal information (sensitive and other personal information) — Business general — Public • Identifying processes, systems, and 	

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<i>Ref</i>	<i>Management Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		<p>third parties that handle personal information</p> <ul style="list-style-type: none"> • Specific security and privacy policies and procedures that apply to each category of information 	
1.2.4	<p>Risk Assessment A risk assessment process is used to establish a risk baseline and to, at least annually, identify new or changed risks to personal information and to develop and update responses to such risks.</p>	<p>A process is in place to periodically identify the risks to the entity's personal information. Such risks may be external (such as loss of information by vendors or failure to comply with regulatory requirements) or internal (such as e-mailing unprotected sensitive information). When new or changed risks are identified, the privacy risk assessment and the response strategies are updated.</p> <p>The process considers factors such as experience with privacy incident management, the complaint and dispute resolution process, and monitoring activities.</p>	<p>Ideally, the privacy risk assessment should be integrated with the security risk assessment and be a part of the entity's overall enterprise risk management program. The board or a committee of the board should provide oversight and review of the privacy risk assessment.</p>
1.2.5	<p>Consistency of Commitments With Privacy Policies and Procedures</p> <p>Internal personnel or advisers review contracts for consistency with privacy policies and procedures and address any inconsistencies.</p>	<p>Both management and the legal department review all contracts and service-level agreements for consistency with the entity's privacy policies and procedures.</p>	

<i>Ref.</i>	<i>Management Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
1.2.6	<p>Infrastructure and Systems Management</p> <p>The potential privacy impact is assessed when new processes involving personal information are implemented, and when changes are made to such processes (including any such activities outsourced to third parties or contractors), and personal information continues to be protected in accordance with the privacy policies. For this purpose, processes involving personal information include the design, acquisition, development, implementation, configuration, modification and management of the following:</p> <ul style="list-style-type: none"> • Infrastructure • Systems • Applications • Websites • Procedures • Products and services • Data bases and information repositories • Mobile computing and other similar electronic devices <p>The use of personal information in process and system test and development is prohibited unless such information is anonymized or otherwise protected in accordance with the entity's privacy policies and procedures.</p>	<p>The following are used for addressing privacy impact:</p> <ul style="list-style-type: none"> • Management assesses the privacy impact of new and significantly changed products, services, business processes, and infrastructure. • The entity uses a documented systems development and change management process for all information systems and related technology (including manual procedures, application programs, technology infrastructure, organizational structure, and the responsibilities of users and systems personnel), used to collect, use, retain, disclose, and destroy personal information. • The entity assesses planned new systems and changes for their potential effect on privacy. • Changes to system components are tested to minimize the risk of any adverse effect on the protection of personal information. All test data are anonymized. A controlled test database is maintained for full regression testing to ensure that changes to one program do not adversely affect other programs that process personal information. 	<p>Some jurisdictions prohibit the use of personal information for test and development purposes unless it has been anonymized or otherwise protected to the same level required in its policies for production information.</p>

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<i>Ref.</i>	<i>Management Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		<ul style="list-style-type: none"> • Procedures ensure the maintenance of integrity and protection of personal information during migration from old to new or changed systems. • Documentation and approval by the privacy officer, security officer, business unit manager, and IT management are required before implementing the changes to systems and procedures that handle personal information, including those that may affect security. Emergency changes are required to maintain the same level of protection of personal information; however, they may be documented and approved on an after-the-fact basis. <p>The IT function maintains a listing of all software that processes personal information and the respective level, version, and patches that have been applied.</p> <p>Procedures exist to provide that only authorized, tested, and documented changes are made to the system.</p> <p>Where computerized systems are involved, appropriate procedures are followed, such as the use of separate development, test, and production libraries to ensure that access to personal information is appropriately restricted.</p> <p>Personnel responsible for initiating or</p>	

Ref.	Management Criteria	Illustrative Controls and Procedures	Additional Considerations
1.2.7	<p data-bbox="250 473 498 666">Privacy Incident and Breach Management A documented privacy incident and breach management program has been implemented that includes, but is not limited to, the following:</p> <ul data-bbox="250 666 498 1409" style="list-style-type: none"> <li data-bbox="250 666 498 808">• Procedures for the identification, management, and resolution of privacy incidents and breaches <li data-bbox="250 808 498 857">• Defined responsibilities <li data-bbox="250 857 498 999">• A process to identify incident severity and determine required actions and escalation procedures <li data-bbox="250 999 498 1142">• A process for complying with breach laws and regulations, including stakeholders breach notification, if required <li data-bbox="250 1142 498 1284">• An accountability process for employees or third parties responsible for incidents or breaches with remediation, penalties, or discipline as appropriate <li data-bbox="250 1284 498 1409">• A process for periodic review (at least 	<p data-bbox="517 175 747 461">implementing new systems and changes, and users of new or revised processes and applications, are provided training and awareness sessions related to privacy. Specific roles and responsibilities are assigned related to privacy.</p> <p data-bbox="517 473 747 640">A formal, comprehensive privacy incident and breach management program has been implemented, which specifies the following:</p> <ul data-bbox="517 640 747 1409" style="list-style-type: none"> <li data-bbox="517 640 747 1025">• Incidents and breaches are reported to a member of the breach team, who assesses if it is privacy or security related, or both, classifies the severity of the incident, initiates required actions, and determines the required involvement by individuals who are responsible for privacy and security. <li data-bbox="517 1025 747 1409">• The chief privacy officer (CPO) has the overall accountability for the program and is supported by the privacy and security steering committees and assisted by the breach team. Incidents and breaches that do not involve personal information are the responsibility of the chief security officer. 	<p data-bbox="785 473 1036 760">Some entities may adopt a breach notification policy for consistent use across all jurisdictions in which they operate. By necessity, such a policy would, at a minimum, be based on the most comprehensive legal requirements in any such jurisdiction.</p>

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<i>Ref.</i>	<i>Management Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
	<p>on an annual basis) of actual incidents to identify necessary program updates based on the following:</p> <ul style="list-style-type: none"> — Incident patterns and root cause — Changes in the internal control environment or external requirements (regulation or legislation) <ul style="list-style-type: none"> • Periodic testing or walkthrough process (at least on an annual basis) and associated program remediation as needed 	<ul style="list-style-type: none"> • The entity has a privacy breach notification policy, supported by (a) a process for identifying the notification and related requirements of other applicable jurisdictions relating to the data subjects affected by the breach, (b) a process for assessing the need for stakeholders breach notification, if required by law, regulation, or policy, and (c) a process for delivering the notice in a timely manner. The entity has agreements in place with a third party to manage the notification process and provide credit monitoring services for individuals, if needed. • The program includes a clear escalation path, based on the type or severity, or both, of the incident, up to executive management, legal counsel, and the board. • The program sets forth a process for contacting law enforcement, regulatory, or other authorities when necessary. • Program training for new hires and team members, and awareness training for general staff, is conducted annually, when a significant change in the program is implemented, and after any major incident. 	

<i>Ref.</i>	<i>Management Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		<p>The privacy incident and breach management program also specifies the following:</p> <ul style="list-style-type: none"> • After any major privacy incident, a formal incident evaluation is conducted by internal audit or outside consultants. • A quarterly review of actual incidents is conducted and required program updates are identified based on the following: <ul style="list-style-type: none"> — Incident root cause — Incident patterns — Changes in the internal control environment and legislation • Results of the quarterly review are reported to the privacy steering committee and annually to the audit committee. • Key metrics are defined, tracked and reported to senior management on a quarterly basis. • The program is tested at least every six months and shortly after the implementation of significant system or procedural changes. 	
1.2.8	<p>Supporting Resources Resources are provided by the entity to implement and support its privacy policies.</p>	Management annually reviews the assignment of personnel, budgets, and allocation of other resources to its privacy program.	
1.2.9	<p>Qualifications of Internal Personnel</p>	The qualifications of internal personnel responsible for	

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<i>Ref</i>	<i>Management Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
	The entity establishes qualifications for personnel responsible for protecting the privacy and security of personal information and assigns such responsibilities only to those personnel who meet these qualifications and have received needed training.	<p>protecting the privacy and security of personal information are ensured by procedures such as the following:</p> <ul style="list-style-type: none"> • Formal job descriptions (including responsibilities, educational and professional requirements, and organizational reporting for key privacy management positions) • Hiring procedures (including the comprehensive screening of credentials, background checks, and reference checking) and formal employment and confidentiality agreements • Performance appraisals (performed by supervisors, including assessments of professional development activities) 	
1.2.10	<p>Privacy Awareness and Training</p> <p>A privacy awareness program about the entity's privacy policies and related matters, and specific training for selected personnel depending on their roles and responsibilities, are provided.</p>	<p>An interactive online privacy and security awareness course is required annually for all employees. New employees, contractors, and others are required to complete this course within the first month following employment in order to retain their access privileges.</p> <p>In-depth training is provided which covers privacy and relevant security policies and procedures, legal and regulatory considerations, incident response, and related topics. Such training is</p> <ul style="list-style-type: none"> • required annually for all employees who have access to 	

Ref.	Management Criteria	Illustrative Controls and Procedures	Additional Considerations
1.2.11	<p>Changes in Regulatory and Business Requirements For each jurisdiction in which the entity operates, the effect on privacy requirements from changes in the following factors is identified and addressed:</p> <ul style="list-style-type: none"> • Legal and regulatory • Contracts, including service-level agreements • Industry requirements • Business operations and processes • People, roles, and responsibilities • Technology <p>Privacy policies and procedures are updated to reflect changes in requirements.</p>	<p>personal information or are responsible for protection of personal information.</p> <ul style="list-style-type: none"> • tailored to the employee's job responsibilities. • supplemented by external training and conferences. <p>Attendance at the entity's privacy training and awareness courses is monitored.</p> <p>Training and awareness courses are reviewed and updated to reflect current legislative, regulatory, industry, and entity policy and procedure requirements.</p> <p>The entity has an ongoing process in place to monitor, assess, and address the effect on privacy requirements from changes in the following:</p> <ul style="list-style-type: none"> • Legal and regulatory environments • Industry requirements (such as those for the Direct Marketing Association) • Contracts, including service-level agreements with third parties (changes that alter the privacy and security related clauses in contracts are reviewed and approved by the privacy officer or legal counsel before they are executed) • Business operations and processes • People assigned responsibility for privacy and security matters • Technology (prior to implementation) 	<p>Ideally, these procedures would be coordinated with the risk assessment process.</p> <p>The entity also should consider emerging and good practices, such as breach notification in jurisdictions where none is required.</p>

Notice

<i>Ref.</i>	<i>Notice Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
2.0	The entity provides notice about its privacy policies and procedures and identifies the purposes for which personal information is collected, used, retained, and disclosed.		
2.1	Policies and Communications		
2.1.0	Privacy Policies		
	The entity's privacy policies address providing notice to individuals.		
2.1.1	Communication to Individuals	<p>The entity's privacy notice</p> <ul style="list-style-type: none"> describes the personal information collected, the sources of such information, and purposes for which it is collected. indicates the purpose for collecting sensitive personal information and whether such purpose is part of a legal requirement. describes the consequences, if any, of not providing the requested information. indicates that certain information may be developed about individuals, such as buying patterns. may be provided in various ways (for example, in a face-to-face conversation, on a telephone interview, on an application form or questionnaire, or electronically). However, written notice is the preferred method. 	<p>Notice also may describe situations in which personal information will be disclosed, such as the following:</p> <ul style="list-style-type: none"> Certain processing for purposes of public security or defense Certain processing for purposes of public health or safety When allowed or required by law <p>The purpose described in the notice should be stated in such a manner that the individual can reasonably understand the purpose and how the personal information is to be used. Such purpose should be consistent with the business purpose of the entity and not overly broad.</p> <p>Consideration should be given to providing a summary level notice with links to more detailed sections of the policy.</p>
	<p>Notice is provided to individuals regarding the following privacy policies:</p> <ol style="list-style-type: none"> Purpose for collecting personal information Choice and consent (See 3.1.1) Collection (See 4.1.1) Use, retention, and disposal (See 5.1.1) Access (See 6.1.1) Disclosure to third parties (See 7.1.1) Security for privacy (See 8.1.1) Quality (See 9.1.1) Monitoring and enforcement (See 10.1.1) <p>If personal information is collected from sources other than the individual, such sources are described in the notice.</p>		

<i>Ref.</i>	<i>Notice Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
2.2	Procedures and Controls		
2.2.1	<p>Provision of Notice</p> <p>Notice is provided to the individual about the entity's privacy policies and procedures (a) at or before the time personal information is collected, or as soon as practical thereafter, (b) at or before the entity changes its privacy policies and procedures, or as soon as practical thereafter, or (c) before personal information is used for new purposes not previously identified.</p>	<p>The privacy notice is</p> <ul style="list-style-type: none"> • readily accessible and available when personal information is first collected from the individual. • provided in a timely manner (that is, at or before the time personal information is collected, or as soon as practical thereafter) to enable individuals to decide whether or not to submit personal information to the entity. • clearly dated to allow individuals to determine whether the notice has changed since the last time they read it or since the last time they submitted personal information to the entity. <p>In addition, the entity</p> <ul style="list-style-type: none"> • tracks previous iterations of the entity's privacy policies and procedures. • informs individuals of a change to a previously communicated privacy notice, for example, by posting the notification on the entity's website, by sending written notice via postal mail, or by sending an e-mail. • documents that changes to privacy policies and procedures were communicated to individuals. 	<p>See 3.2.2, "Consent for New Purposes and Uses."</p> <p>Some regulatory requirements indicate that a privacy notice is to be provided on a periodic basis, for example, annually in the Gramm-Leach-Bliley Act (GLBA).</p>
2.2.2	<p>Entities and Activities Covered</p> <p>An objective description of the entities and activities covered by</p>	<p>The privacy notice describes the particular entities, business segments, locations, and types of information covered, such as:</p>	

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<i>Ref</i>	<i>Notice Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
	the privacy policies and procedures is included in the entity's privacy notice.	<ul style="list-style-type: none"> • Operating jurisdictions (legal and political) • Business segments and affiliates • Lines of business • Types of third parties (for example, delivery companies and other types of service providers) • Types of information (for example, information about customers and potential customers) • Sources of information (for example, mail order or online) <p>The entity informs individuals when they might assume they are covered by the entity's privacy policies but, in fact, are no longer covered (for example, linking to another website that is similar to the entity's, or using services on the entity's premises provided by third parties).</p>	
2.2.3	Clear and Conspicuous The entity's privacy notice is conspicuous and uses clear language.	<p>The privacy notice is</p> <ul style="list-style-type: none"> • in plain and simple language. • appropriately labeled, easy to see, and not in unusually small print. • linked to or displayed on the website at points of data collection. • available in the national languages used on the site or in languages required by law. 	<p>If multiple notices are used for different subsidiaries or segments of an entity, similar formats are encouraged to avoid consumer confusion and allow consumers to identify any differences.</p> <p>Some regulations may contain specific information that a notice must contain.</p> <p>Illustrative notices are often available for certain industries and types of collection, use, retention, and disclosure.</p>

Choice and Consent

<i>Ref.</i>	<i>Choice and Consent Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
3.0	The entity describes the choices available to the individual and obtains implicit or explicit consent with respect to the collection, use, and disclosure of personal information.		
3.1	Policies and Communications		
3.1.0	Privacy Policies		
	The entity's privacy policies address the choices available to individuals and the consent to be obtained.		
3.1.1	Communication to Individuals		
	Individuals are informed about (a) the choices available to them with respect to the collection, use, and disclosure of personal information, and (b) that implicit or explicit consent is required to collect, use, and disclose personal information, unless a law or regulation specifically requires or allows otherwise.	<p>The entity's privacy notice describes, in a clear and concise manner, the following:</p> <ul style="list-style-type: none"> • The choices available to the individual regarding the collection, use, and disclosure of personal information • The process an individual should follow to exercise these choices (for example, checking an opt out box to decline receiving marketing materials) • The ability of, and process for, an individual to change contact preferences • The consequences of failing to provide personal information required for a transaction or service <p>Individuals are advised of the following:</p> <ul style="list-style-type: none"> • Personal information not essential to the purposes identified in the privacy notice need not be provided. • Preferences may be changed, and consent may be withdrawn at a later 	<p>Some laws and regulations (such as Principle 11, "Limits on disclosure of personal information," section 1 of the Australian Privacy Act of 1988) provide specific exemptions for the entity not to obtain the individual's consent. Examples of such situations include the following:</p> <ul style="list-style-type: none"> • The record keeper believes, on reasonable grounds, that use of the information for that other purpose is necessary to prevent or lessen a serious and imminent threat to the life or health of the individual concerned or another person. • Use of the information for that other purpose is required or authorized by or under law.

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<i>Ref</i>	<i>Choice and Consent Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		time, subject to legal or contractual restrictions and reasonable notice.	
		The type of consent required depends on the nature of the personal information and the method of collection (for example, an individual subscribing to a newsletter gives implied consent to receive communications from the entity).	
3.1.2	<p>Consequences of Denying or Withdrawing Consent When personal information is collected, individuals are informed of the consequences of refusing to provide personal information or of denying or withdrawing consent to use personal information for purposes identified in the notice.</p>	<p>At the time of collection, the entity informs individuals of the following:</p> <ul style="list-style-type: none"> • About the consequences of refusing to provide personal information (for example, transactions may not be processed) • About the consequences of denying or withdrawing consent (for example, opting out of receiving information about products and services may result in not being made aware of sales promotions) • About how they will or will not be affected by failing to provide more than the minimum required personal information (for example, services or products will still be provided) 	
3.2	<p>Procedures and Controls</p>		
3.2.1	<p>Implicit or Explicit Consent Implicit or explicit consent is obtained from the individual at or before the time personal</p>	<p>The entity</p> <ul style="list-style-type: none"> • obtains and documents an individual's consent in a timely manner (that is, at or before the 	

<i>Ref.</i>	<i>Choice and Consent Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
	information is collected or soon after. The individual's preferences expressed in his or her consent are confirmed and implemented.	<p>time personal information is collected or soon after).</p> <ul style="list-style-type: none"> • confirms an individual's preferences (in writing or electronically). • documents and manages changes to an individual's preferences. • ensures that an individual's preferences are implemented in a timely fashion. • addresses conflicts in the records about an individual's preferences by providing a process for users to notify and challenge a vendor's interpretation of their contact preferences. • ensures that the use of personal information, throughout the entity and by third parties, is in accordance with an individual's preferences. 	
3.2.2	<p>Consent for New Purposes and Uses If information that was previously collected is to be used for purposes not previously identified in the privacy notice, the new purpose is documented, the individual is notified, and implicit or explicit consent is obtained prior to such new use or purpose.</p>	<p>When personal information is to be used for a purpose not previously specified, the entity</p> <ul style="list-style-type: none"> • notifies the individual and documents the new purpose. • obtains and documents consent or withdrawal of consent to use the personal information for the new purpose. • ensures that personal information is being used in accordance with the new 	

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<i>Ref</i>	<i>Choice and Consent Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		purpose or, if consent was withdrawn, not so used.	
3.2.3	<p>Explicit Consent for Sensitive Information</p> <p>Explicit consent is obtained directly from the individual when sensitive personal information is collected, used, or disclosed, unless a law or regulation specifically requires otherwise.</p>	<p>The entity collects sensitive information only if the individual provides explicit consent. <i>Explicit consent</i> requires that the individual affirmatively agree, through some action, to the use or disclosure of the sensitive information. Explicit consent is obtained directly from the individual and documented, for example, by requiring the individual to check a box or sign a form. This is sometimes referred to as opt in.</p>	<p>Canada's Personal Information Protection and Electronic Documents Act (PIPEDA), Schedule 1, clause 4.3.6, states that an organization should generally seek explicit consent when the information is likely to be considered sensitive.</p> <p>Many jurisdictions prohibit the collection of sensitive data, unless specifically allowed. For example, in the EU member state of Greece, Article 7 of Greece's "Law on the protection of individuals with regard to the processing of personal data" states, "The collection and processing of sensitive data is forbidden." However, a permit to collect and process sensitive data may be obtained.</p> <p>Some jurisdictions consider government-issued personal identifiers, for example, Social Security numbers or Social Insurance numbers, to be sensitive information.</p>
3.2.4	<p>Consent for Online Data Transfers To or From an Individual's Computer or Other Similar Electronic Devices</p> <p>Consent is obtained before personal</p>	<p>The entity requests customer permission to store, alter, or copy personal information (other than cookies) in the customer's computer or other similar electronic device.</p>	<p>Consideration should be given to prevent or detect the introduction of software that is designed to mine or extract information from a computer or other similar electronic device and therefore</p>

<i>Ref.</i>	<i>Choice and Consent Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
	information is transferred to or from an individual's computer or other similar device.	<p>If the customer has indicated to the entity that it does not want cookies, the entity has controls to ensure that cookies are not stored on the customer's computer or other similar electronic device.</p> <p>Entities will not download software that will transfer personal information without obtaining permission.</p>	may be used to extract personal information, for example, spyware.

Collection

<i>Ref.</i>	<i>Collection Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
4.0	The entity collects personal information only for the purposes identified in the notice.		
4.1	Policies and Communications		
4.1.0	Privacy Policies The entity's privacy policies address the collection of personal information.		Some jurisdictions, such as some countries in Europe, require entities that collect personal information to register with their regulatory body.
4.1.1	Communication to Individuals Individuals are informed that personal information is collected only for the purposes identified in the notice.	The entity's privacy notice discloses the types of personal information collected, the sources and methods used to collect personal information, and whether information is developed or acquired about individuals, such as buying patterns.	
4.1.2	Types of Personal Information Collected and Methods of Collection The types of personal information collected and the methods of collection, including the use of cookies or other	Types of personal information collected include the following: <ul style="list-style-type: none"> • Financial (for example, financial account information) • Health (for example, information about physical or 	Some jurisdictions, such as those in the EU, require that individuals have the opportunity to decline the use of cookies.

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<i>Ref</i>	<i>Collection Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
	tracking techniques, are documented and described in the privacy notice.	<p>mental status or history)</p> <ul style="list-style-type: none"> Demographic (for example, age, income range, social geocodes) <p>Methods of collecting and third-party sources of personal information include the following:</p> <ul style="list-style-type: none"> Credit reporting agencies Over the telephone Via the Internet using forms, cookies, or Web beacons <p>The entity's privacy notice discloses whether it uses cookies and Web beacons and how they are used. The notice also describes the consequences if the cookie is refused.</p>	
4.2	Procedures and Controls		
4.2.1	<p>Collection Limited to Identified Purpose</p> <p>The collection of personal information is limited to that necessary for the purposes identified in the notice.</p>	<p>Systems and procedures are in place to</p> <ul style="list-style-type: none"> specify the personal information essential for the purposes identified in the notice and differentiate it from optional personal information. periodically review the entity's program or service needs for personal information (for example, once every five years or when changes to the program or service are made). obtain explicit consent when sensitive personal information is collected (see 3.2.3, "Explicit Consent for Sensitive Information"). monitor that the collection of personal information is 	

<i>Ref.</i>	<i>Collection Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
4.2.2	<p>Collection by Fair and Lawful Means Methods of collecting personal information are reviewed by management before they are implemented to confirm that personal information is obtained (a) fairly, without intimidation or deception, and (b) lawfully, adhering to all relevant rules of law, whether derived from statute or common law, relating to the collection of personal information.</p>	<p>limited to that necessary for the purposes identified in the privacy notice and that all optional data is identified as such.</p> <p>The entity's management, privacy officer, and legal counsel, review the methods of collection and any changes thereto.</p>	<p>The following may be considered deceptive practices:</p> <ul style="list-style-type: none"> • To use tools, such as cookies and Web beacons, on the entity's website to collect personal information without providing notice to the individual • To link information collected during an individual's visit to a website with personal information from other sources without providing notice to the individual • To use a third party to collect information in order to avoid providing notice to individuals <p>Entities should consider legal and regulatory requirements in jurisdictions other than the one in which they operate (for example, an entity in Canada collecting personal information about Europeans may be subject to certain European legal requirements).</p> <p>A review of complaints may help to identify whether unfair or unlawful practices exist.</p>

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<i>Ref.</i>	<i>Collection Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
4.2.3	<p>Collection From Third Parties</p> <p>Management confirms that third parties from whom personal information is collected (that is, sources other than the individual) are reliable sources that collect information fairly and lawfully.</p>	<p>The entity</p> <ul style="list-style-type: none"> performs due diligence before establishing a relationship with a third-party data provider. reviews the privacy policies, collection methods, and types of consents of third parties before accepting personal information from third-party data sources. 	<p>Contracts include provisions requiring personal information to be collected fairly and lawfully and from reliable sources.</p>
4.2.4	<p>Information Developed about Individuals</p> <p>Individuals are informed if the entity develops or acquires additional information about them for its use.</p>	<p>The entity's privacy notice indicates that, if applicable, it may develop and acquire information about the individual using third-party sources, browsing, credit and purchasing history, and so on.</p>	

Use, Retention, and Disposal

<i>Ref.</i>	<i>Use, Retention, and Disposal Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
5.0	<p>The entity limits the use of personal information to the purposes identified in the notice and for which the individual has provided implicit or explicit consent. The entity retains personal information for only as long as necessary to fulfill the stated purposes or as required by law or regulations and thereafter appropriately disposes of such information.</p>		
5.1	<p>Policies and Communications</p>		
5.1.0	<p>Privacy Policies</p> <p>The entity's privacy policies address the use, retention, and disposal of personal information.</p>		
5.1.1	<p>Communication to Individuals</p> <p>Individuals are informed that personal information is (a) used only for the purposes identified in the notice and only if the individual has provided implicit or explicit consent, unless a law or</p>		
		<p>The entity's privacy notice describes the following uses of personal information, for example:</p> <ul style="list-style-type: none"> Processing business transactions such as claims and warranties, payroll, taxes, benefits, stock options, bonuses, or 	

<i>Ref.</i>	<i>Use, Retention, and Disposal Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
	regulation specifically requires otherwise, (b) retained for no longer than necessary to fulfill the stated purposes, or for a period specifically required by law or regulation, and (c) disposed of in a manner that prevents loss, theft, misuse, or unauthorized access.	<p>other compensation schemes</p> <ul style="list-style-type: none"> • Addressing inquiries or complaints about products or services, or interacting during the promotion of products or services • Product design and development, or purchasing of products or services • Participation in scientific or medical research activities, marketing, surveys, or market analysis • Personalization of websites or downloading software • Legal requirements • Direct marketing <p>The entity's privacy notice explains that personal information will be retained only as long as necessary to fulfill the stated purposes, or for a period specifically required by law or regulation and thereafter will be disposed of securely or made anonymous so that it cannot be identified to any individual.</p>	
5.2	Procedures and Controls		
5.2.1	<p>Use of Personal Information</p> <p>Personal information is used only for the purposes identified in the notice and only if the individual has provided implicit or explicit consent, unless a law or regulation specifically requires otherwise.</p>	<p>Systems and procedures are in place to ensure that personal information is used</p> <ul style="list-style-type: none"> • in conformity with the purposes identified in the entity's privacy notice. • in agreement with the consent received from the individual. • in compliance with applicable laws and regulations. 	<p>Some regulations have specific provisions concerning the use of personal information. Examples are the GLBA, the Health Insurance Portability and Accountability Act (HIPAA), and the Children's Online Privacy Protection Act (COPPA).</p>

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<i>Ref.</i>	<i>Use, Retention, and Disposal Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
5.2.2	<p>Retention of Personal Information</p> <p>Personal information is retained for no longer than necessary to fulfill the stated purposes unless a law or regulation specifically requires otherwise.</p>	<p>The entity</p> <ul style="list-style-type: none"> documents its retention policies and disposal procedures. retains, stores, and disposes of archived and backup copies of records in accordance with its retention policies. ensures personal information is not kept beyond the standard retention time unless a justified business or legal reason for doing so exists. <p>Contractual requirements are considered when establishing retention practices when they may be exceptions to normal policies.</p>	<p>Some laws specify the retention period for personal information. For example, HIPAA has retention requirements on accounting for disclosures of personal health information—three years for electronic health records, and six years for nonelectronic health records.</p> <p>Other statutory record retention requirements may exist; for example, certain data may need to be retained for tax purposes or in accordance with employment laws.</p>
5.2.3	<p>Disposal, Destruction and Redaction of Personal Information</p> <p>Personal information no longer retained is anonymized, disposed of, or destroyed in a manner that prevents loss, theft, misuse, or unauthorized access.</p>	<p>The entity</p> <ul style="list-style-type: none"> erases or destroys records in accordance with the retention policies, regardless of the method of storage (for example, electronic, optical media, or paper based). disposes of original, archived, backup and ad hoc or personal copies of records in accordance with its destruction policies. documents the disposal of personal information. within the limits of technology, locates and removes or redacts specified personal information about an individual as required, for example, removing credit card numbers after the transaction is complete. 	<p>Consideration should be given to using the services of companies that provide secure destruction services for personal information. Certain of these companies will provide a certificate of destruction where needed.</p> <p>Certain archiving techniques, such as DVDs, CDs, microfilm, or microfiche may not permit the removal of individual records without destruction of the entire database contained on such media.</p>

<i>Ref.</i>	<i>Use, Retention, and Disposal Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		<ul style="list-style-type: none"> regularly and systematically destroys, erases, or makes anonymous personal information no longer required to fulfill the identified purposes or as required by laws and regulations. <p>Contractual requirements are considered when establishing disposal, destruction, and redaction practices if they may result in exception to the entity's normal policies.</p>	

Access

<i>Ref.</i>	<i>Access Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
6.0	The entity provides individuals with access to their personal information for review and update.		
6.1	Policies and Communications		
6.1.0	Privacy Policies The entity's privacy policies address providing individuals with access to their personal information.		
6.1.1	Communication to Individuals Individuals are informed about how they may obtain access to their personal information to review, update, and correct that information.	<p>The entity's privacy notice</p> <ul style="list-style-type: none"> explains how individuals may gain access to their personal information and any costs associated with obtaining such access. outlines the means by which individuals may update and correct their personal information (for example, in writing, by phone, 	

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<i>Ref.</i>	<i>Access Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		<p>by e-mail, or by using the entity's website).</p> <ul style="list-style-type: none"> explains how disagreements related to personal information may be resolved. 	
6.2	Procedures and Controls		
6.2.1	<p>Access by Individuals to Their Personal Information</p> <p>Individuals are able to determine whether the entity maintains personal information about them and, upon request, may obtain access to their personal information.</p>	<p>Procedures are in place to</p> <ul style="list-style-type: none"> determine whether the entity holds or controls personal information about an individual. communicate the steps to be taken to gain access to the personal information. respond to an individual's request on a timely basis. provide a copy of personal information, upon request, in printed or electronic form that is convenient to both the individual and the entity. record requests for access and actions taken, including denial of access and unresolved complaints and disputes. 	<p>Some laws and regulations specify the following:</p> <ul style="list-style-type: none"> Provisions and requirements for providing access to personal information (for example, HIPAA) Requirements that requests for access to personal information be submitted in writing
6.2.2	<p>Confirmation of an Individual's Identity</p> <p>The identity of individuals who request access to their personal information is authenticated before they are given access to that information.</p>	<p>Employees are adequately trained to authenticate the identity of individuals before granting the following:</p> <ul style="list-style-type: none"> Access to their personal information Requests to change sensitive or other personal information (for example, to update information such as address or bank details) 	<p>The extent of authentication depends on the type and sensitivity of personal information that is made available. Different techniques may be considered for the different channels, such as the following:</p> <ul style="list-style-type: none"> Web Interactive voice response system Call center In person

Ref.	Access Criteria	Illustrative Controls and Procedures	Additional Considerations
6.2.3	<p>Understandable Personal Information, Time Frame, and Cost</p> <p>Personal information is provided to the individual in an understandable form, in a reasonable timeframe, and at a reasonable cost, if any.</p>	<p>The entity</p> <ul style="list-style-type: none"> • does not use government-issued identifiers (for example, Social Security numbers or Social Insurance numbers) for authentication. • mails information about a change request only to the address of record or, in the case of a change of address, to both the old and new addresses. • requires that a unique user identification and password (or equivalent) be used to access user account information online. <p>The entity</p> <ul style="list-style-type: none"> • provides personal information to the individual in a format that is understandable (for example, not in code, not in a series of numbers, not in overly technical language or other jargon), and in a form convenient to both the individual and the entity. • makes a reasonable effort to locate the personal information requested and, if personal information cannot be found, keeps sufficient records to demonstrate that a reasonable search was made. • takes reasonable precautions to ensure that personal information released does not identify another 	<p>Entities may provide individuals with access to their personal information at no cost or at a minimal cost because of the potential business and customer-relationship benefits, as well as the opportunity to enhance the quality of the information.</p>

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<i>Ref</i>	<i>Access Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		<p>person, directly or indirectly.</p> <ul style="list-style-type: none"> • provides access to personal information in a timeframe that is similar to the entity's normal response times for other business transactions, or as permitted or required by law. • provides access to personal information in archived or backup systems and media. • informs individuals of the cost of access at the time the access request is made or as soon as practicable thereafter. • charges the individual for access to personal information at an amount, if any, which is not excessive in relation to the entity's cost of providing access. • provides an appropriate physical space to inspect personal information. 	
6.2.4	<p>Denial of Access Individuals are informed, in writing, of the reason a request for access to their personal information was denied, the source of the entity's legal right to deny such access, if applicable, and the individual's right, if any, to challenge such denial, as specifically permitted or required by law or regulation.</p>	<p>The entity</p> <ul style="list-style-type: none"> • outlines the reasons why access to personal information may be denied. • records all denials of access and unresolved complaints and disputes. • provides the individual with partial access in situations in which access to some of his or her personal information is justifiably denied. • provides the individual with a written explanation about why access to 	<p>Some laws and regulations (for example, Principle 5, "Information relating to records kept by record-keeper," point 2 of the Australian Privacy Act of 1988, and PIPEDA, Sections 8.(4), 8.(5), 8.(7), 9, 10, and 28) specify the situations in which access can be denied, the process to be followed (such as notifying the customer of the denial in writing within 30 days), and potential penalties or sanctions for lack of compliance.</p>

<i>Ref.</i>	<i>Access Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		<p>personal information is denied.</p> <ul style="list-style-type: none"> • provides a formal escalation (appeal) process if access to personal information is denied. • conveys the entity's legal rights and the individual's right to challenge, if applicable. 	
6.2.5	<p>Updating or Correcting Personal Information Individuals are able to update or correct personal information held by the entity. If practical and economically feasible to do so, the entity provides such updated or corrected information to third parties that previously were provided with the individual's personal information.</p>	<p>The entity</p> <ul style="list-style-type: none"> • describes the process an individual must follow to update or correct personal information records (for example, in writing, by phone, by e-mail, or by using the entity's website). • verifies the accuracy and completeness of personal information that an individual updates or changes (for example, by edit and validation controls, and forced completion of mandatory fields). • records the date, time, and identification of the person making the change if the entity's employee is making a change on behalf of an individual. • notifies third parties to whom personal information has been disclosed of amendments, erasures, or blocking of personal information, if it is possible and reasonable to do so. 	<p>In some jurisdictions (for example, PIPEDA, Schedule 1, clauses 4.5.2 and 4.5.3), personal information cannot be erased, but an entity is bound to cease further processing.</p>

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<i>Ref.</i>	<i>Access Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
6.2.6	<p>Statement of Disagreement</p> <p>Individuals are informed, in writing, about the reason a request for correction of personal information was denied, and how they may appeal.</p>	<p>If an individual and an entity disagree about whether personal information is complete and accurate, the individual may ask the entity to accept a statement claiming that the personal information is not complete and accurate.</p> <p>The entity</p> <ul style="list-style-type: none"> documents instances where an individual and the entity disagree about whether personal information is complete and accurate. informs the individual, in writing, of the reason a request for correction of personal information is denied, citing the individual's right to appeal. informs the individual, when access to personal information is requested or when access is actually provided, that the statement of disagreement may include information about the nature of the change sought by the individual and the reason for its refusal by the entity. if appropriate, notifies third parties who have previously been provided with personal information that there is a disagreement and the nature of the disagreement. 	<p>See 10.1.1, "Communications to Individuals," 10.2.1, "Inquiry, Complaint, and Dispute Process," and 10.2.2, "Dispute Resolution and Recourse."</p> <p>Some regulations (for example, HIPAA) have specific requirements for denial of requests and handling of disagreements from individuals.</p> <p>If a challenge is not resolved to the satisfaction of the individual, when appropriate, the existence of such challenge is communicated to third parties having access to the information in question.</p>

Disclosure to Third Parties

<i>Ref.</i>	<i>Disclosure to Third Parties Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
7.0	The entity discloses personal information to third parties only for the purposes identified in the notice and with the implicit or explicit consent of the individual.		
7.1	Policies and Communications		
7.1.0	Privacy Policies		
	The entity's privacy policies address the disclosure of personal information to third parties.		
7.1.1	Communication to Individuals	The entity's privacy notice	The entity's privacy notice may disclose the following:
	Individuals are informed that personal information is disclosed to third parties only for the purposes identified in the notice and for which the individual has provided implicit or explicit consent unless a law or regulation specifically allows or requires otherwise.	<ul style="list-style-type: none"> describes the practices related to the sharing of personal information (if any) with third parties and the reasons for information sharing. identifies third parties or classes of third parties to whom personal information is disclosed. informs individuals that personal information is disclosed to third parties only for the purposes (a) identified in the notice, and (b) for which the individual has provided implicit or explicit consent, or as specifically allowed or required by law or regulation. 	<ul style="list-style-type: none"> The process used to assure the privacy and security of personal information that has been disclosed to a third party How personal information shared with a third party will be kept up to date, so that outdated or incorrect information shared with a third party will be changed if the individual has changed his or her information
7.1.2	Communication to Third Parties	Prior to sharing personal information with a third party, the entity communicates its privacy policies or other specific instructions or requirements for handling personal information to, and obtains a written agreement from the third party that its	
	Privacy policies or other specific instructions or requirements for handling personal information are communicated to third parties to whom personal information is disclosed.		

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<i>Ref</i>	<i>Disclosure to Third Parties Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		privacy practices over the disclosed personal information adhere to those policies or requirements.	
7.2	Procedures and Controls		
7.2.1	Disclosure of Personal Information Personal information is disclosed to third parties only for the purposes described in the notice, and for which the individual has provided implicit or explicit consent, unless a law or regulation specifically requires or allows otherwise.	Systems and procedures are in place to <ul style="list-style-type: none"> • prevent the disclosure of personal information to third parties unless an individual has given implicit or explicit consent for the disclosure. • document the nature and extent of personal information disclosed to third parties. • test whether disclosure to third parties is in compliance with the entity's privacy policies and procedures, or as specifically allowed or required by law or regulation. • document any third-party disclosures for legal reasons. 	Personal information may be disclosed through various legal processes to law enforcement or regulatory agencies. Some laws and regulations have specific provisions for the disclosure of personal information. Some permit disclosure of personal information without consent whereas others require verifiable consent.
7.2.2	Protection of Personal Information Personal information is disclosed only to third parties who have agreements with the entity to protect personal information in a manner consistent with the relevant aspects of the entity's privacy policies or other specific instructions or requirements. The entity has procedures in place to evaluate that the third parties have effective controls to meet the terms of the agreement, instructions, or requirements.	When providing personal information to third parties, the entity enters into contracts that require a level of protection of personal information equivalent to that of the entity's. In doing so, the entity <ul style="list-style-type: none"> • limits the third party's use of personal information to purposes necessary to fulfill the contract. • communicates the individual's preferences to the third party. • refers any requests for access or complaints about the 	The entity is responsible for personal information in its possession or custody, including information that has been transferred to a third party. Some regulations (for example, from the U.S. federal financial regulatory agencies) require that an entity take reasonable steps to oversee appropriate service providers by exercising appropriate due diligence in the selection of service providers.

<i>Ref.</i>	<i>Disclosure to Third Parties Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		<p>personal information transferred by the entity to a designated privacy executive, such as a corporate privacy officer.</p> <ul style="list-style-type: none"> • specifies how and when third parties are to dispose of or return any personal information provided by the entity. <p>The entity evaluates compliance with such contract using one or more of the following approaches to obtain an increasing level of assurance depending on its risk assessment:</p> <ul style="list-style-type: none"> • The third party responds to a questionnaire about their practices. • The third party self-certifies that its practices meet the entity's requirements based on internal audit reports or other procedures. • The entity performs an onsite evaluation of the third party. • The entity receives an audit or similar report provided by an independent auditor. 	<p>Some jurisdictions, including some countries in Europe, require entities that transfer personal information to register with their regulatory body prior to transfer.</p> <p>PIPEDA requires a comparable level of protection while the personal information is being processed by a third party.</p> <p>Article 25 of the EU's Directive requires that such transfers take place only where the third party ensures an adequate level of protection.</p>
7.2.3	<p>New Purposes and Uses</p> <p>Personal information is disclosed to third parties for new purposes or uses only with the prior implicit or explicit consent of the individual.</p>	<p>Systems and procedures are in place to</p> <ul style="list-style-type: none"> • notify individuals and obtain their consent prior to disclosing personal information to a third party for purposes not identified in the privacy notice. • document whether the entity has notified the individual and received the individual's consent. 	<p>Other types of onward transfers include transfers to third parties who are</p> <ul style="list-style-type: none"> • subsidiaries or affiliates. • providing a service requested by the individual. • law enforcement or regulatory agencies. • in another country and may be subject to other requirements.

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<i>Ref.</i>	<i>Disclosure to Third Parties Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
7.2.4	<p>Misuse of Personal Information by a Third Party The entity takes remedial action in response to misuse of personal information by a third party to whom the entity has transferred such information.</p>	<ul style="list-style-type: none"> • monitor that personal information is being provided to third parties only for uses specified in the privacy notice. <p>The entity</p> <ul style="list-style-type: none"> • reviews complaints to identify indications of any misuse of personal information by third parties. • responds to any knowledge of a third party using or disclosing personal information in variance with the entity's privacy policies and procedures or contractual arrangements. • mitigates, to the extent practicable, any harm caused by the use or disclosure of personal information by the third party in violation of the entity's privacy policies and procedures (for example, notify individuals affected, attempt to recover information disclosed to others, void affected numbers and reissue new numbers). • takes remedial action in the event that a third party misuses personal information (for example, contractual clauses address the ramification of misuse of personal information). 	

Security for Privacy

<i>Ref.</i>	<i>Security for Privacy Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
8.0	The entity protects personal information against unauthorized access (both physical and logical).		
8.1	Policies and Communications		
8.1.0	Privacy Policies The entity's privacy policies (including any relevant security policies), address the security of personal information.	Privacy policies adequately address security measures to safeguard the privacy of personal information whether in electronic, paper, or other forms. Security measures are consistent with the sensitivity of the personal information.	Personal information in any location under control of the entity or deemed to be under control of the entity must be protected.
8.1.1	Communication to Individuals Individuals are informed that precautions are taken to protect personal information.	The entity's privacy notice describes the general types of security measures used to protect the individual's personal information, for example: <ul style="list-style-type: none"> • Employees are authorized to access personal information based on job responsibilities. • Authentication is used to prevent unauthorized access to personal information stored electronically. • Physical security is maintained over personal information stored in hard copy form, and encryption is used to prevent unauthorized access to personal information sent over the Internet. • Additional security safeguards are applied to sensitive information. 	Users, management, providers, and other parties should strive to develop and adopt good privacy practices and to promote conduct that recognizes security needs and respects the legitimate interests of others. Consideration should be given to disclosing in the privacy notice the security obligations of individuals, such as keeping user IDs and passwords confidential and reporting security compromises. Consideration should be given to limiting the disclosure of detailed security procedures so as not to compromise internal security.

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<i>Ref.</i>	<i>Security for Privacy Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
8.2	Procedures and Controls		
8.2.1	<p>Information Security Program</p> <p>A security program has been developed, documented, approved, and implemented that includes administrative, technical, and physical safeguards to protect personal information from loss, misuse, unauthorized access, disclosure, alteration, and destruction. The security program should address, but not be limited to, limited to, the following areas³ insofar as they relate to the security of personal information:</p> <ol style="list-style-type: none"> a. Risk assessment and treatment [1.2.4] b. Security policy [8.1.0] c. Organization of information security [sections 1, 7, and 10] d. Asset management [section 1] e. Human resources security [section 1] f. Physical and environmental security [8.2.3 and 8.2.4] g. Communications and operations 	<p>The entity's security program addresses the following matters related to protection of personal information:</p> <ul style="list-style-type: none"> • Periodic risk assessments • Identification of all types of personal information and the related processes, systems, and third parties that are involved in the handling of such information • Identification and documentation of the security requirements of authorized users • Allowing access, the nature of that access, and who authorizes such access • Preventing unauthorized access by using effective physical and logical access controls • The procedures to add new users, modify the access levels of existing users, and remove users who no longer need access • Assignment of responsibility and accountability for security 	<p>Safeguards employed may consider the nature and sensitivity of the data, as well as the size and complexity of the entity's operations. For example, the entity may protect personal information and other sensitive information to a level greater than it applies for other information.</p> <p>Some regulations (for example, HIPAA) provide a greater level of detail and guidance on specific security measures to be considered and implemented.</p> <p>Some security rules (for example, GLBA-related rules for safeguarding information) require the following:</p> <ul style="list-style-type: none"> • Board (or committee or individual appointed by the board) approval and oversight of the entity's information security program. • That an entity take reasonable steps to oversee appropriate service providers by — exercising appropriate due

³ These areas are drawn from ISO/IEC 27002:2005, Information technology—Security techniques—Code of practice for information security management. Permission is granted by the American National Standards Institute (ANSI) on behalf of the International Organization for Standardization (ISO). Copies of ISO/IEC 27002 can be purchased from ANSI in the United States at <http://webstore.ansi.org/> and in Canada from the Standards Council of Canada at www.standardsstore.ca/eSpecs/index.jsp. It is not necessary to meet all of the criteria of ISO/IEC 27002:2005 to satisfy *Generally Accepted Privacy Principles'* criterion 8.2.1. The references associated with each area indicate the most relevant *Generally Accepted Privacy Principles'* criteria for this purpose.

<i>Ref.</i>	<i>Security for Privacy Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
	management [sections 1, 7, and 10]		diligence in the selection of service providers.
<i>h.</i>	Access control [sections 1, 8.2, and 10]	<ul style="list-style-type: none"> • Assignment of responsibility and accountability for system changes and maintenance 	— requiring service providers by contract to implement and maintain appropriate safeguards for the personal information at issue.
<i>i.</i>	Information systems acquisition, development, and maintenance [1.2.6]	<ul style="list-style-type: none"> • Protecting operating system and network software and system files 	
<i>j.</i>	Information security incident management [1.2.7]	<ul style="list-style-type: none"> • Protecting cryptographic tools and information 	
<i>k.</i>	Business continuity management [section 8.2]	<ul style="list-style-type: none"> • Implementing system software upgrades and patches 	The payment card industry has established specific security and privacy requirements for cardholder information from certain brands.
<i>l.</i>	Compliance [sections 1 and 10]	<ul style="list-style-type: none"> • Testing, evaluating, and authorizing system components before implementation • Addressing how complaints and requests relating to security issues are resolved • Handling errors and omissions, security breaches, and other incidents • Procedures to detect actual and attempted attacks or intrusions into systems and to proactively test security procedures (for example, penetration testing) • Allocating training and other resources to support its security policies • Provision for the handling of exceptions and situations not specifically addressed in its system processing integrity and related system security policies • Business continuity management and disaster recovery plans and related testing • Provision for the identification of, 	

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<i>Ref</i>	<i>Security for Privacy Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		<p>and consistency with, applicable laws and regulations, defined commitments, service-level agreements, and other contracts</p> <ul style="list-style-type: none"> • A requirement that users, management, and third parties confirm (initially and annually) their understanding of and agreement to comply with the entity's privacy policies and procedures related to the security of personal information • Procedures to cancel access privileges and ensure return of computers and other devices used to access or store personal information when personnel are terminated <p>The entity's security program prevents access to personal information in computers, media, and paper based information that are no longer in active use by the organization (for example, computers, media, and paper-based information in storage, sold, or otherwise disposed of).</p>	
8.2.2	<p>Logical Access Controls</p> <p>Logical access to personal information is restricted by procedures that address the following matters:</p> <ol style="list-style-type: none"> a. Authorizing and registering internal personnel and individuals b. Identifying and authenticating 	<p>Systems and procedures are in place to</p> <ul style="list-style-type: none"> • establish the level and nature of access that will be provided to users based on the sensitivity of the data and the user's legitimate business need to access the personal information. 	<p>User authorization processes consider the following:</p> <ul style="list-style-type: none"> • How the data is accessed (internal or external network), as well as the media and technology platform of storage • Access to paper and backup media containing personal information

<i>Ref.</i>	<i>Security for Privacy Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
	internal personnel and individuals		
c.	Making changes and updating access profiles	<ul style="list-style-type: none"> authenticate users, for example, by user name and password, certificate, external token, or biometrics before access is granted to systems handling personal information. 	<ul style="list-style-type: none"> Denial of access to joint accounts without other methods to authenticate the actual individuals
d.	Granting privileges and permissions for access to IT infrastructure components and personal information	<ul style="list-style-type: none"> require enhanced security measures for remote access, such as additional or dynamic passwords, callback procedures, digital certificates, secure ID cards, virtual private network (VPN), or properly configured firewalls. 	Some jurisdictions require stored data (at rest) to be encrypted or otherwise obfuscated.
e.	Preventing individuals from accessing anything other than their own personal or sensitive information	<ul style="list-style-type: none"> implement intrusion detection and monitoring systems. 	
f.	Limiting access to personal information to only authorized internal personnel based upon their assigned roles and responsibilities		
g.	Distributing output only to authorized internal personnel		
h.	Restricting logical access to offline storage, backup data, systems, and media		
i.	Restricting access to system configurations, superuser functionality, master passwords, powerful utilities, and security devices (for example, firewalls)		
j.	Preventing the introduction of viruses, malicious code, and unauthorized software		

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<i>Ref</i>	<i>Security for Privacy Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
8.2.3	<p>Physical Access Controls</p> <p>Physical access is restricted to personal information in any form (including the components of the entity's system(s) that contain or protect personal information).</p>	<p>Systems and procedures are in place to</p> <ul style="list-style-type: none"> • manage logical and physical access to personal information, including hard copy, archival, and backup copies. • log and monitor access to personal information. • prevent the unauthorized or accidental destruction or loss of personal information. • investigate breaches and attempts to gain unauthorized access. • communicate investigation results to the appropriate designated privacy executive. • maintain physical control over the distribution of reports containing personal information. • securely dispose of waste containing confidential information (for example, shredding). 	<p>Physical safeguards may include the use of locked file cabinets, card access systems, physical keys, sign in logs, and other techniques to control access to offices, data centers, and other locations in which personal information is processed or stored.</p>
8.2.4	<p>Environmental Safeguards</p> <p>Personal information, in all forms, is protected against accidental disclosure due to natural disasters and environmental hazards.</p>	<p>Management maintains measures to protect against environmental factors (for example, fire, flood, dust, power failure, and excessive heat and humidity) based on its risk assessment. The entity's controlled areas are protected against fire using both smoke detectors and a fire suppression system.</p> <p>In addition, the entity maintains physical and other safeguards to prevent accidental disclosure of personal information in the event of an environmental incident.</p>	<p>Some regulations, such as those in the EU Directive, also require that personal information is protected against unlawful destruction, accidental loss, natural disasters, and environmental hazards, in addition to accidental disclosure.</p>

<i>Ref.</i>	<i>Security for Privacy Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
8.2.5	<p>Transmitted Personal Information</p> <p>Personal information is protected when transmitted by mail or other physical means. Personal information collected and transmitted over the Internet, over public and other nonsecure networks, and wireless networks is protected by deploying industry standard encryption technology for transferring and receiving personal information.</p>	<p>Systems and procedures are in place to</p> <ul style="list-style-type: none"> define minimum levels of encryption and controls. employ industry standard encryption technology, for example, 128-bit Transport Layer Security (TLS), over VPNs, for transferring and receiving personal information. approve external network connections. protect personal information in both hardcopy and electronic forms sent by mail, courier, or other physical means. encrypt personal information collected and transmitted wirelessly and protect wireless networks from unauthorized access. 	<p>Some regulations (for example, HIPAA) have specific provisions for the electronic transmission and authentication of signatures with respect to health information records (that is, associated with the standard transactions).</p> <p>Some credit card vendors have issued minimum requirements for protecting cardholder data, including the requirement to use encryption techniques for credit card and transaction related data in transmission and in storage.</p> <p>As technology, market, and regulatory conditions evolve, new measures may become necessary to meet acceptable levels of protection (for example, 128-bit secure TLS, including user IDs and passwords).</p> <p>Voice transmission from wireless devices (for example, cell phones) of personal information may not be encrypted.</p>
8.2.6	<p>Personal Information on Portable Media</p> <p>Personal information stored on portable media or devices is protected from unauthorized access.</p>	<p>Policies and procedures prohibit the storage of personal information on portable media or devices unless a business need exists and such storage is approved by management.</p> <p>Policies, systems, and procedures are in place to protect personal information accessed or stored in manners such as using the following:</p>	<p>Consideration should be given to the protection needed for any personal information provided to, for example, regulators and auditors.</p>

(continued)

<i>Ref</i>	<i>Security for Privacy Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		<ul style="list-style-type: none"> • Laptop computers, PDAs, smart-phones and similar devices • Computers and other devices used by employees while, for example, traveling and working at home • USB drives, CDs and DVDs, magnetic tape, or other portable media <p>Such information is encrypted, password protected, physically protected, and subject to the entity's access, retention, and destruction policies.</p> <p>Controls exist over creation, transfer, storage, and disposal of media containing personal information used for backup and recovery.</p> <p>Procedures exist to report loss or potential misuse of media containing personal information.</p> <p>Upon termination of employees or contractors, procedures provide for the return or destruction of portable media and devices used to access and store personal information, and of printed and other copies of such information.</p>	
8.2.7	<p>Testing Security Safeguards Tests of the effectiveness of the key administrative, technical, and physical safeguards protecting personal information are conducted at least annually.</p>	<p>Systems and procedures are in place to</p> <ul style="list-style-type: none"> • regularly test the effectiveness of the key administrative, technical, and physical safeguards protecting personal information. • periodically undertake independent 	<p>The frequency and nature of the testing of security safeguards will vary with the entity's size and complexity, the nature and scope of its activities, and the sensitivity of personal information.</p> <p>Some security regulations (for</p>

<i>Ref.</i>	<i>Security for Privacy Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		<p>audits of security controls using either internal or external auditors.</p> <ul style="list-style-type: none"> • test card access systems and other physical security devices at least annually. • document and test disaster recovery and contingency plans at least annually to ensure their viability. • periodically undertake threat and vulnerability testing, including security penetration and Web vulnerability and resilience. • make appropriate modifications to security policies and procedures on a periodic basis, taking into consideration the results of tests performed and new and changing threats and vulnerabilities. • periodically report the results of security testing to management. 	<p>example, GLBA-related rules for safeguarding information) require an entity to</p> <ul style="list-style-type: none"> • conduct regular tests of key controls, systems, and procedures by independent third parties or by staff independent of those that develop or maintain security (or at least have these independent parties review results of testing). • assess and possibly adjust its information security at least annually.

Quality

<i>Ref.</i>	<i>Quality Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Consideration</i>
9.0	The entity maintains accurate, complete, and relevant personal information for the purposes identified in the notice.		
9.1	Policies and Communications		
9.1.0	Privacy Policies		
	The entity's privacy policies address the quality of personal information.		

(continued)

<i>Ref.</i>	<i>Quality Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Consideration</i>
9.1.1	<p>Communication to Individuals</p> <p>Individuals are informed that they are responsible for providing the entity with accurate and complete personal information, and for contacting the entity if correction of such information is required.</p>	<p>The entity's privacy notice explains that personal information needs to be kept accurate and complete only when the individual has an ongoing relationship with the entity.</p>	
9.2	<p>Procedures and Controls</p>		
9.2.1	<p>Accuracy and Completeness of Personal Information</p> <p>Personal information is accurate and complete for the purposes for which it is to be used.</p>	<p>Systems and procedures are in place to</p> <ul style="list-style-type: none"> • edit and validate personal information as it is collected, created, maintained, and updated. • record the date when the personal information is obtained or updated. • specify when the personal information is no longer valid. • specify when and how the personal information is to be updated and the source for the update (for example, annual reconfirmation of information held and methods for individuals to proactively update personal information). • indicate how to verify the accuracy and completeness of personal information obtained directly from an individual, received from a third party (see 4.2.3, "Collection From Third Parties"), or disclosed to a third party (see 7.2.2, 	

<i>Ref.</i>	<i>Quality Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Consideration</i>
9.2.2	<p>Relevance of Personal Information Personal information is relevant to the purposes for which it is to be used.</p>	<p>“Protection of Personal Information”).</p> <ul style="list-style-type: none"> • ensure personal information used on an ongoing basis is sufficiently accurate and complete to make decisions, unless clear limits exist for the need for accuracy. • ensure personal information is not routinely updated unless such a process is necessary to fulfill the purposes for which it is to be used. <p>The entity undertakes periodic assessments to check the accuracy of personal information records and to correct them, as necessary, to fulfill the stated purpose.</p> <p>Systems and procedures are in place to</p> <ul style="list-style-type: none"> • ensure personal information is sufficiently relevant for the purposes for which it is to be used and to minimize the possibility that inappropriate information is used to make business decisions about the individual. • periodically assess the relevance of personal information records and to correct them, as necessary, to minimize the use of inappropriate data for decision making. 	

Monitoring and Enforcement

<i>Ref.</i>	<i>Monitoring and Enforcement Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
10.0	The entity monitors compliance with its privacy policies and procedures and has procedures to address privacy related inquiries, complaints and disputes.		
10.1	Policies and Communications		
10.1.0	Privacy Policies		
	The entity's privacy policies address the monitoring and enforcement of privacy policies and procedures.		
10.1.1	Communication to Individuals	The entity's privacy notice	
	Individuals are informed about how to contact the entity with inquiries, complaints and disputes.	<ul style="list-style-type: none"> describes how individuals can contact the entity with complaints (for example, via an e-mail link to the entity's website or a telephone number). provides relevant contact information to which the individual can direct complaints (for example, name, telephone number, mailing address, and e-mail address of the individual or office responsible for handling complaints). 	
10.2	Procedures and Controls		
10.2.1	Inquiry, Complaint, and Dispute Process	The corporate privacy officer or other designated individual is authorized to address privacy related complaints, disputes, and other problems.	
	A process is in place to address inquiries, complaints, and disputes.	Systems and procedures are in place that allow for	
		<ul style="list-style-type: none"> procedures to be followed in communicating and resolving complaints about the entity. 	

<i>Ref.</i>	<i>Monitoring and Enforcement Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
10.2.2	<p>Dispute Resolution and Recourse Each complaint is addressed, and the resolution is documented and communicated to the individual.</p>	<p>The entity has a formally documented process in place to</p> <ul style="list-style-type: none"> • train employees responsible for handling individuals' complaints and disputes about the resolution and escalation processes. • document and respond to all complaints in a timely manner. • periodically review unresolved disputes and complaints to ensure they are resolved in a timely manner. • escalate unresolved complaints and disputes for review by management. • identify trends and the potential need 	<p>Some regulations (for example HIPAA and COPPA) have specific procedures and requirements.</p> <p>Some laws (for example, PIPEDA) permit escalation through the court system up to the most senior court.</p>

(continued)

<i>Ref</i>	<i>Monitoring and Enforcement Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		<p>to change the entity's privacy policies and procedures.</p> <ul style="list-style-type: none"> • use specified independent third-party dispute resolution services or other processes mandated by regulatory bodies in the event the individual is not satisfied with the entity's proposed resolution, together with a commitment from such third parties to handle such recourses. <p>If the entity offers a third-party dispute resolution process for complaints that cannot be resolved directly with the entity, an explanation is provided about how an individual can use that process.</p>	
10.2.3	<p>Compliance Review Compliance with privacy policies and procedures, commitments and applicable laws, regulations, service-level agreements, and other contracts is reviewed and documented, and the results of such reviews are reported to management. If problems are identified, remediation plans are developed and implemented.</p>	<p>Systems and procedures are in place to</p> <ul style="list-style-type: none"> • annually review compliance with privacy policies and procedures, commitments and applicable laws, regulations, service-level agreements, standards adopted by the entity, and other contracts. • document periodic reviews, for example, internal audit plans, audit reports, compliance checklists, and management sign offs. • report the results of the compliance review and recommendations for improvement to management, and implement a remediation plan. • monitor the resolution of issues and vulnerabilities 	<p>In addition to legal, regulatory and contractual requirements, some entities may elect to comply with certain standards, such as those published by ISO, or may be required to comply with certain standards, such as those published by the payment card industry, as a condition of doing business.</p>

<i>Ref.</i>	<i>Monitoring and Enforcement Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
10.2.4	<p>Instances of Noncompliance Instances of noncompliance with privacy policies and procedures are documented and reported and, if needed, corrective and disciplinary measures are taken on a timely basis.</p>	<p>noted in the compliance review to ensure that appropriate corrective action is taken on a timely basis (that is, privacy policies and procedures are revised, as necessary).</p> <p>Systems and procedures are in place to</p> <ul style="list-style-type: none"> • notify employees of the need to report privacy breaches and security vulnerabilities in a timely manner. • inform employees of the appropriate channels to report security vulnerabilities and privacy breaches. • document instances of noncompliance with privacy policies and procedures. • monitor the resolution of security vulnerabilities and privacy breaches to ensure appropriate corrective measures are taken on a timely basis. • discipline employees and others, as appropriate, who cause privacy incidents or breaches. • mitigate, to the extent practicable, any harm caused by the use or disclosure of personal information by the third party in violation of the entity's privacy policies and procedures (for example, notify individuals affected, attempt to recover information disclosed to others, void affected account numbers and 	

(continued)

<i>Ref.</i>	<i>Monitoring and Enforcement Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		<ul style="list-style-type: none"> reissue new numbers). identify trends that may require revisions to privacy policies and procedures. 	
10.2.5	<p>Ongoing Monitoring Ongoing procedures are performed for monitoring the effectiveness of controls over personal information, based on a risk assessment [1.2.4], and for taking timely corrective actions where necessary.</p>	<p>The entity uses the following:</p> <ul style="list-style-type: none"> Control reports Trend analysis Training attendance and evaluations Complaint resolutions Regular internal reviews Internal audit reports Independent audit reports covering controls at service organizations Other evidence of control effectiveness <p>The selection of controls to be monitored, and the frequency with which they are monitored are based on the sensitivity of the information and the risks of possible exposure of the information.</p> <p>Examples of such controls are as follows:</p> <ul style="list-style-type: none"> Policies require that all employees take initial privacy training within 30 days of employment. Ongoing monitoring activities would include a review of human resource files of selected employees to determine that they contain the appropriate evidence of course completion. Policies require that whenever an employee changes job responsibilities or is terminated, such employee's access to 	<p><i>Guidance on Monitoring Internal Control Systems</i>, published by COSO (the Committee of Sponsoring Organizations of the Treadway Commission), provides helpful guidance for monitoring the effectiveness of controls.</p>

<i>Ref.</i>	<i>Monitoring and Enforcement Criteria</i>	<i>Illustrative Controls and Procedures</i>	<i>Additional Considerations</i>
		<p>personal information be reviewed and appropriately modified or terminated within 24 hours (or immediately in the case of employee termination). This is controlled by an automated process within the human resource system which produces a report of employee status changes, which requires supervisor action to avoid automatic termination of access. This is monitored by the security group which receives copies of these reports and the related supervisor actions.</p> <ul style="list-style-type: none"> • Policies state that confirmation of a privacy-related complaint is provided to the complainant within 72 hours, and if not resolved within 10 working days, then the issue is escalated to the CPO. The control is a log used to record privacy complaints, including complaint date, and subsequent activities through to resolution. The monitoring activity is the monthly review of such logs for consistency with this policy. 	

Appendix A—Glossary

affiliate. An entity that controls, is controlled by, or is under common control with another entity.

anonymize. The removal of any person-related information that could be used to identify a specific individual.

confidentiality. The protection of nonpersonal information and data from unauthorized disclosure.

consent. Agreement by the individual for the entity to collect, use, and disclose personal information in accordance with the privacy notice. Such agreement can be explicit or implied. *Explicit consent* is given orally, electronically, or in writing, is unequivocal and does not require any inference on the part of the entity seeking consent. *Implicit consent* may reasonably be inferred from the action or inaction of the individual such as not having *opted out*, or providing credit card information to complete a transaction. (see opt in and opt out).

cookies. Cookies are pieces of information generated by a Web server and stored in the user's computer, ready for future access. The information can then be used to identify the user when returning to the website, to personalize Web content, and suggest items of potential interest based on previous buying habits. Certain advertisers use tracking methods, including cookies, to analyze the patterns and paths through a site.

encryption. The process of transforming information to make it unreadable to anyone except those possessing special key (to decrypt).

entity. An organization that collects, uses, retains, and discloses personal information.

individual. The person about whom the personal information is being collected (sometimes referred to as the *data subject*).

internal personnel. Employees, contractors, agents, and others acting on behalf of the entity and its affiliates.

opt in. Personal information may not be collected, used, retained and disclosed by the entity without the explicit consent of the individual.

opt out. Implied consent exists for the entity to collect, use, retain, and disclose personal information unless the individual explicitly denies permission.

outsourcing. The use and handling of personal information by a third party that performs a business function for the entity.

personal information. Information that is or can be about or related to an identifiable individual.

personal information cycle. The collection, use, retention, disclosure, disposal, or anonymization of personal information.

policy. A written statement that communicates management's intent, objectives, requirements, responsibilities, and standards.

privacy. The rights and obligations of individuals and organizations with respect to the collection, use, retention, disclosure, and destruction of personal information.

privacy breach. A privacy breach occurs when personal information is collected, retained, accessed, used, or disclosed in ways that are not in accordance with the provisions of the enterprise's policies, applicable privacy laws, or regulations.

privacy program. The policies, communications, procedures, and controls in place to manage and protect personal information in accordance with business and compliance risks and requirements.

purpose. The reason personal information is collected by the entity.

redact. To delete or black out personal information from a document or file.

sensitive personal information. Personal information that requires an extra level of protection and a higher duty of care, for example, information on medical or health conditions, certain financial information, racial or ethnic origin, political opinions, religious or philosophical beliefs, trade union membership, sexual preferences, or information related to offenses or criminal convictions.

third party. An entity that is not affiliated with the entity that collects personal information or any affiliated entity not covered by the entity's privacy notice.

Web beacon. Web beacons, also known as Web bugs, are small strings of code that provide a method for delivering a graphic image on a Web page or in an e-mail message for the purpose of transferring data. Businesses use Web beacons for many purposes, including site traffic reporting, unique visitor counts, advertising and e-mail auditing and reporting, and personalization. For example, a Web beacon can gather a user's IP address, collect the referrer, and track the sites visited by users.

Appendix B—CPA and CA Practitioner Services Using Generally Accepted Privacy Principles

This appendix provides a high level overview of the services that CPAs and CAs in public practice (practitioners) can provide using *Generally Accepted Privacy Principles* (GAPP). Additional guidance for practitioners is available from both the AICPA and Canadian Institute of Chartered Accountants (CICA) (see www.aicpa.org/INTERESTAREAS/INFORMATIONTECHNOLOGY/RESOURCES/PRIVACY/Pages/default.aspx and www.cica.ca).

Privacy Advisory Engagements

Practitioners can provide a variety of advisory services to their clients, which include strategic, diagnostic, implementation, and sustaining and managing services using GAPP criteria. These services could include advising clients on system weaknesses, assessing risk, and recommending a course of action using GAPP criteria as a benchmark.

Practitioners in the United States providing such advisory services follow CS section 100 of Statement on Standards for Consulting Services, *Consulting Services: Definition and Standards* (AICPA, *Professional Standards*). No standards for Canadian practitioners exist in the CICA Handbook covering the performance of consulting services.

Privacy Attestation and Assurance Engagements

Practitioners also can use GAPP to provide attestation and assurance services to their clients, which typically result in a report for use by third parties. The nature of these services, the relevant professional standards, and the types of reports that may be issued for each are described subsequently.

Privacy Examination and Audit Engagements

Relevant U.S. standards for attestation engagements are contained in the Statements on Standards for Attestation Engagements. Relevant Canadian standards for assurance engagements are contained in Section 5025 of the CICA Handbook. Privacy attestation and assurance engagements are defined within the context of these standards. A practitioner is expected to comply with the requirements established by the relevant professional standards.

Examination and audit engagements are designed to provide a high, though not absolute, level of assurance on the subject matter or assertion. With that objective, the practitioner develops audit procedures that, in the practitioner's professional judgment, reduce to a low level the risk that the practitioner will reach an inappropriate conclusion. Illustrative privacy examination and audit reports are included in appendix C.

The following key concepts apply to privacy examination and audit engagements:

- Privacy examination and audit reports ordinarily cover all 10 principles. All of the relevant criteria for each principle need to be met during the period covered by the report to issue an unqualified report.^{4, 5}

⁴ See appendix C, "Illustrative Privacy Examination and Audit Reports."

⁵ In certain circumstances (such as a report on a third-party service provider), special purpose privacy reports covering some of the 10 principles could be issued. It is recommended that such reports contain language that indicates that the privacy principles not covered are essential for overall assurance of privacy and be "restricted use" reports.

- The work should be performed at the examination or equivalent level of assurance.
- The scope of the engagement can cover (1) either all personal information or only certain identified types of personal information, such as customer information or employee information, and (2) all business segments and locations for the entire entity or only certain identified segments of the business (retail operations, but not manufacturing operations or only operations originating on the entity's website or specified web domains) or geographic locations (such as only Canadian operations). In addition:
 - The privacy notice either should (1) be readily available to the users of the auditor's report and be clearly described in management's assertion and the report, or (2) accompany management's assertion and the auditor's report.
 - The scope of the engagement should generally be consistent with the description of the entities and activities covered in the privacy notice (see criterion 2.2.2). The scope often could be narrower, but ordinarily not broader, than that covered by the related privacy notice.
 - The scope of the engagement should cover all of the activities in the information cycle for the relevant personal information. These should include collection, use, retention, disclosure, disposal, or anonymization. Defining a business segment that does not include this entire cycle could be misleading to the user of the practitioner's report.
 - If the identified personal information included in the scope of the examination is commingled with other personal information not in the scope of the engagement, the scope of the engagement needs to cover controls over all of the information from the point of commingling forward.
 - The practitioner's report should ordinarily cover a period of time (not less than two months); however, the practitioner's initial report can be a point in time report.

Management's Assertion

Under AICPA attestation standards, in an examination engagement, the practitioner should ordinarily obtain a written assertion. If management will not provide the practitioner with a written assertion, the practitioner may still report on the subject matter; however, the form of the report will vary depending on the circumstances.⁶

Under AICPA standards, the practitioner may report on either management's assertion or the subject matter of the engagement. When the practitioner reports on the assertion, the assertion should accompany the practitioner's report, or the first paragraph of the report should contain a statement of the assertion.⁷ When the practitioner reports on the subject matter, the practitioner may want to request that management make an assertion available to the users of the practitioner's report.

Under CICA assurance standards, the practitioner may report on either management's assertion regarding the subject matter of the engagement, or directly

⁶ See paragraph .58 of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*) for a description of a practitioner's options, if a written assertion is not obtained.

⁷ See paragraph .64 of AT section 101.

on the subject matter. When the practitioner reports on management's assertion, the assertion should accompany the practitioner's report. When the practitioner reports directly on the subject matter, the practitioner is not required to obtain a written assertion of management. However, when the practitioner has not obtained such assertion, the practitioner is required to establish by other means that management is responsible for the subject matter—this is fundamental to performing the engagement.

For a privacy examination or audit, it is believed that an assertion-based engagement is more appropriate than an engagement to report directly on the subject matter. By providing a publicly available assertion, management explicitly acknowledges its responsibility for the matters addressed in its assertion.

Privacy Review Engagements

A *review engagement* is a type of attestation or assurance engagement. However, the term *privacy review* is often misused to refer either to a privacy examination or to certain types of privacy advisory engagements, such as a privacy diagnostic engagement or an engagement to develop findings and recommendations related to privacy. To reduce the risk that either the practitioner or the client may misinterpret the needs or expectations of the other party, the practitioner should establish an understanding with the client regarding the specifics of services to be performed and type of report to be issued.

A review engagement, as defined in professional standards, is a type of attestation or assurance engagement in which the practitioner reports on whether any information came to his or her attention, on the basis of the work performed, that indicates that the subject matter is not based on (or in conformity with) the criteria, or the assertion is not presented (or fairly stated) in all material respects based on the criteria. The procedures performed to provide a basis for the practitioner's review engagement report generally are limited to inquiry, analytical review procedures, and discussion. In the view of the AICPA and CICA Privacy Task Force, these types of procedures and the limited assurance provided from a review engagement would not be adequate to meet the needs of most parties affected by privacy requirements and expectations when the reporting entity is expected to demonstrate compliance with generally accepted privacy principles and criteria. Accordingly, no guidance is provided on the performance of privacy review engagements.

Agreed-Upon (Specified Auditing) Procedures Engagements

In an agreed-upon or specified procedures engagement, the practitioner performs specified procedures, agreed to by the parties,⁸ and reports his or her findings. The practitioner does not perform an audit or review of an assertion or subject matter nor does the practitioner express an opinion or negative assurance about the assertion or subject matter.⁹ In this type of engagement, the practitioner's report is in the form of a description of procedures and

⁸ The specified users of the report and the practitioner agree upon the procedures to be performed by the practitioner.

⁹ In the United States, agreed-upon procedures engagements are performed under paragraph .15 of AT section 201, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*). In Canada there are no general standards for agreed-upon procedures/specified procedures. A practitioner could, however, look to the guidance provided by the Canadian Institute of Chartered Accountants (CICA) handbook section 9100 that contains standards for performing Specified Procedures on Financial Information Other Than Financial Statements. In specified auditing procedures engagements, the practitioner is engaged to report to specific users the results of applying specified procedures. In applying such procedures, the practitioner does not express a conclusion concerning the subject matter because he or she does not

findings. Generally accepted privacy principles and criteria may be used in such engagements. This type of work would not lead to an examination or audit report, but rather to a report presenting the agreed-upon or specified procedures and the corresponding findings for each procedure. Agreed-upon or specified procedures could be undertaken to address a subset of an entity's system or a subset of the generally accepted privacy principles and criteria, or both. For example, an entity may request that a practitioner complete agreed-upon or specified procedures using selected criteria from generally accepted privacy principles and report the findings. In Canada, specified procedures engagements are permitted, although they are not considered to be assurance engagements under CICA Handbook section 5025.

Because users' needs may vary widely, the nature, timing, and extent of the agreed-upon and specified procedures may vary as well. Consequently, the specified users and the client assume responsibility for the sufficiency of the procedures since they best understand their own needs. The use of such a report is restricted to the specified parties who agreed upon the procedures.

Relationship Between Generally Accepted Privacy Principles and the Trust Services Principles and Criteria

Generally accepted privacy principles are part of the AICPA and CICA *Trust Services Principles and Criteria* that are based upon a common framework (that is, a core set of principles and criteria) to provide professional attestation or assurance and consulting or advisory services. The *Trust Services Principles and Criteria*¹⁰ were developed by volunteer task forces under the auspices of the AICPA and CICA. The other *trust services principles and criteria* are:

- *Security*. The system is protected against unauthorized access (both physical and logical).
- *Availability*. The system is available for operation and use as committed or agreed.
- *Processing integrity*. System processing is complete, accurate, timely, and authorized.
- *Confidentiality*. Information designated as confidential is protected as committed or agreed.

These are discussed more fully at www.aicpa.org/INTERESTAREAS/INFORMATIONTECHNOLOGY/RESOURCES/TRUSTSERVICES/Pages/default.aspx.

(footnote continued)

necessarily perform all of the procedures that, in the practitioner's judgment, would be necessary to provide a high level of assurance. Rather, the practitioner's report sets out the factual results of the procedures applied, including any exceptions found.

¹⁰ WebTrust and SysTrust are two specific attestation or assurance services offerings developed by the AICPA and the CICA that are based on the *Trust Services Principles and Criteria*. Practitioners must be licensed by the CICA to use either the WebTrust or SysTrust seals. When the privacy engagement incorporates an online segment and the entity has received an examination or audit report that does not include a qualification or scope limitation, an entity may choose to display a WebTrust Online Privacy seal. For more information on licensure and Online Privacy Engagements see www.webtrust.org.

Appendix C—Illustrative Privacy Examination and Audit Reports

The following appendix includes examples of examination and audit reports under AICPA or Canadian Institute of Chartered Accountants (CICA) professional reporting standards, respectively:

<i>Under AICPA Attestation Standards</i>	<i>Under CICA Assurance Standards</i>
Illustration 1—Reporting on Management’s Assertion and Sample Management Assertion	Illustration 3—Reporting on Management’s Assertion and Sample Management Assertion
Illustration 2—Reporting Directly on the Subject Matter	Illustration 4—Reporting Directly on the Subject Matter

Illustration 1—Reporting on Management’s Assertion Under AICPA Attestation Standards

Independent Practitioner’s Privacy Report

To the Management of ABC Company, Inc.:

We have examined ABC Company, Inc.’s (ABC Company) management assertion that, during the period Xxxx xx, 2009 through Yyyy yy, 2009, it:

- Maintained effective controls over the privacy of personal information collected in its _____ [*description of the entities and activities covered, for example “the mail-order catalog-sales operations”*] business (the Business) to provide reasonable assurance that the personal information was collected, used, retained, disclosed, and disposed of in conformity with its commitments in its privacy notice related to the Business and with criteria set forth in Generally Accepted Privacy Principles, issued by the American Institute of Certified Public Accountants (AICPA) and the Canadian Institute of Chartered Accountants, and
- Complied with its commitments in its privacy notice, which is dated xxxx xx, 2009 and [is available at www.ABC-Company/privacy or accompanies this report].

This assertion is the responsibility of ABC Company’s management. Our responsibility is to express an opinion 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 (1) obtaining an understanding of ABC Company’s controls over the privacy of personal information, (2) testing and evaluating the operating effectiveness of the controls, (3) testing compliance with ABC Company’s commitments in its privacy notice, and (4) 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, ABC Company’s management assertion that, during the period Xxxx xx, 2009 through Yyyy yy, 2009, ABC Company:

- Maintained effective controls over the privacy of personal information collected in the Business to provide reasonable assurance that the personal information was collected, used, retained, disclosed and disposed of in conformity with its commitments in its privacy notice and with criteria set forth in Generally Accepted Privacy Principles; and
- Complied with its commitments in its privacy notice referred to above, is, in all material respects, fairly stated.

OR

In our opinion, ABC Company's management assertion referred to above is fairly stated, in all material respects, in conformity with ABC Company's privacy notice referred to above and with criteria set forth in Generally Accepted Privacy Principles.

Because of the nature and inherent limitations of controls, ABC Company's ability to meet the aforementioned criteria and the commitments in its privacy notice may be affected. For example, fraud, unauthorized access to systems and information, and failure to comply with internal and external policies or requirements may not be prevented or detected. Also, the projection of any conclusions, based on our findings, to future periods is subject to the risk that any changes or future events may alter the validity of such conclusions.

[Name of CPA firm]

Certified Public Accountants

[City, State]

[Date]

Sample Management Assertion for Illustration 1

During the period Xxxx xx, 2009 through Yyyy yy, 2009, ABC Company, in all material respects:

- Maintained effective controls over the privacy of personal information collected in our _____ [description of the entities and activities covered, for example "the mail-order catalog-sales operations"] business (the Business) to provide reasonable assurance that the personal information was collected, used, retained, disclosed, and disposed of in conformity with our commitments in our privacy notice related to the Business and with criteria set forth in Generally Accepted Privacy Principles, issued by the American Institute of Certified Public Accountants and the Canadian Institute of Chartered Accountants, and
- Complied with our commitments in our privacy notice, which is dated xxxx xx, 2009 and [is available at www.ABC-Company/privacy or accompanies this report].

Illustration 2—Reporting Directly on the Subject Matter Under AICPA Attestation Standards

Independent Practitioner's Privacy Report

To the Management of ABC Company, Inc.:

We have examined (1) the effectiveness of ABC Company, Inc.'s (ABC Company) controls over the personal information collected in its _____ [description of the entities and activities covered, for example "the mail-order catalog-sales operations"] business (the Business) to provide reasonable assurance that the personal information was collected, used, retained, disclosed, and disposed of in conformity with its commitments in its privacy notice and with criteria set forth in Generally Accepted Privacy Principles, issued by the American Institute of Certified Public Accountants (AICPA) and the Canadian Institute of Chartered Accountants, and (2) ABC Company's compliance with its commitments in its privacy notice, which is dated xxxx xx, 2009 and [is available at www.ABC-Company/privacy or accompanies this report], related to the Business during the period Xxxx xx, 2009 through Yyyy yy, 2009. ABC Company's management is responsible for maintaining the effectiveness of these controls and for

compliance with its commitments in its privacy notice. Our responsibility is to express an opinion based on our examination.

Our examination was conducted in accordance with attestation standards established by the AICPA and, accordingly, included (1) obtaining an understanding of ABC Company's controls over the privacy of personal information, (2) testing and evaluating the operating effectiveness of the controls, (3) testing compliance with ABC Company's commitments in its privacy notice, and (4) 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, during the period Xxxx xx, 2009 through Yyyy yy, 2009, ABC Company, in all material respects (1) maintained effective controls over privacy of personal information collected in the Business to provide reasonable assurance that the personal information was collected, used, retained, disclosed, and disposed of in conformity with its commitments in its privacy notice and with criteria set forth in Generally Accepted Privacy Principles; and (2) complied with its commitments in its privacy notice referred to above.

Because of the nature and inherent limitations of controls, ABC Company's ability to meet the aforementioned criteria and the commitments in its privacy notice may be affected. For example, fraud, unauthorized access to systems and information, and failure to comply with internal or external policies or requirements may not be prevented or detected. Also, the projection of any conclusions, based on our findings, to future periods is subject to the risk that any changes or future events may alter the validity of such conclusions.

[Name of CPA firm]

Certified Public Accountants

[City, State]

[Date]

Illustration 3—Reporting on Management's Assertion Under CICA Assurance Standards

Auditor's Privacy Report

To the Management of ABC Company, Inc.:

We have audited ABC Company, Inc.'s (ABC Company) management assertion that, during the period Xxxx xx, 2009 through Yyyy yy, 2009, it:

- Maintained effective controls over the privacy of personal information collected in its _____ [description of the entities and activities covered, for example "the mail-order catalog-sales operations"] business (the Business) to provide reasonable assurance that the personal information was collected, used, retained, disclosed, and disposed of in conformity with its commitments in its privacy notice related to the Business and with criteria set forth in Generally Accepted Privacy Principles, issued by the American Institute of Certified Public Accountants and the Canadian Institute of Chartered Accountants (CICA), and
- Complied with its commitments in its privacy notice, which is dated xxxx xx, 2009 and [is available at www.ABC-Company/privacy or accompanies this report].

This assertion is the responsibility of management. Our responsibility is to express an opinion based on our audit.

Our audit was conducted in accordance with standards for assurance engagements established by the CICA. Those standards require that we plan and perform our audit to obtain reasonable assurance as a basis for our opinion. Our audit included (1) obtaining an understanding of ABC Company's controls over the privacy of personal information, (2) testing and evaluating the operating effectiveness of the controls, (3) testing compliance with ABC Company's commitments in its privacy notice and (4) performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, ABC Company's management assertion that, during the period Xxxx xx, 2009 through Yyyy yy, 2009, ABC Company:

- Maintained effective controls over the privacy of personal information collected in the Business to provide reasonable assurance that the personal information was collected, used, retained, disclosed, and disposed of in conformity with its commitments in its privacy notice and with criteria set forth in Generally Accepted Privacy Principles; and
- Complied with its commitments in its privacy notice referred to above, is, in all material respects, fairly stated.

OR

In our opinion, ABC Company management's assertion referred to above is fairly stated, in all material respects, in conformity with ABC Company's privacy notice referred to above and with criteria set forth in Generally Accepted Privacy Principles.

Because of the nature and inherent limitations of controls, ABC Company's ability to meet the aforementioned criteria and the commitments in its privacy notice may be affected. For example, fraud, unauthorized access to systems and information, failure to comply with internal and external policies and requirements may not be prevented or detected. Also, the projection of any conclusions, based on our findings, to future periods is subject to the risk that any changes or future events may alter the validity of such conclusions.

[Name of CA firm]

[City, Province]

Chartered Accountants

[Date]

Sample Management Assertion for Illustration 3

During the period Xxxx xx, 2009 through Yyyy yy, 2009, ABC Company, in all material respects:

- Maintained effective controls over the privacy of personal information collected in our _____ business [description of the entities and activities covered, for example "the mail-order catalog-sales operations"] (the Business) to provide reasonable assurance that the personal information was collected, used, retained, disclosed, and disposed of in accordance with our commitments in the privacy notice related to the Business and with the criteria set forth in Generally Accepted Privacy Principles, issued by the American Institute of Certified Public Accountants and the Canadian Institute of Chartered Accountants, and

- Complied with our commitments in our privacy notice which is dated xxxx xx, 2009 and [is available at www.ABC-Company/privacy or accompanies this report].

Illustration 4—Reporting Directly on the Subject Matter Under CICA Assurance Standards

Auditor’s Privacy Report

To the Management of ABC Company, Inc.:

We have audited (1) the effectiveness of ABC Company, Inc.’s (ABC Company) controls over the personal information collected in its _____ [*description of the entities and activities covered, for example “the mail-order catalog-sales operations”*] business (the Business) to provide reasonable assurance that the personal information was collected, used, retained, disclosed, and disposed of in conformity with its commitments in its privacy notice and with criteria set forth in Generally Accepted Privacy Principles, issued by the American Institute of Certified Public Accountants and the Canadian Institute of Chartered Accountants (CICA), and (2) ABC Company’s compliance with its commitments in its privacy notice, which is dated xxxx xx, 2009 and [is available at www.ABC-Company/privacy or accompanies this report], related to the Business during the period Xxxx xx, 2009 through Yyyy yy, 2009. ABC Company’s management is responsible for maintaining the effectiveness of these controls and for compliance with its commitments in its privacy notice. Our responsibility is to express an opinion based on our audit.

Our audit was conducted in accordance with standards for assurance engagements established by the CICA. Those standards require that we plan and perform our audit to obtain reasonable assurance as a basis for our opinion. Our audit included (1) obtaining an understanding of ABC Company’s controls over the privacy of personal information, (2) testing and evaluating the operating effectiveness of the controls, (3) testing compliance with ABC Company’s commitments in its privacy notice, and (4) performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, during the period Xxxx xx, 2009 through Yyyy yy, 2009, ABC Company, in all material respects (1) maintained effective controls over privacy of personal information collected in the Business to provide reasonable assurance that the personal information was collected, used, retained, disclosed, and disposed of in conformity with its commitments in its privacy notice and with criteria set forth in the Generally Accepted Privacy Principles; and (2) complied with its commitments in its privacy notice referred to above.

Because of the nature and inherent limitations of controls, ABC Company’s ability to meet the aforementioned criteria and the commitments in its privacy notice may be affected. For example, fraud, unauthorized access to systems and information, and failure to comply with internal or external policies or requirements may not be prevented or detected. Also, the projection of any conclusions,

based on our findings, to future periods is subject to the risk that any changes or future events may alter the validity of such conclusions.

[*Name of CA firm*]

[*City, Province*]

Chartered Accountants

[*Date*]

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Section 200

Trust Services Principles and Criteria for Certification Authorities Version 2.0

April 2012

(To supersede the 2000 version of the *Trust Services Principles, Criteria, and Illustrations for WebTrust® for Certification Authorities* [Version 1.0])

Introduction

Introduction to Trust Service Principles and Criteria for Certification Authorities Version 2.0

.01 This document provides a framework for third party assurance providers to assess the adequacy and effectiveness of the controls employed by certification authorities (CAs). As a result of the technical nature of the activities involved in securing e-commerce transactions, this document also provides a brief overview of public key infrastructure (PKI) using cryptography and trusted third party concepts.

.02 This document replaces version 1.0 of the AICPA/Canadian Institute of Chartered Accountants (CICA) *Trust Services Principles, Criteria, and Illustrations for WebTrust® for Certification Authorities (WebTrust® Program for Certification Authorities v1)* that was issued in August 2000. Unlike version 1.0, which was intended to be used by licensed WebTrust®¹ practitioners only, this version is regarded as “open-source” and can be used in the conduct of any assurance engagement, internal or external, by any third party service provider. It also represents an effective benchmark for CAs to conduct self-assessments. The public accounting profession has continued to play its role, with an intent to increase consumer confidence in the application of PKI technology by establishing a basis for providing third party assurance to the assertions made by CAs.

.03 This document was developed by an AICPA/CICA Task Force using International Organization for Standardization (ISO) 21188, “Public key infrastructure for financial service—Practices and policy Framework,” and version 1.0 of the AICPA/CICA *WebTrust® Program for Certification Authorities*.

.04 Input and approval was also obtained from the Certification Authority Browser Forum (CA/Browser Forum; see www.cabforum.org) for the content and control activities contained in this framework. The CA/Browser Forum was formed among CAs and vendors of Internet browser software and other applications. This voluntary organization has worked collaboratively in defining guidelines and means of implementation for the Extended Validation (EV) Secure Sockets Layer (SSL) Certificate standard as a way of providing a heightened security for Internet transactions and creating a more intuitive method of displaying secure sites to Internet users.

¹ WebTrust® is an assurance services offering developed by the AICPA and Canadian Institute of Chartered Accountants (CICA) that is based on the Trust Services Principles and Criteria. Practitioners must be licensed by CICA to use these registered service marks. For more information on licensure, see www.webtrust.org.

.05 The principles and criteria for CAs are consistent with standards developed by the American National Standards Institute (ANSI), the International Organization for Standardization (ISO), and the Internet Engineering Task Force (IETF). The principles and criteria are also consistent with the practices established by the CA Browser Forum.

Importance of PKI

.06 PKI provides a means for *relying parties* (that is, recipients of certificates, who act in reliance on those certificates or digital signatures, or both, verified using those certificates) to know that another individual's or entity's public key actually belongs to that individual or entity. CA organizations or CA functions, or both, have been established to address this need.

.07 Cryptography is critical to establishing secure e-commerce; however, it has to be coupled with other secure protocols in order to provide a comprehensive security solution. Several cryptographic protocols require digital certificates (in effect, electronic credentials) issued by an independent trusted third party (the CA) to authenticate the transaction. CAs have assumed an increasingly important role in secure e-commerce. Although a large body of national, international, and proprietary standards and guidelines for the use of cryptography, the management of digital certificates, and the policies and practices of CAs exist, these standards have not been applied or implemented uniformly.

.08 This version is titled, "Trust Services Principles and Criteria for Certification Authorities Version 2.0." These principles and criteria are intended to address *user* (that is, subscriber and relying party) needs and concerns and are designed to benefit users and providers of CA e-commerce assurance services by providing a common body of knowledge that is communicated to such parties.

Overview

What Is a Public Key Infrastructure?

.09 With the expansion of e-commerce, PKI is growing in importance and will continue to be a critical enterprise security investment. PKI enables parties to an e-commerce transaction to identify one another by providing authentication with digital certificates and allows reliable business communications by providing confidentiality through the use of encryption and authentication data integrity and a reasonable basis for nonrepudiation through the use of digital signatures.

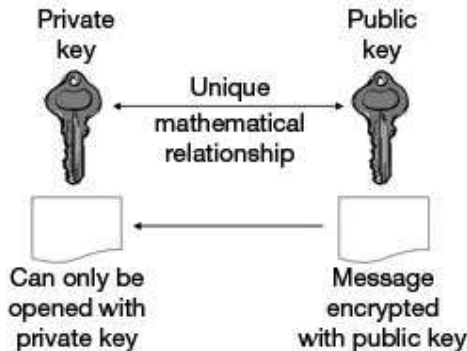
.10 PKI uses public and private key pairs—two mathematically related keys. Typically, one of the keys is made public by posting it on the Internet, for example, while the other remains private. Public key cryptography works in such a way that a message encrypted with the public key can only be decrypted with the private key and, conversely, a message signed with a private key can only be verified with the public key. This technology can be used in different ways to provide the four ingredients required for trust in e-commerce transactions, namely confidentiality, authentication, integrity, and nonrepudiation.

.11 Using PKI, a *subscriber* (that is, an end entity [or individual] whose public key is cryptographically bound to his or her identity in a digital certificate) has an asymmetric, cryptographic key pair (that is, a public key and a private key). The subscriber's private key must be kept secret, whereas the

public key may be made widely available, usually presented in the form of a digital certificate, to ensure that relying parties know with confidence the identity to which the public key belongs. Using public key cryptography, the subscriber could send a message signed with his or her private key. The signature can be validated by the message recipient using the subscriber's public key. The subscriber could also encrypt a message using the recipient's public key. The message can be decrypted only with the recipient's private key.

.12 A subscriber first obtains a public and private key pair (generated by the subscriber, or for the subscriber, as a service). The subscriber then goes through a registration process by submitting his or her public key to a certification authority or a registration authority (RA), which acts as an agent for the CA. The CA or RA verifies the identity of the subscriber in accordance with the CA's established business practices (that may be contained in a certification practice statement), and then issues a digital certificate. The certificate includes the subscriber's public key and identity information and is digitally signed by the CA, which binds the subscriber's identity to that public key. The CA also manages the subscriber's digital certificate through the *certificate life cycle* (that is, from registration through revocation or expiration). In some circumstances, it remains important to manage digital certificates even after expiry or revocation so that digital signatures on stored documents held past the revocation or expiry period can be validated at a later date.

.13 The following diagram illustrates the relationship between a subscriber's public and private keys and how they are used to secure messages sent to a relying party.



.14 A transaction submitted by a customer to an online merchant via the Internet can be encrypted with the merchant's public key and, therefore, can only be decrypted by that merchant using the merchant's private key, ensuring a level of confidentiality. Confidentiality can also be achieved through the use of SSL, Secure/Multipurpose Internet Mail Extensions (S/MIME), and other protocols, such as Secure Electronic Transaction (SET).

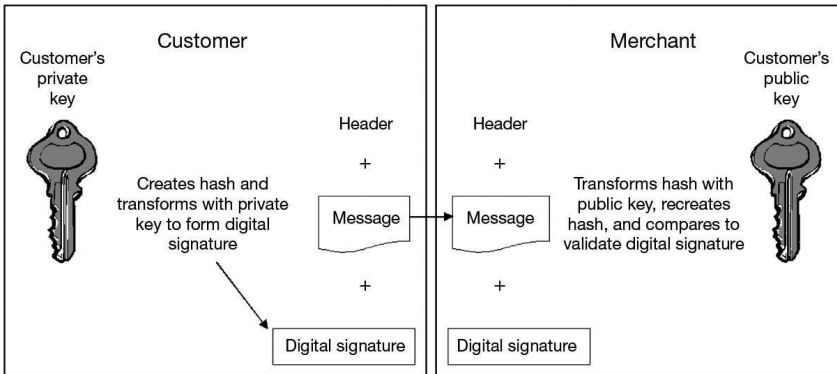
What Is a Digital Signature?

.15 Digital signatures can be used to provide authentication, integrity, and nonrepudiation. Generally speaking, if a customer sends a digitally signed message to a merchant, the customer's private key is used to generate the digital signature, and the customer's public key can be used by the merchant to verify the signature. The mathematical processes employed are somewhat

different depending on the kind of asymmetric, cryptographic algorithm employed. For example, the processes are slightly different for *reversible algorithms* (that is, those which can be readily used to support digital signatures as well as encryption), such as Rivest Shamir Adleman (RSA), and irreversible algorithms, such as the Digital Signature Algorithm (DSA).

.16 The following example illustrates the digital signature generation and verification process for a reversible asymmetric cryptographic algorithm (such as RSA). Suppose a customer wants to send a digitally signed message to a merchant. The customer runs the message through a *hash function* (that is, a mathematical function that converts a message into a fixed length block of data [the hash], in a fashion such that the hash uniquely reflects the message. In effect, it is the message's "fingerprint.") The customer then transforms the hash using the algorithm and the customer's private key to create the digital signature, which is appended to the message. A header is also appended to the message, indicating the merchant's email address, the sender's email address, and other information, such as the time the message is sent. The message header, the message itself, and the digital signature are then sent to the merchant. The customer can optionally send his or her public key certificate to the merchant in the message itself. All of this is usually done by the e-mail software in such a way that the process is transparent to the user.

.17 The following diagram illustrates the process of using a subscriber's key pair to ensure the integrity and authenticity of a message sent by the customer (subscriber) to a merchant.



.18 To determine whether the message came from the customer (that is, authentication) and to determine whether the message has not been modified (that is, integrity), the merchant validates the digital signature. To do so, the merchant must obtain the customer's public key certificate. If the customer did not send his or her public key certificate as part of the message, the merchant would typically obtain the customer's public key certificate from an online repository (maintained by the CA or another party acting as the agent of the CA or any other source even if unrelated to the CA). The merchant then validates that the customer's digital certificate (containing the customer's public key) was signed by a recognized CA to ensure that the binding between the public key and the customer represented in the certificate has not been altered. Next, the merchant extracts the public key from the certificate and uses that public key to transform the digital signature to reveal the original hash. The merchant then runs the message as received through the same hash

function to create a hash of the received message. To verify the digital signature, the merchant compares these two hashes. If they match, then the digital signature validates and the merchant knows that the message came from the customer, and it was not modified from the time the signature was made. If the hashes do not match, then the merchant knows that the message was either modified in transit, or the message was not signed with the customer's private key. As a result, the merchant cannot rely on the digital signature.

.19 Digital signatures can also be used to provide a basis for nonrepudiation so that the signer cannot readily deny having signed the message. For example, an online brokerage customer who purchases one thousand shares of stock using a digitally signed order via the Internet should have a difficult task if he or she later tries to deny (that is, repudiate) having authorized the purchase.

What Are the Differences Between Encryption Key Pairs and Signing Key Pairs?

.20 As stated earlier, establishing a reasonable basis for nonrepudiation requires that the private key used to create a digital signature (that is, the signing private key) be generated and stored securely under the sole control of the user. In the event a user forgets his or her password or loses, breaks, or destroys his or her signing private key, it is acceptable to generate a new signing key pair for use from that point forward with minimal impact to the subscriber. Previously signed documents can still be verified with the user's old signature verification public key. Documents subsequently signed with the user's new signing private key must be verified with the user's new signature verification public key.

.21 Extra care is required to secure the CA's signing private key, which is used for signing user certificates. The trustworthiness of all certificates issued by a CA depends on the CA's ability to protect its private signing key. CAs securely back up their private signing key(s) for business continuity purposes to allow the CA to continue to operate in the event that the CA's private signing key is accidentally destroyed (but not compromised) as a result of hardware failure, for example. Except for CA business continuity purposes, generally, no technical or business reasons exist to back up a private signing key.

.22 On the other hand, and as cited earlier, it is often desirable that a key pair used for encryption and decryption be securely backed up to ensure that encrypted data can be recovered when a user forgets his or her password or otherwise loses access to his or her decryption key. This is analogous to requiring that the combination to a safe be backed up in case the user forgets it or becomes incapacitated. As a result, a PKI typically requires two key pairs for each user: one key pair for encryption and decryption and a second key pair for signing and signature verification.

What Is a Certification Authority?

.23 In order for these technologies to enable parties to securely conduct e-commerce, one important question must be answered: In the digital world, how does one know that an individual's public key actually belongs to that individual? A *digital certificate*, which is an electronic document containing information about an individual and his or her public key, is the answer. This document is digitally signed by a trusted organization referred to as a CA. The basic premise is that the CA is vouching for the link between an individual's identity and his or her public key. The CA provides a level of assurance that the

public key contained in the certificate does, indeed, belong to the entity named in the certificate. The digital signature placed on the public key certificate by the CA provides the cryptographic binding between the entity's public key, the entity's name, and other information in the certificate, such as a validity period. For a relying party to determine whether the certificate was issued by a legitimate CA, the relying party must verify the issuing CA's signature on the certificate. The public keys of many common root CAs (as later defined) are preloaded into standard Web browser software (for example, Netscape Navigator or Microsoft Internet Explorer). This allows the relying party to verify the issuing CA's signature using the CA's public key to determine whether the certificate was issued by a trusted CA.

.24 The purpose of a CA is to manage the *certificate life cycle*, which includes generation and issuance, distribution, renewal and rekey, revocation, and suspension of certificates. The CA frequently delegates the initial registration of subscribers to RAs, which act as agents for the CA. In some cases, the CA may perform registration functions directly. The CA is also responsible for providing certificate status information through the issuance of certificate revocation lists (CRLs) or the maintenance of an online status-checking mechanism, or both. Typically, the CA posts the certificates and CRLs that it has issued to a repository (such as an online directory), which is accessible to relying parties.

What Is a Registration Authority?

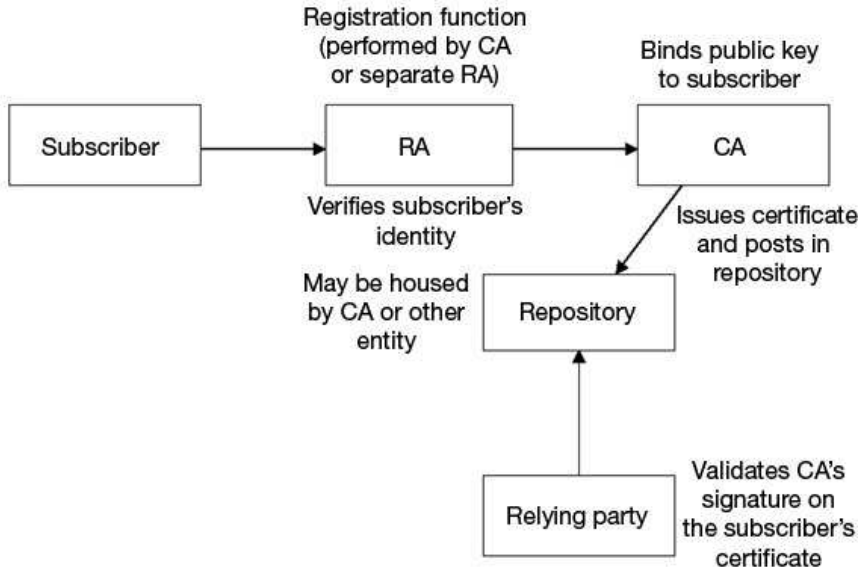
.25 A *registration authority*, or RA, is an entity that is responsible for the identification and authentication of subscribers, but does not sign or issue certificates. In some cases, the CA performs the subscriber registration function internally. In other cases, the CA might delegate the RA function to external registration authorities (sometimes referred to as *local registration authorities* or LRAs) that may or may not be part of the same legal entity as the CA. In still other cases, a customer of a CA (for example, a company) may arrange with that CA to perform the RA function itself or use its agent.

.26 The initial registration process for a subscriber is as follows, though the steps may vary from CA to CA and will also depend upon the certificate policy under which the certificate is to be issued. The subscriber first generates his or her own public and private key pair. (In some implementations, a CA may generate the subscriber's key pair and securely deliver it to the subscriber, but this is normally done only for encryption key pairs, not signature key pairs.) Then, the subscriber produces proof of identity in accordance with the applicable certificate policy requirements and demonstrates that he or she holds the private key corresponding to the public key without disclosing the private key (typically by digitally signing a piece of data with the private key, with the subscriber's digital signature then verified by the CA). Once the association between a person and a public key is verified, the CA issues a certificate. The CA digitally signs each certificate that it issues with its private key to provide the means for establishing authenticity and integrity of the certificate.

.27 The CA then notifies the subscriber of certificate issuance and gives the subscriber an opportunity to review the contents of the certificate before it is made public. Assuming the subscriber approves the accuracy of the certificate, the subscriber will either publish the certificate or have the CA publish it and make it available to other users. A *repository* is an electronic certificate database that is available online. The repository may be maintained by the CA or a third party contracted for that purpose by the subscriber or by any other party. Subscribers may obtain other subscriber's certificates and certificate

status information from the repository. For example, if a subscriber's certificate was revoked, the repository would indicate that the subscriber's certificate has been revoked and should not be relied on. The ability to update the repository is typically retained by the CA. Subscribers and other relying parties would have read-only access to the repository. Because the certificates stored in the repository are digitally signed by the CA, they cannot be maliciously changed without detection, even if someone were to hack into the repository.

.28 The following diagram illustrates the relationship between the subscriber and the RA and CA functions.



What Is the Impact of an External RA?

.29 External registration authorities are required to comply with the relevant provisions of the CA's business practices disclosures, often documented in a certification practice statement and applicable certificate policy(s). In performing a WebTrust® Program for Certification Authorities engagement, the practitioner must consider how the CA handles the RA function and whether the RA function is within the scope of the examination. For example, a CA that provides CA services to several banks might delegate the subscriber registration function to RAs that are specifically designated functional groups within each bank. The functions performed by these specific groups would typically be outside the scope of the WebTrust® Program for Certification Authorities examination performed for the CA. In this case, management's assertion should specify those aspects of the registration process that are not handled by the CA. There may be scenarios, however, in which the CA exercises extensive monitoring controls (including on-site audit) over all aspects of the RA operations, and the CA is willing to assert to the effectiveness of the controls performed by the external RAs and include the RA operations in the examination. In these rare situations, the CA and the auditor need to agree in advance with this approach, including the extent and sufficiency of controls being exercised.

.30 External RAs could be examined and reported on separately from the CA using the relevant criteria contained in this *Trust Services Principles and Criteria for Certification Authorities Version 2.0*. Illustrative reports for these types of examinations will be the subject of future guidance.

What Is an Extended Validation Certificate?

.31 When a CA performs additional steps to authenticate the entity to which certificates are being issued, the certificates issued are differentiated and issued as extended validation certificates. These certificates provide even more assurance regarding the identity of the website owner.

.32 According to www.cabforum.org

Extended Validation SSL (EV SSL) Certificates build on the existing SSL certificate format, but provide an additional layer of protection in a strictly defined issuance process created to ensure that the certificate holder is who they claim to be. To ensure the ongoing integrity of the process, revocation measures are specified that allow for the quick and effective revocation of improperly issued or misused certificates. Leading Relying-Party Application Software Suppliers support EV SSL, which allows the browser to display the verified identity of the website owner to the user.²

What Is a Certification Practice Statement and a Certificate Policy?

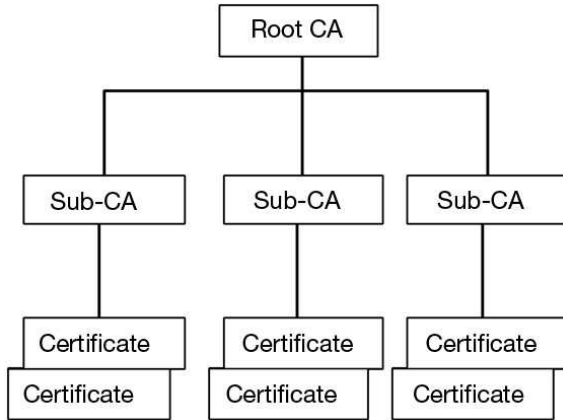
.33 A *certification practice statement* (CPS) is a statement of the practices that a CA employs in issuing and managing certificates. A *certificate policy* (CP) is a named set of rules that indicates the applicability of a certificate to a particular community or class of application, or both, with common security requirements. For example, a particular CP might indicate the applicability of a type of certificate to the authentication of electronic data interchange transactions for the trading of goods within a given price range.

What Are the Hierarchical and Cross-Certified CA Models?

.34 CAs may be linked using two basic architectures or a hybrid of the two: hierarchical and cross-certified (shared trust). In a hierarchical model, a highest level (or root) CA is deployed, and subordinate CAs may be set up for various business units, domains, or communities of interest. The *root CA* validates the subordinate CAs, which, in turn, issue certificates to lower tier CAs or directly to subscribers. Such a root CA typically has more stringent security requirements than a subordinate CA. Although it is difficult for an attacker to access the root CA (which, in some implementations, is only online in the rare event that it must issue, renew, or revoke subordinate CA certificates), one drawback to this model is that the root CA represents a single point of failure. In the hierarchical model, the root CA maintains the established “community of trust” by ensuring that each entity in the hierarchy conforms to a minimum set of practices. Adherence to the established policies may be tested through audits of the subordinate CAs and, in a number of cases, the RAs.

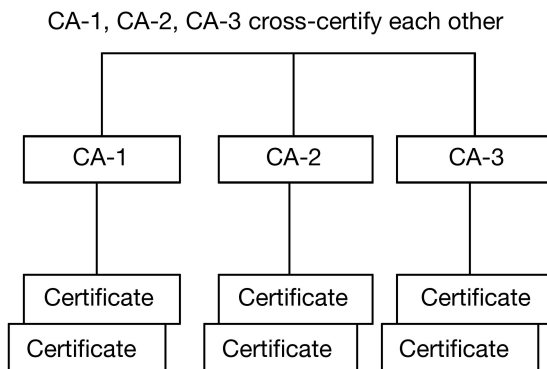
² See www.cabforum.org.

.35 The following diagram illustrates the structure and relationships between CAs and subscribers operating in a hierarchical model.



.36 In an alternative model, cross-certified CAs are built on a “peer-to-peer” model. Rather than deploying a common root CA, the cross-certification model shares trust among CAs known to one another. *Cross-certification* is a process in which two CAs certify the trustworthiness of the other’s certificates. If two CAs, CA1 and CA2, cross-certify, CA1 creates and digitally signs a certificate containing the public key of CA2 (and vice versa). Consequently, users in either CA domain are assured that each CA trusts the other and, therefore, subscribers in each domain can trust each other. Cross-certified CAs are not subject to the single point of failure in the hierarchical model. However, the network is only as strong as the weakest CA and requires continual policing. In the cross-certified model, to establish and maintain a community of trust, audits may be performed to ensure that each cross-certified CA conforms to a minimum set of practices as agreed upon by the members of the community of trust.

.37 The following diagram illustrates the structure and relationships between CAs and subscribers operating in a cross-certified (shared trust) model.



.38 In a hybrid model, both a hierarchical structure and cross-certification are employed. For example, two existing hierarchical communities of trust may want to cross-certify each other, such that members of each community can rely on the certificates issued by the other to conduct e-commerce.

What Is the Impact of Subordinate CAs?

.39 Depending on report users' needs, subordinate CAs may or may not be included in the scope of examination. It is important that the system description and assertion clearly articulate the hierarchy that is in scope.

What Are Some of the Business Issues Associated With CAs?

.40 Unless they are subject to governmental licensing and regulation, CAs may use different standards or procedures to verify the identity of persons to whom they issue certificates. Thus, a digital signature is only as reliable as the CA is trustworthy in performing its functions. Consequently, a relying party needs some way to gauge how much reliance it should place on a digital signature supported by a certificate issued by a particular CA.

.41 CA topology (for example, a hierarchical, cross-certified, or a hybrid model) is a developing issue. Which model is most appropriate depends on the particular business circumstances. Although it is important that public keys be certified, the issuance of nonstandard certificates can be a concern. For example, if the broadly recognized International Telecommunications Union-Telecommunication Standardization Sector's X.509 data format standard³ is not used, subscribers and relying parties may be unable to process such certificates. Implementing the cross-certified CA model (discussed previously) would also be very difficult. For these reasons, major entities, such as the U.S. and Canadian governments, are using, or plan to use, X.509 certificates for their internal and external activities.

Principles and Criteria for Certification Authorities

.42 In order to be understandable to the ultimate users (the subscriber and the relying party), the principles set out in the following sections have been developed with the relying party in mind and, as a result, are intended to be practical and nontechnical in nature.

CA Principles

CA Business Practices Disclosure

- .43 The certification authority (CA)
- discloses its business, key life cycle management, certificate life cycle management, and CA environmental control practices in its certification practice statement and
 - discloses its business, key life cycle management, certificate life cycle management, and CA environmental control policies in its certificate policy (if applicable).

³ International Telecommunications Union-Telecommunication Standardization Sector Recommendation X.509 (1997) was also standardized by the International Organization for Standardization (ISO) as ISO/IEC 9594-8.

.44 The CA maintains effective controls to provide reasonable assurance that

- the CA's certification practice statement is consistent with its certificate policy (if applicable), and
- the CA provides its services in accordance with its certificate policy (if applicable) and certification practice statement (CPS).

.45 The CA must disclose its key and certificate life cycle management business and information privacy practices. Information regarding the CA's business practices should be made available to all subscribers and all potential relying parties, typically by posting on its website. Such disclosure may be contained in a certificate policy (CP) or CPS, or both, or in other informative materials that are available to users (subscribers and relying parties).

Service Integrity

.46 The certification authority (CA) maintains effective controls to provide reasonable assurance that

- the integrity of keys and certificates it manages is established and protected throughout their life cycles;
- the subscriber information is properly authenticated (for the registration activities performed by ABC Certification Authority, Inc.); and
- subordinate CA certificate requests are accurate, authenticated, and approved.

.47 Effective key management controls and practices are essential to the trustworthiness of the public key infrastructure. Cryptographic key management controls and practices cover CA key generation, CA key storage, backup and recovery, CA public key distribution (especially when done in the form of self-signed root certificates), CA key escrow (if applicable), CA key usage, CA key destruction, CA key archival, the management of CA cryptographic hardware through its life cycle, and CA-provided subscriber key management services (if applicable). Strong key life cycle management controls are vital to guard against key compromise, which can damage the integrity of the public key infrastructure.

.48 The user certificate life cycle is at the core of the services provided by the CA. The CA establishes its standards and practices by which it will deliver services in its published certification practice statement and certificate policy. The user certificate life cycle includes the following:

- Registration (that is, the identification and authentication process related to binding the individual subscriber to the certificate)
- The renewal of certificates (if applicable)
- The rekey of certificates
- The revocation of certificates
- The suspension of certificates (if applicable)
- The timely publication of certificate status information (through certificate revocation lists or some form of online certificate status protocol)
- The management of integrated circuit cards (ICCs) holding private keys through their life cycle (if applicable)

.49 Effective controls over the registration process are essential because poor identification and authentication controls jeopardize the ability of subscribers and relying parties to rely on the certificates issued by the CA. Effective revocation procedures and timely publication of certificate status information are also critical elements because it is critical for subscribers and relying parties to know when they are unable to rely on certificates that have been issued by the CA.

CA Environmental Controls

.50 The certification authority (CA) maintains effective controls to provide reasonable assurance that

- logical and physical access to CA systems and data are restricted to authorized individuals;
- the continuity of key and certificate management operations is maintained; and
- CA systems development, maintenance, and operations are properly authorized and performed to maintain CA systems integrity.

.51 The establishment and maintenance of a trustworthy CA environment is essential to the reliability of the CA's business processes. Without strong CA environmental controls, strong key and certificate life cycle management controls are severely diminished in value. CA environmental controls include certification practice statement and certificate policy management, security policy management, security management, asset classification and management, personnel security, physical and environmental security of the CA facility, operations management, system access management, systems development and maintenance, business continuity management, monitoring and compliance, and event journaling.

.52 The original CA Business Practices Disclosure criteria in version 1.0 were derived primarily from the IETF's Internet X.509 Public Key Infrastructure Certificate Policy and Certification Practices Framework—Request For Comments Draft (RFC 2527), which has been incorporated into Annex A of the draft ANSI X9.79 standard. *Trust Services Principles and Criteria for Certification Authorities Version 2.0* currently allows the CA to use RFC 2527, version 1.0 of the *WebTrust® Program for Certification Authorities Criteria*, or RFC 3647 that was issued in November 2003.⁴ For specific key and certificate life cycle management and CA environmental illustrative controls, in which the CA's implemented controls may vary depending on the CA's business practices, such illustrative controls refer to specifically required CA business practices disclosures included in principle 1 of the CA Business Practices Disclosure.

Intended Use of the Trust Services Principles and Criteria

.53 The *Trust Services Principles and Criteria for Certification Authorities* can be used as a control framework to assess the adequacy of the CA systems, policies, and procedures. It provides a basis for self-assessment for either development or maintaining strong PKI systems.

.54 Assessors and auditors can use the framework as a benchmark for performing an internal or independent assessment as an internal auditor or independent external auditor as supported by the CA/Browser Forum. For

⁴ In the event that a replacement for Request for Comments 3647 is issued at a future date, that version could also be used.

licensed WebTrust® auditors, additional support is provided online at www.webtrust.org.

Trust Service Principles and Criteria for Certification Authorities

1. CA Business Practices Disclosure

.55 The certification authority (CA)

- discloses its business, key life cycle management, certificate life cycle management, and CA environmental control practices in its certification practice statement;
- discloses its business, key life cycle management, certificate life cycle management, and CA environmental control policies in its certificate policy (if applicable); and
- provides services in accordance with its disclosed practices.

1.1 Certification Practice Statement

Criteria:

The certification authority (CA) discloses its business practices, including, but not limited to, the topics listed in RFC 3647, RFC 2527, or *WebTrust® Program for Certification Authorities v1 CA Business Practices Disclosure Criteria* (see appendix A) in its certification practice statement.

1.2 Certificate Policy (if applicable)

Criteria:

The certification authority discloses its business practices, including, but not limited to, the topics listed in RFC 3647, RFC 2527, or *WebTrust® Program for Certification Authorities v1* (see appendix A) in its certificate policy.

2. CA Business Practices Management

.56 The certification authority (CA) maintains effective controls to provide reasonable assurance that

- the CA's certification practice statement is consistent with its certificate policy (if applicable), and
- the CA provides its services in accordance with its certificate policy (if applicable) and certification practice statement.

2.1 Certificate Policy Management (if applicable)

Criteria:

The certification authority (CA) maintains controls to provide reasonable assurance that its certificate policy management process is effective.

<i>Illustrative Controls:</i>	
	Certificate Policy Management
1	The policy authority (PA) has the responsibility of defining the business requirements and policies for using digital certificates and specifying them in a certificate policy (CP) and supporting agreements.
2	The PA has final authority and responsibility for specifying and approving CP(s).
3	CP(s) are approved by the PA in accordance with a defined review process, including responsibilities for maintaining and tracking changes to the CP(s).
4	A defined review process exists to assess that the CP(s) are capable of support by the controls specified in the certification practice statement.
5	The PA makes available the CPs supported by the CA to subscribers and relying parties.

2.2 Certification Practice Statement Management

<i>Criteria:</i>
The certification authority (CA) maintains controls to provide reasonable assurance that its certification practice statement management processes are effective.

<i>Illustrative Controls:</i>	
	Certification Practice Statement Management
1	The policy authority (PA) has final authority and responsibility for approving the CA's certification practice statement (CPS).
2	Responsibilities for maintaining the CPS have been formally assigned.
3	The CA's CPS is modified and approved in accordance with a defined review process.
4	The CA makes available its CPS to all appropriate parties.
5	Revisions to the CA's CPS are made available to appropriate parties.
6	The CA updates its CPS to reflect changes in the environment as they occur.

2.3 CP and CPS Consistency (if applicable)

<i>Criteria:</i>
The certification authority (CA) maintains controls to provide reasonable assurance that its certification practice statement (CPS) addresses the topics included in its certificate policy (CP).

Illustrative Controls:	
	CP and CPS Consistency
1	The policy authority (PA) is responsible for ensuring that the CA's control processes, as stated in a CPS or equivalent, fully comply with the requirements of the CP.
2	The CA addresses the requirements of the CP when developing its CPS.
3	The CA assesses the impact of proposed CPS changes to ensure that they are consistent with the CP.
4	A defined review process exists to ensure that CP(s) are supported by the CA's CPS.

3. CA Environmental Controls

.57 The certification authority (CA) maintains effective controls to provide reasonable assurance that

- logical and physical access to CA systems and data is restricted to authorized individuals;
- the continuity of key and certificate management operations is maintained; and
- CA systems development, maintenance, and operations are properly authorized and performed to maintain CA systems integrity.

3.1 Security Management

Criteria:	
	The certification authority (CA) maintains controls to provide reasonable assurance that
	<ul style="list-style-type: none"> • security is planned, managed, and supported within the organization; • security risks are identified and managed; • the security of CA facilities, systems, and information assets accessed by third parties is maintained; and • the security of subscriber and relying party information is maintained when the responsibility for CA subfunctions has been outsourced to another organization or entity.

Illustrative Controls:	
	Information Security Policy
1	An information security policy document (that includes physical, personnel, procedural, and technical controls), is approved by management, published, and communicated to all employees.
2	The information security policy includes the following: <ol style="list-style-type: none"> a. A definition of information security, its overall objectives and scope, and the importance of security as an enabling mechanism for information sharing

(continued)

<i>Illustrative Controls:</i>	
	<ul style="list-style-type: none"> b. A statement of management intent, supporting the goals and principles of information security c. An explanation of the security policies, principles, standards, and compliance requirements of particular importance to the organization d. A definition of general and specific responsibilities for information security management, including reporting security incidents e. References to documentation, which supports the policy
3	A defined review process exists for maintaining the information security policy, including responsibilities and review dates.
Information Security Infrastructure	
4	Senior management or a high-level management information security committee, or both, have the responsibility to ensure there is clear direction and management support to manage risks effectively.
5	A management group or security committee exists to coordinate the implementation of information security controls and the management of risk.
6	Responsibilities for the protection of individual assets and for carrying out specific security processes are clearly defined.
7	A management authorization process for new information processing facilities exists and is followed.
Security of Third Party Access	
8	Procedures exist and are enforced to control physical and logical access to CA facilities and systems by third parties (for example, on-site contractors, trading partners, and joint ventures).
9	If a business need exists for the CA to allow third party access to CA facilities and systems, a risk assessment is performed to determine security implications and specific control requirements.
10	Arrangements involving third party access to CA facilities and systems are based on a formal contract containing necessary security requirements.
Outsourcing	
11	If the CA outsources the management and control of all or some of its information systems, networks, or desktop environments, the CA's security requirements are addressed in a contract agreed upon between the parties.
12	If the CA chooses to delegate a portion of the CA roles and respective functions to another party, the CA maintains responsibility for the completion of the outsourced functions and the definition and maintenance of a statement of its certification practice statement.

3.2 Asset Classification and Management

Criteria:

The certification authority (CA) maintains controls to provide reasonable assurance that CA assets and subscriber and relying party information receive an appropriate level of protection based upon identified risks and in accordance with the CA's disclosed business practices.

Illustrative Controls:

1	Owners are identified for all CA assets and assigned responsibility for the protection of the assets.
2	Inventories of CA assets are maintained.
3	The CA has implemented information classification and associated protective controls for information based on business needs and the business impacts associated with such needs.
4	Information labeling and handling are performed in accordance with the CA's information classification scheme and documented procedures.

3.3 Personnel Security

Criteria:

The certification authority (CA) maintains controls to provide reasonable assurance that personnel and employment practices enhance and support the trustworthiness of the CA's operations.

Illustrative Controls:

1	The CA employs personnel (that is, employees and contractors) who possess the relevant skills, knowledge, and experience required for the job function.
2	Security roles and responsibilities, as specified in the organization's security policy, are documented in job descriptions.
3	Trusted roles, on which the security of the CA's operation is dependent, are clearly identified. Trusted roles include, at a minimum, the following responsibilities: <ol style="list-style-type: none"> a. Overall responsibility for administering the implementation of the CA's security practices b. Approval of the generation, revocation, and suspension of certificates c. Installation, configuration, and maintenance of the CA systems d. Day-to-day operation of CA systems and system backup and recovery e. Viewing and maintenance of CA system archives and audit logs

(continued)

<i>Illustrative Controls:</i>	
	<p>f. Cryptographic key life cycle management functions (for example, key component custodians)</p> <p>g. CA systems development</p>
4	The CA's policies and procedures specify the background checks and clearance procedures required for trusted roles and nontrusted roles. As a minimum, verification checks on permanent staff are performed at the time of job application and periodically for those individuals undertaking trusted roles.
5	An individual's trusted status is approved prior to gaining access to systems and facilities or performing actions requiring trusted status.
6	CA employees and trusted roles sign a confidentiality (nondisclosure) agreement as a condition of employment.
7	Contractors who perform trusted roles are subject to at least the same background check and personnel management procedures as employees.
8	<p>Any contract arrangement between contractors and CAs allows for the provision of temporary contract personnel that explicitly allows the organization to take measures against contract staff who violate the organization's security policies. Protective measures may include</p> <p>a. bonding requirements on contract personnel;</p> <p>b. indemnification for damages due to contract personnel willful, harmful actions; and</p> <p>c. financial penalties.</p>
9	Periodic reviews occur to verify the continued trustworthiness of personnel involved in the activities related to key management and certificate management.
10	A formal disciplinary process exists and is followed for employees who have violated organizational security policies and procedures. The CA's policies and procedures specify the sanctions against personnel for unauthorized actions, unauthorized use of authority, and unauthorized use of systems.
11	Physical and logical access to CA facilities and systems is disabled upon termination of employment.
12	If required based on a risk assessment, duress alarms are provided for users who might be the target of coercion.
13	<p>All employees of the organization and, when relevant, third party contractors, receive appropriate training in organizational policies and procedures. The CA's policies and procedures specify the following:</p> <p>a. The training requirements and training procedures for each role</p> <p>b. Any retraining period and retraining procedures for each role</p>

3.4 Physical and Environmental Security

Criteria:	
The certification authority (CA) maintains controls to provide reasonable assurance that	
<ul style="list-style-type: none"> • physical access to CA facilities and equipment is limited to authorized individuals, protected through restricted security perimeters, and is operated under multiple person (at least dual custody) control; • CA facilities and equipment are protected from environmental hazards; • loss, damage, or compromise of assets and interruption to business activities are prevented; and • compromise of information and information processing facilities is prevented. 	

Illustrative Controls:	
	CA Facility Physical Security
1	Entry to the building or site containing the CA's certificate manufacturing facility is achieved only through a limited number of controlled access points.
2	All critical CA operations take place within a physically secure facility with at least four layers of security to access sensitive hardware or software. Such systems are physically separated from the organization's other systems so that only authorized employees of the CA can access them.
3	A manned reception area or other means to control physical access is in place to restrict access to the building or site housing CA operations to authorized personnel only.
4	Physical barriers are in place (for example, solid walls that extend from real floor to real ceiling) to prevent unauthorized entry and environmental contamination to the CAs certificate manufacturing facility.
5	Physical barriers are in place (for example, Faraday cage) to prevent electromagnetic radiation emissions for all root CA operations (for example, key generation and certification of CA certificates) as disclosed in certificate policy or certification practice statement, or both.
6	Fire doors on security perimeters around CA operational facilities are alarmed and conform to local fire regulations.
7	Intruder detection systems are installed and regularly tested to cover all external doors of the building housing the CA operational facilities.
8	CA operational facilities are physically locked and alarmed when unoccupied.
9	All personnel are required to wear visible identification. Employees are encouraged to challenge anyone not wearing visible identification.

(continued)

<i>Illustrative Controls:</i>	
10	Access to CA operational facilities is controlled and restricted to authorized persons through the use of multifactor authentication controls.
11	All personnel entering and leaving CA operational facilities are logged (that is, an audit trail of all access is securely maintained).
12	Entry, exit, and activities within CA facilities are monitored by cameras.
13	Visitors to CA facilities are supervised and their date and time of entry and departure recorded.
14	Third party support services personnel is granted restricted access to secure CA operational facilities only when required, and such access is authorized and accompanied.
15	Access rights to CA facilities are regularly reviewed and updated.
Equipment Security	
16	The CA maintains an equipment inventory.
17	Equipment is sited or protected to reduce the risks from environmental threats and hazards and opportunities for unauthorized access.
18	Equipment is protected from power failures and other electrical anomalies.
19	Power and telecommunications within the facility housing the CA operation, cabling carrying data, or supporting CA services is protected from interception or damage.
20	Equipment is maintained in accordance with the manufacturer's instructions or other documented procedures, or both.
21	All items of equipment containing storage media (fixed and removable disks) are checked to ensure that they do not contain sensitive data prior to their disposal. Storage media containing sensitive data is physically destroyed or securely overwritten prior to disposal or reused.
General Controls	
22	Sensitive or critical business information is locked away when not required and when the CA facility is vacated.
23	Procedures require that personal computers and workstations are logged off or protected by key locks, passwords, or other controls when not in use.
24	The movement of materials to and from the CA facility requires prior authorization.

3.5 Operations Management

Criteria:

The certification authority (CA) maintains controls to provide reasonable assurance that

- the correct and secure operation of CA information processing facilities is ensured;
- the risk of CA systems failure is minimized;
- the integrity of CA systems and information is protected against viruses and malicious software;
- damage from security incidents and malfunctions is minimized through the use of incident reporting and response procedures; and
- media are securely handled to protect them from damage, theft, and unauthorized access.

Illustrative Controls:

Illustrative Controls:	
	Operational Procedures and Responsibilities
1	CA operating procedures are documented and maintained for each functional area.
2	Formal management responsibilities and procedures exist to control all changes to CA equipment, software, and operating procedures.
3	Duties and areas of responsibility are segregated in order to reduce opportunities for unauthorized modification or misuse of information or services.
4	Development and testing facilities are separated from operational facilities.
5	Prior to using external facilities management services, risks and related controls are identified, agreed upon with the contractor, and incorporated into the contract.
	System Planning and Acceptance
6	Capacity demands are monitored and projections of future capacity requirements made to ensure that adequate processing power and storage are available.
7	Acceptance criteria for new information systems, upgrades, and new versions are established and suitable tests of the system carried out prior to acceptance.
	Protection Against Viruses and Malicious Software
8	Detection and prevention controls to protect against viruses and malicious software are implemented. Employee awareness programs are in place.
	Incident Reporting and Response
9	A formal security incident reporting procedure exists, setting out the actions to be taken upon receipt of an incident report. This includes a definition and documentation of assigned responsibilities and escalation procedures. Any incidents are reported to the policy authority as a matter of urgency.

(continued)

<i>Illustrative Controls:</i>	
10	Users of CA systems are required to note and report observed or suspected security weaknesses in, or threats to, systems or services as they are detected.
11	Procedures exist and are followed for reporting hardware and software malfunctions.
12	Procedures exist and are followed to assess that corrective action is taken for reported incidents.
13	A formal problem management process exists that allows the types, volumes, and impacts of incidents and malfunctions to be documented, quantified, and monitored.
Media Handling and Security	
14	Procedures for the management of removable computer media require the following: <ul style="list-style-type: none"> a. If no longer required, the previous contents of any reusable media that are to be removed from the organization are erased or media is destroyed. b. Authorization is required for all media removed from the organization, and a record of all such removals to maintain an audit trail is kept. c. All media are stored in a safe, secure environment, in accordance with manufacturers' specifications.
15	Equipment containing storage media (that is, fixed hard disks) is checked to determine whether they contain any sensitive data prior to disposal or reuse. Storage devices containing sensitive information are physically destroyed or securely overwritten prior to disposal or reuse.
16	Procedures for the handling and storage of information exist and are followed in order to protect such information from unauthorized disclosure or misuse.
17	System documentation is protected from unauthorized access.

3.6 System Access Management

<i>Criteria:</i>
<p>The certification authority (CA) maintains controls to provide reasonable assurance that CA system access is limited to authorized individuals. Such controls provide reasonable assurance that</p> <ul style="list-style-type: none"> • operating system and database access is limited to authorized individuals with predetermined task privileges; • access to network segments housing CA systems is limited to authorized individuals, applications, and services; and • CA application use is limited to authorized individuals.

<i>Illustrative Controls:</i>	
	User Access Management
1	Business requirements for access control are defined and documented in an access control policy that includes at least the following: <ol style="list-style-type: none"> a. Roles and corresponding access permissions b. Identification and authentication process for each user c. Segregation of duties d. Number of persons required to perform specific CA operations (that is, m of n rule, where m represents the number of key shareholders required to perform an operation, and n represents the total number of key shares)
2	A formal user registration and deregistration procedure for access to CA information systems and services exists.
3	The allocation and use of privileges is restricted and controlled.
4	The allocation of passwords is controlled through a formal management process.
5	Access rights for users with trusted roles are reviewed at regular intervals and updated.
6	Users are required to follow defined policies and procedures in the selection and use of passwords.
7	Users are required to ensure that unattended equipment has appropriate protection.
	Network Access Control
8	CA employed personnel are provided direct access only to the services that they have been specifically authorized to use. The path from the user terminal to computer services is controlled.
9	Remote access to CA systems made by CA employees or external systems, if permitted, requires authentication.
10	Connections made by CA employees or CA systems to remote computer systems are authenticated.
11	Access to diagnostic ports is securely controlled.
12	Controls (for example, firewalls) are in place to protect the CA's internal network domain from any unauthorized access from any other domain.
13	Controls are in place to limit the network services (for example, HTTP, FTP, and so forth) available to authorized users in accordance with the CA's access control policies. The security attributes of all network services used by the CA organization are documented by the CA.
14	Routing controls are in place to ensure that computer connections and information flows do not breach the CA's access control policy.

(continued)

<i>Illustrative Controls:</i>	
15	The CA maintains local network components (for example, firewalls and routers) in a physically secure environment and audits their configurations periodically for compliance with the CA's configuration requirements.
16	Sensitive data is encrypted when exchanged over public or untrusted networks.
Operating System and Database Access Control	
17	Operating systems and databases are configured in accordance with the CA's system configuration standards and periodically reviewed and updated.
18	Operating system and database patches and updates are applied in a timely manner when deemed necessary based on a risk assessment.
19	Automatic terminal identification is used to authenticate connections to specific locations and to portable equipment.
20	Access to CA systems requires a secure logon process.
21	All CA personnel users have a unique identifier (user ID) for their personal and sole use so that activities can be traced to the responsible individual. When shared or group accounts are required, other monitoring controls are implemented to maintain individual accountability.
22	Uses of system utility programs are restricted to authorized personnel and tightly controlled.
23	Inactive terminals serving CA systems require reauthentication prior to use.
24	Restrictions on connection times are used to provide additional security for high risk applications.
25	Sensitive data is protected against disclosure to unauthorized users.
Application Access Control	
26	Access to information and application system functions is restricted in accordance with the CA's access control policy.
27	CA personnel are successfully identified and authenticated before using critical applications related to certificate management.
28	Sensitive systems (for example, root CA) require a dedicated (isolated) computing environment.

3.7 Systems Development and Maintenance

<i>Criteria:</i>
The certification authority (CA) maintains controls to provide reasonable assurance that CA systems development and maintenance activities are documented, tested, authorized, and properly implemented to maintain CA system integrity.

Illustrative Controls:	
1	Business requirements for new systems or enhancements to existing systems specify the control requirements.
2	Software testing and change control procedures exist and are followed for the implementation of software on operational systems, including scheduled software releases, modifications, and emergency software fixes.
3	Change control procedures exist and are followed for the hardware, network component, and system configuration changes.
4	Test data is protected and controlled.
5	Control is maintained over access to program source libraries.
6	Application systems are reviewed and tested when operating system changes occur.
7	The implementation of changes is strictly controlled by the use of formal change control procedures to minimize the risk of corruption of information systems.
8	Modifications to software packages are discouraged, and all changes are strictly controlled.
9	The purchase, use, and modification of software are controlled and checked to protect against possible covert channels and Trojan code. This includes the authentication of the source of the software. These controls apply equally to outsourced software development.

3.8 Business Continuity Management

Criteria:
<p>The certification authority (CA) maintains controls to provide reasonable assurance of continuity of operations in the event of a disaster. Such controls include, at a minimum</p> <ul style="list-style-type: none"> • the development and testing of a CA business continuity plan that includes a disaster recovery process for critical components of the CA system; • the storage of required cryptographic materials (that is, secure cryptographic device and activation materials) at an alternate location; • the storage of backups of systems, data, and configuration information at an alternate location; and • the availability of an alternate site, equipment, and connectivity to enable recovery. <p>The CA maintains controls to provide reasonable assurance that potential disruptions to subscribers and relying parties are minimized as a result of the cessation or degradation of the CA's services.</p>

Illustrative Controls:	
1	The CA has a managed process for developing and maintaining its business continuity plans. The CA has a business continuity planning strategy based on an appropriate risk assessment.

(continued)

<i>Illustrative Controls:</i>	
2	<p>The CA has a business continuity plan to maintain or restore the CA's operations in a timely manner following interruption to, or failure of, critical CA processes. The CA's business continuity plan addresses the following:</p> <ol style="list-style-type: none"> a. The conditions for activating the plans b. Emergency procedures c. Fallback procedures d. Resumption procedures e. A maintenance schedule for the plan f. Awareness and education requirements g. The responsibilities of the individuals h. Recovery time objective i. Regular testing of contingency plans
3	<p>The CA's business continuity plans include disaster recovery processes for all critical components of a CA system, including the hardware, software, and keys, in the event of a failure of one or more of these components. Specifically</p> <ol style="list-style-type: none"> a. cryptographic devices used for storage of backup CA private keys are securely stored at an off-site location in order for the CA to recover in the event of a disaster at the primary CA facility; and b. the requisite secret key shares or key components needed to use and manage the disaster recovery cryptographic devices are securely stored at an off-site location.
4	<p>Backup copies of essential business information are regularly taken. The security requirements of these copies are consistent with the controls for the information backed up.</p>
5	<p>The CA identifies and arranges for an alternate site where core public key infrastructure operations can be restored in the event of a disaster at the CA's primary site. Fallback equipment and backup media are sited at a safe distance to avoid damage from disaster at the main site.</p>
6	<p>The CA's business continuity plans include procedures for securing its facility to the extent possible during the period of time following a disaster and prior to restoring a secure environment either at the original or a remote site.</p>
7	<p>The CA's business continuity plans address the recovery procedures used if computing resources, software, or data are corrupted or suspected to be corrupted.</p>
8	<p>Business continuity plans are tested regularly to ensure that they are up to date and effective.</p>
9	<p>Business continuity plans define an acceptable system outage time, recovery time, and the average time between failures as disclosed in the certificate policy (CP) or certification practice statement (CPS), or both.</p>
10	<p>Business continuity plans are maintained by regular reviews and updates to ensure their continuing effectiveness.</p>

Illustrative Controls:

11	The CA maintains procedures for the termination, notification of affected entities, and for transferring relevant archived CA records to a custodian as disclosed in the CP or CPS, or both.
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3.9 Monitoring and Compliance**Criteria:**

The certification authority (CA) maintains controls to provide reasonable assurance that

- it conforms with the relevant legal, regulatory, and contractual requirements;
- compliance with the CA's security policies and procedures is ensured;
- the effectiveness of the system audit process is maximized and interference to and from the system audit process is minimized; and
- unauthorized CA system usage is detected.

Illustrative Controls:

Compliance With Legal Requirements	
1	Relevant statutory, regulatory, and contractual requirements are explicitly defined and documented.
2	The CA has implemented procedures to comply with legal restrictions on the use of material in respect of intellectual property rights and on the use of proprietary software products.
3	Controls are in place to ensure compliance with national agreements, laws, regulations, or other instruments to control the access to, or use of, cryptographic hardware and software.
4	Procedures exist to ensure that personal information is protected in accordance with relevant legislation.
5	The information security policy addresses the following: <ol style="list-style-type: none"> a. The information that must be kept confidential by CA or registration authority b. The information that is not considered confidential c. The policy on release of information to law enforcement officials d. Information that can be revealed as part of civil discovery e. The conditions upon which information may be disclosed with the subscriber's consent f. Any other circumstances under which confidential information may be disclosed
6	CA records are protected from loss, unauthorized destruction, and falsification.
7	Management authorizes the use of information processing facilities, and controls are applied to prevent the misuse of such facilities.

(continued)

Illustrative Controls:	
	Review of Security Policy and Technical Compliance
8	Managers are responsible for ensuring that security procedures within their area of responsibility are carried out correctly.
9	The CA's operations are subject to regular review to ensure timely compliance with its certification practice statement.
10	CA systems are periodically checked for compliance with security implementation standards.
System Audit Process	
11	Audits of operational systems are planned and agreed to minimize the risk of disruptions to business processes.
12	Access to system audit tools is protected to prevent possible misuse or compromise.
Monitoring System Access and Use	
13	Procedures for monitoring the use of CA systems are established, which include the timely identification and follow up of unauthorized or suspicious activity. Alerting mechanisms are implemented to detect unauthorized access.

3.10 Audit Logging

Criteria:	
<p>The certification authority (CA) maintains controls to provide reasonable assurance that</p> <ul style="list-style-type: none"> • significant CA environmental, key management, and certificate management events are accurately and appropriately logged; • the confidentiality and integrity of current and archived audit logs are maintained; • audit logs are completely and confidentially archived in accordance with disclosed business practices; and • audit logs are reviewed periodically by authorized personnel. 	

Illustrative Controls:	
Audit Logs	
1	The CA generates automatic (electronic) and manual audit logs in accordance with the requirements of the certificate policy (CP) or certification practice statement (CPS).
2	<p>All journal entries include the following elements:</p> <ol style="list-style-type: none"> a. Date and time of the entry b. Serial or sequence number of entry (for automatic journal entries) c. Kind of entry d. Source of entry (for example, terminal, port, location, customer, and so forth) e. Identity of the entity making the journal entry

<i>Illustrative Controls:</i>	
	Events Logged
3	<p>The CA logs the following CA and subscriber (if applicable) key life cycle management related events:</p> <ul style="list-style-type: none"> a. CA key generation b. Installation of manual cryptographic keys and its outcome (with the identity of the operator) c. CA key backup d. CA key storage e. CA key recovery f. CA key escrow activities (if applicable) g. CA key usage h. CA key archival i. Withdrawal of keying material from service j. CA key destruction k. Identity of the entity authorizing a key management operation l. Identity of the entities handling any keying material (such as key components or keys stored in portable devices or media) m. Custody of keys and of devices or media holding keys n. Compromise of a private key
4	<p>The CA logs the following cryptographic device life cycle management related events:</p> <ul style="list-style-type: none"> a. Device receipt and installation b. Placing into or removing a device from storage c. Device activation and usage d. Device deinstallation e. Designation of a device for service and repair f. Device retirement
5	<p>If the CA provides subscriber key management services, the CA logs the following subscriber key life cycle management related events:</p> <ul style="list-style-type: none"> a. Key generation b. Key distribution (if applicable) c. Key backup (if applicable) d. Key escrow (if applicable) e. Key storage f. Key recovery (if applicable) g. Key archival (if applicable) h. Key destruction i. Identity of the entity authorizing a key management operation j. Key compromise

(continued)

<i>Illustrative Controls:</i>	
6	<p>The CA records (or requires that the registration authority [RA] record) the following certificate application information:</p> <ol style="list-style-type: none"> a. The method of identification applied, and information used to meet, subscriber requirements b. Record of unique identification data, numbers, or a combination thereof (for example, applicant's driver's license number) of identification documents, if applicable c. Storage location of copies of applications and identification documents d. Identity of entity accepting the application e. Method used to validate identification documents, if any f. Name of receiving CA or submitting RA, if applicable g. The subscriber's acceptance of the subscriber agreement h. When required under privacy legislation, the subscriber's consent to allow the CA to keep records containing personal data, pass this information to specified third parties, and publication of certificates
7	<p>The CA logs the following certificate life cycle management related events:</p> <ol style="list-style-type: none"> a. Receipt of requests for certificate(s), including initial certificate requests, renewal requests, and rekey requests b. Submissions of public keys for certification c. Change of affiliation of an entity d. Generation of certificates e. Distribution of the CA's public key f. Certificate revocation requests g. Certificate revocation h. Certificate suspension requests (if applicable) i. Certificate suspension and reactivation j. Generation and issuance of certificate revocation lists
8	<p>The CA logs the following security-sensitive events:</p> <ol style="list-style-type: none"> a. Security-sensitive files or records read or written, including the audit log itself b. Actions taken against security-sensitive data c. Security profile changes d. Use of identification and authentication mechanisms, both successful and unsuccessful (including multiple failed authentication attempts) e. System crashes, hardware failures, and other anomalies f. Actions taken by individuals in trusted roles, computer operators, system administrators, and system security officers g. Change of affiliation of an entity

<i>Illustrative Controls:</i>	
	<p><i>h.</i> Decisions to bypass encryption and authentication processes or procedures</p> <p><i>i.</i> Access to the CA system or any component thereof</p>
9	Audit logs do not record the private keys in any form (for example, plaintext or enciphered).
10	CA computer system clocks are synchronized for accurate recording as defined in the CP or CPS, or both, that specifies the accepted time source.
Audit Log Protection	
11	Current and archived audit logs are maintained in a form that prevents their modification, substitution, or unauthorized destruction.
12	Digital signatures are used to protect the integrity of audit logs, when applicable, or are required to satisfy legal requirements.
13	The private key used for signing audit logs is not used for any other purpose. This applies equally to a symmetric secret key used with a symmetric message authentication code (MAC) mechanism.
Audit Log Archival	
14	The CA archives audit log data on a periodic basis as disclosed in the CP or CPS, or both.
15	In addition to possible regulatory stipulation, a risk assessment is performed to determine the appropriate length of time for retention of archived audit logs.
16	The CA maintains archived audit logs at a secure off-site location for a predetermined period as determined by risk assessment and legal requirements.
Review of Audit Logs	
17	Current and archived audit logs are only retrieved by authorized individuals for valid business or security reasons.
18	Audit logs are reviewed periodically according to the practices established in the CPS. The review of current and archived audit logs include a validation of the audit logs' integrity and the timely identification and follow-up of unauthorized or suspicious activity.

4. CA Key Life Cycle Management Controls

.58 The certification authority (CA) maintains effective controls to provide reasonable assurance that the integrity of the keys and certificates it manages is established and protected throughout their life cycles.

4.1 CA Key Generation

Criteria:	
<p>The certification authority (CA) maintains controls to provide reasonable assurance that CA key pairs are generated in accordance with the CA's disclosed business practices and defined procedures specified within detailed key generation ceremony scripts.</p> <p>The CA's disclosed business practices include, but are not limited to, the following:</p> <ol style="list-style-type: none"> a. Generation of CA keys is undertaken in a physically secured environment (see section 3.4). b. Generation of CA keys is performed by personnel in trusted roles (see section 3.3) under the principles of multiple person control and split knowledge. c. Generation of CA keys occurs within cryptographic modules, meeting the applicable technical and business requirements as disclosed in the CA's certification practice statement (CPS). d. Generation of CA keys is witnessed by an independent party or videotaped, or both. e. CA key generation activities are logged. <p>The CA key generation script includes the following:</p> <ol style="list-style-type: none"> a. Definition of roles and participant responsibilities b. Approval for conduct of the key generation ceremony c. Cryptographic hardware and activation materials required for the ceremony d. Specific steps performed during the key generation ceremony e. Physical security requirements for the ceremony location f. Procedures for secure storage of cryptographic hardware and activation materials following the key generation ceremony g. Sign-off from participants and witnesses indicating whether the key generation ceremony was performed in accordance with the detailed key generation ceremony script h. Notation of any deviations from the key generation ceremony script 	

Illustrative Controls:	
	Generation of CA Keys Including Root CA Keys—General Requirements
1	Generation of CA keys occurs within a cryptographic module, meeting the applicable requirements of ISO 15782-1/FIPS 140-2 (or equivalent)/ANSI X9.66 and the business requirements in accordance with the CPS. Such cryptographic devices perform key generation using a random number generator or pseudo random number generator.
2	The CA generates its own key pair in the same cryptographic device in which it will be used, or the key pair is injected directly

<i>Illustrative Controls:</i>	
	from the device where it was generated into the device where it will be used.
3	<p>CA key generation generates keys that</p> <ol style="list-style-type: none"> a. use a key generation algorithm as disclosed within the CA's CP or CPS, or both. b. have a key length that is appropriate for the algorithm and for the validity period of the CA certificate as disclosed in the CA's CP or CPS, or both. The public key length to be certified by a CA is less than or equal to that of the CA's private signing key. c. take into account requirements on parent and subordinate CA key sizes and have a key size in accordance with the CA's CP or CPS, or both.
4	CA key generation ceremonies are independently witnessed by internal or external auditors.
Generation of CA Keys Including Root CA Keys—Script Requirements	
5	<p>The CA follows a CA key generation script for key generation ceremonies that includes the following:</p> <ol style="list-style-type: none"> a. Definition and assignment of participant roles and responsibilities b. Management approval for conduct of the key generation ceremony c. Specific cryptographic hardware, software, and other materials, including identifying information, for example, serial numbers d. Specific steps performed during the key generation ceremony <ol style="list-style-type: none"> i. Hardware preparation ii. Operating system installation iii. CA application installation and configuration iv. CA key generation v. CA key backup vi. CA certificate signing vii. CA system shutdown viii. Preparation of materials for storage e. Physical security requirements for the ceremony location (for example, barriers, access controls, and logging controls) f. Procedures for secure storage of cryptographic hardware and activation materials following the key generation ceremony (for example, detailing the allocation of materials between storage locations) g. Sign-off on the script or in a log from participants and witnesses, indicating whether the key generation ceremony was performed in accordance with the detailed key generation ceremony script h. Notation of any deviations from the key generation ceremony

(continued)

Illustrative Controls:	
	script (for example, documentation of steps taken to address any technical issues)
6	The integrity of the hardware and software used for key generation, and the interfaces to the hardware and software, is tested before production usage.

4.2 CA Key Storage, Backup, and Recovery

Criteria:
The certification authority (CA) maintains controls to provide reasonable assurance that CA private keys remain confidential and maintain their integrity. The CA's private keys are backed up, stored, and recovered by authorized personnel in trusted roles, using multiple person control in a physically secured environment.

Illustrative Controls:	
1	The CA's private (signing and confidentiality) keys are stored and used within a secure cryptographic device meeting the appropriate ISO 15408 protection profile or FIPS 140-2 level requirement based on a risk assessment and the business requirements of the CA and in accordance with the CA's certification practice statement and applicable certificate policy(s).
2	If the CA's private keys are not exported from a secure, cryptographic module, then the CA private key is generated, stored, and used within the same cryptographic module.
3	If the CA's private keys are exported from a secure, cryptographic module to secure storage for purposes of offline processing or backup and recovery, then they are exported within a secure key management scheme that may include any of the following: <ol style="list-style-type: none"> a. As cipher-text, using a key which is appropriately secured b. As encrypted key fragments, using multiple control and split knowledge and ownership c. In another secure cryptographic module, such as a key transportation device, using multiple control
4	Backup copies of the CA's private keys are subject to the same, or greater, level of security controls as keys currently in use. The recovery of the CA's keys is carried out in as secure a manner as the backup process, using multiperson control.

4.3 CA Public Key Distribution

Criteria:
The certification authority (CA) maintains controls to provide reasonable assurance that the integrity and authenticity of the CA public keys, and any associated parameters, are maintained during initial and subsequent distribution.

Illustrative Controls:	
1	For the root CA distribution process (that is, using a self-signed certificate), an out-of-band notification mechanism is employed. When a self-signed certificate is used for any CA, the CA provides a mechanism to verify the authenticity of the self-signed certificate (for example, publication of the certificate's fingerprint). For subsequent or subordinate CA public keys, or both, validation is completed by using a chaining method or similar process to link back to the trusted root certificate.
2	The initial distribution mechanism for the CA's public key is controlled and initially distributed within a certificate using one of the following methods: <ol style="list-style-type: none"> Machine readable media (for example, smart card, CD-ROM) from an authenticated source Embedding in an entity's cryptographic module Other secure means that ensure authenticity and integrity
3	The CA's public key is changed (rekeyed) periodically according to the requirements of the certification practice statement with advance notice provided to avoid disruption of the CA services.
4	The subsequent distribution mechanism for the CA's public key is controlled in accordance with the CA's disclosed business practices.
5	If an entity already has an authenticated copy of the CA's public key, a new CA public key is distributed using one of the following methods: <ol style="list-style-type: none"> Direct electronic transmission from the CA Placing into a remote cache or directory Loading into a cryptographic module Any of the methods used for initial distribution
6	The CA provides a mechanism for validating the authenticity and integrity of the CA's public keys.

4.4 CA Key Usage

Criteria:	
The certification authority (CA) maintains controls to provide reasonable assurance that CA keys are used only for their intended functions in their predetermined locations.	

Illustrative Controls:	
1	The activation of the CA private signing key is performed using multiparty control (that is, m of n) with a minimum value of m (for example, m greater than two for root CAs).

(continued)

<i>Illustrative Controls:</i>	
2	If necessary, based on a risk assessment, the activation of the CA private key is performed using multifactor authentication (for example, smart card and password, biometric and password, and so forth).
3	CA signing key(s) used for generating certificates or issuing revocation status information, or both, are not used for any other purpose.
4	The CA ceases to use a key pair at the end of the key pair's defined operational lifetime or when the compromise of the private key is known or suspected.
5	An annual review is required by the policy authority on key lengths to determine the appropriate key usage period with recommendations acted upon.

4.5 CA Key Archival and Destruction

<i>Criteria:</i>
<p>The certification authority (CA) maintains controls to provide reasonable assurance that</p> <ul style="list-style-type: none"> archived CA keys remain confidential and secured and are never put back into production, and CA keys are completely destroyed at the end of the key pair life cycle in accordance with the CA's disclosed business practices.

<i>Illustrative Controls:</i>	
	CA Key Archival
1	Archived CA keys are subject to the same, or greater, level of security controls as keys currently in use.
2	All archived CA keys are destroyed at the end of the archive period using dual control in a physically secure site.
3	Archived keys are only accessed when historical evidence requires validation. Control processes are required to ensure the integrity of the CA systems and the key sets.
4	Archived keys are recovered for the shortest possible time period technically permissible to meet business requirements.
5	Archived keys are periodically verified to ensure that they are properly destroyed at the end of the archive period.
	CA Key Destruction
6	The CA's private keys are not destroyed until the business purpose or application has ceased to have value or legal obligations have expired, as disclosed within the CA's certification practice statement (CPS).

Illustrative Controls:	
7	Authorization to destroy a CA private key and how the CA's private key is destroyed (for example, token surrender, token destruction, or key overwrite) are limited in accordance with the CA's CPS.
8	All copies and fragments of the CA's private key are destroyed at the end of the key pair life cycle in a manner such that the private key cannot be retrieved.
9	If a secure cryptographic device is accessible and known to be permanently removed from service, all CA private keys stored within the device that have ever been, or potentially could be, used for any cryptographic purpose are destroyed.
10	If a CA cryptographic device is being permanently removed from service, then any key contained within the device that has been used for any cryptographic purpose is erased from the device.
11	If a CA cryptographic device case is intended to provide tamper-evident characteristics and the device is being permanently removed from service, then the case is destroyed.

4.6 CA Key Compromise

Criteria:
The certification authority (CA) maintains controls to provide reasonable assurance that continuity of operations is maintained in the event of the compromise of the CA's private keys, and any certificates signed with the compromised keys are revoked and reissued.

Illustrative Controls:	
1	The CA's business continuity plans address the compromise, or suspected compromise, of a CA's private keys as a disaster.
2	Disaster recovery procedures include the revocation and reissuance of all certificates that were signed with that CA's private key in the event of the compromise, or suspected compromise, of a CA's private signing key.
3	The recovery procedures used if the CA's private key is compromised include the following actions: <ol style="list-style-type: none"> a. How secure key usage in the environment is reestablished b. How the CA's old public key is revoked c. How affected parties are notified (for example, impacted CAs, repositories, subscribers, and competitive video service providers) d. How the CA's new public key is provided to the end entities and relying parties, together with the mechanism for their authentication e. How the subscriber's public keys are recertified

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<i>Illustrative Controls:</i>	
4	In the event that the CA has to replace its root CA private key, procedures are in place for the secure and authenticated revocation of the following: <ol style="list-style-type: none"> a. The old CA root public key b. The set of all certificates (including any self-signed) issued by a root CA, or any CA, based on the compromised private key c. Any subordinate CA public keys and corresponding certificates that require recertification.
5	The CA's business continuity plan for key compromise addresses who is notified and what actions are taken with system software and hardware, symmetric and asymmetric keys, previously generated signatures, and encrypted data.

4.7 CA Cryptographic Hardware Life Cycle Management

<i>Criteria:</i>	
The certification authority (CA) maintains controls to provide reasonable assurance that	
<ul style="list-style-type: none"> • devices used for private key storage and recovery, and the interfaces to these devices, are tested before usage for integrity; • access to CA cryptographic hardware is limited to authorized personnel in trusted roles, using multiple person control; and • CA cryptographic hardware is functioning correctly. 	

<i>Illustrative Controls:</i>	
1	CA cryptographic hardware is sent from the manufacturer via registered mail (or equivalent) using tamper-evident packaging. Upon the receipt of CA cryptographic hardware from the manufacturer, authorized CA personnel inspects the tamper-evident packaging to determine whether the seal is intact.
2	Upon the receipt of CA cryptographic hardware from the manufacturer, acceptance testing and verification of firmware settings is performed. Upon the receipt of CA cryptographic hardware that has been serviced or repaired, acceptance testing and verification of firmware settings is performed.
3	To prevent tampering, CA cryptographic hardware is stored and used in a secure site, with access limited to authorized personnel having the following characteristics: <ol style="list-style-type: none"> a. Inventory control processes and procedures to manage the origination, arrival, condition, departure, and destination of each device b. Access control processes and procedures to limit physical access to authorized personnel c. Recording of all successful or failed access attempts to the CA facility and device storage mechanism (for example, a safe) in audit logs

Illustrative Controls:	
	<ul style="list-style-type: none"> d. Incident handling processes and procedures to handle abnormal events, security breaches, and investigation and reports e. Monitoring processes and procedures to verify the ongoing effectiveness of the controls
4	When not attached to the CA system, the CA cryptographic hardware is stored in a tamper-resistant container that is stored securely under multiple controls (that is, a safe).
5	<p>The handling of CA cryptographic hardware, including the following tasks, is performed in the presence of no less than two trusted employees:</p> <ul style="list-style-type: none"> a. Installation of CA cryptographic hardware b. Removal of CA cryptographic hardware from production c. Servicing or repair of CA cryptographic hardware (including installation of new hardware, firmware, or software) d. Disassembly and permanent removal from use
6	Devices used for private key storage and recovery, and the interfaces to these devices, are tested before usage for integrity.
7	Correct processing of CA cryptographic hardware is verified on a periodic basis.
8	Diagnostic support is provided during troubleshooting of CA cryptographic hardware in the presence of no less than two trusted employees.

4.8 CA Key Escrow (if applicable)

Criteria:
The certification authority (CA) maintains controls to provide reasonable assurance that escrowed CA private signing keys remain confidential.

Illustrative Controls:	
1	If a third party provides CA private key escrow services, a contract exists that outlines the liabilities and remedies between the parties.
2	If CA private signing keys are held in escrow, escrowed copies of the CA private signing keys have the same, or greater, level of security controls as keys currently in use.

5. Subscriber Key Life Cycle Management Controls

.59 The certification authority (CA) maintains effective controls to provide reasonable assurance that the integrity of the subscriber keys and certificates it manages is established and protected throughout their life cycles.

5.1 CA-Provided Subscriber Key Generation Services (if supported)

Criteria:	
<p>If the certification authority (CA) provides subscriber key management services, the CA maintains controls to provide reasonable assurance that</p> <ul style="list-style-type: none"> • subscriber keys generated by the CA (or registration authority [RA] or card bureau) are generated within a secure cryptographic device based on a risk assessment and the business requirements of the CA in accordance with the CA's disclosed business practices, and • subscriber keys generated by the CA (or RA or card bureau) are securely distributed to the subscriber by the CA (or RA or card bureau) in accordance with the CA's disclosed business practices. 	

Illustrative Controls:	
	CA- (or RA or Card Bureau) Provided Subscriber Key Generation
1	Subscriber key generation is performed within a secure cryptographic device, meeting the applicable ISO 15782-1/FIPS 140-2/ANSI X9.66 requirements based on a risk assessment and the business requirements of the CA and in accordance with the applicable certificate policy (CP). Such cryptographic devices perform subscriber key generation using a random number generator or pseudo random number generator as specified in the ANSI X9 or ISO standard ISO/IEC 18032.
2	Subscriber key generation performed by the CA (or RA or card bureau) uses a key generation algorithm, as specified in the CP.
3	Subscriber key generation performed by the CA (or RA) uses a prime number generator, as specified in an ANSI X9 or ISO standard.
4	Subscriber key generation performed by the CA (or RA or card bureau) results in key sizes in accordance with the CP.
5	Subscriber key generation performed by the CA (or RA) is performed by authorized personnel in accordance with the CA's certification practice statement.
6	When subscriber key generation is performed by the CA (or RA or card bureau), the CA (or RA or card bureau) securely (confidentially) delivers the subscriber key pair(s) generated by the CA (or RA or card bureau) to the subscriber in accordance with the CP.

5.2 CA-Provided Subscriber Key Storage and Recovery Services (if supported)

Criteria:	
<p>If the certification authority (CA) provides subscriber (confidentiality) key storage, recovery, or escrow services, the CA maintains controls to provide reasonable assurance that</p> <ul style="list-style-type: none"> • subscriber private keys stored by the CA remain confidential and maintain their integrity; • subscriber private keys archived and escrowed by the CA remain confidential; and • subscriber private keys stored by the CA are completely destroyed at the end of the key pair life cycle. 	

Illustrative Controls:	
CA-Provided Subscriber Key Storage, Backup, and Recovery	
1	Subscriber private keys stored by the CA (or registration authority [RA]) are stored in encrypted form using a cryptographic algorithm and key length based on a risk assessment and requirements of the certificate policy (CP).
2	If the CA generates key pair(s) on behalf of a subscriber, the CA (or RA) ensures that the subscriber's private keys are not disclosed to any entity other than the owner (that is, the subscriber) of the keys.
3	If the CA (or RA) generates public and private signing key pair(s), it does not maintain a copy of any private signing key once the subscriber confirms receipt of that key.
4	If the CA (or RA) provides subscriber (confidentiality) key storage, backup, and recovery, subscriber private (confidentiality) key backup and recovery services are only performed by authorized personnel.
5	If the CA (or RA) provides subscriber key storage, backup, and recovery, controls exist to ensure that the integrity of the subscriber's private (confidentiality) key is maintained throughout its life cycle.
CA-Provided Subscriber Key Archival	
6	Subscriber private (confidentiality) keys archived by the CA are stored in encrypted form using a cryptographic algorithm and key length based on a risk assessment and the requirements of the CP.
7	If the CA provides subscriber (confidentiality) key archival, all archived subscriber keys are destroyed at the end of the archive period.
CA-Provided Subscriber Key Destruction	
8	If the CA provides subscriber (confidentiality) key storage, authorization to destroy a subscriber's private key, and the means

(continued)

Illustrative Controls:	
	to destroy the subscriber’s private (confidentiality) key, (for example, key overwrite) is limited in accordance with the CP.
9	If the CA provides subscriber (confidentiality) key storage, all copies and fragments of the subscriber’s private key are destroyed at the end of the key pair life cycle.
CA-Provided Subscriber Key Escrow	
10	Subscriber private (confidentiality) keys escrowed by the CA are stored in encrypted form using a cryptographic algorithm and key length based on a risk assessment and the requirements of the CP.

5.3 Integrated Circuit Card Life Cycle Management (if supported)

Criteria:	
<p>If the certification authority (CA) (or registration authority [RA]) distributes subscriber key pairs and certificates using integrated circuit cards (ICCs), the CA (or RA) maintains controls to provide reasonable assurance that</p> <ul style="list-style-type: none"> • ICC procurement, preparation, and personalization are securely controlled by the CA (or RA or card bureau); • ICC application data file (ADF) preparation is securely controlled by the CA (or RA); • ICC usage is enabled by the CA (or RA or card bureau) prior to ICC issuance; • ICC deactivation and reactivation are securely controlled by the CA (or RA); • ICCs are securely stored and distributed by the CA (or RA or card bureau); • ICCs are securely replaced by the CA (or RA or card bureau); and • ICCs returned to the CA (or RA or card bureau) are securely terminated. 	

Illustrative Controls:	
ICC Procurement	
1	If the CA or RA engages a card bureau, then a formal contract exists between the relevant parties. Although card issuing functions may be delegated to third parties, the CA retains responsibility and liability for the ICCs.
2	ICCs are logically protected during transport between the card manufacturer and the card issuer through the use of a secret transport key or pass phrase.
3	ICCs issued to subscribers meet the appropriate ISO 15408 protection profile, ISO card standard (for example, ISO 7810, 7811 parts 1-5, 7813, 7816, 10202) or Federal Information Processing Standards (FIPS) 140-2 level requirement based on a risk assessment and the requirements of the certificate policy (CP).
4	The card bureau verifies the physical integrity of ICCs upon receipt from the card manufacturer.
5	ICCs are securely stored and under inventory control while under the control of the card issuer.

<i>Illustrative Controls:</i>	
	Card Preparation and Personalization
6	The CA (or RA), as the card issuer, controls ICC personalization (the loading of common data file [CDF] data and its related cryptographic keys).
7	Common data that identify the ICC, the card issuer, and the cardholder are stored by the card issuer in the ICC CDF. CDF activation is performed by the CA (or RA), as the card issuer, using a securely controlled process.
8	ICC preparation processes and procedures, including the following, exist and are followed: <ul style="list-style-type: none"> a. Loading of the card operating system b. Creation of logical data structures (card file system and card security domains) c. Loading of applications d. Logically protecting the ICC to prevent unauthorized modification of the card operating system, card file system, card security domains, and applications
9	ICC personalization processes and procedures, including the following, exist and are followed: <ul style="list-style-type: none"> a. The loading of identifying information onto the card b. Generation of subscriber key pair(s) in accordance with the CP c. Loading subscriber private key(s) onto the ICC (if generated outside the card) in encrypted form d. Loading subscriber certificate(s) onto the ICC e. Loading the CA and other certificates for the contractual environment onto the ICC f. Logically protecting the ICC from unauthorized access
10	The card bureau or CA (or RA) logs ICC preparation and personalization in an audit log.
11	An ICC is not issued unless the card has been prepared and personalized by the card bureau, the CA, or the RA.
12	An ICC is unusable unless in an activated or reactivated state.
	ICC Storage and Distribution
13	ICCs are securely stored prior to distribution.
14	Processes and procedures exist and are followed for the distribution, tracking, and accounting for the safe receipt of subscriber ICCs to subscribers.
15	ICC initial activation data (initializing personal identification number [PIN]) is securely communicated to the subscriber or, when applicable, to the subscriber using an out-of-band method. The subscriber is encouraged to change the initial activation data upon receipt to make the card active.
16	ICC distribution is logged by the card bureau or CA (or RA) in an audit log.

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<i>Illustrative Controls:</i>	
	Subscriber ICC Usage
17	The subscriber is provided with a mechanism that protects the access to the card data, including the private keys stored on the ICC during use by the subscriber (that is, PIN access control mechanism cardholder verification method).
18	The subscriber private keys on the ICC are not exported to an application to undertake cryptographic (that is, signing) functions.
19	The subscriber is required to use a mutual authentication mechanism for cryptographic application and card functions to ensure system integrity.
20	The subscriber is required to use an application that displays the message or the message's digest to the subscriber prior to signing message (or transaction) data. The subscriber ICC application produces audit logs of all uses of the ICC. This also includes all attempts in the private key owner verification process.
21	The ICC is used by the subscriber or, when applicable, the subscriber in accordance within the terms of the CP.
	ICC Deactivation and Reactivation
22	ADF deactivation can be performed only by the CA, as the application supplier.
23	CDF deactivation can be performed only by the CA, as the card issuer.
24	CDF reactivation is conducted under the control of the CA, as the card issuer.
25	ADF reactivation is conducted under the control of the CA, as the application supplier.
26	ADF deactivation, CDF deactivation, CDF reactivation, and ADF reactivation are logged.
	ICC Replacement
27	Processes and procedures exist and are followed for replacement of a subscriber's lost or damaged ICC.
28	In the event of card loss or damage, subscriber certificates are renewed or rekeyed in accordance with the CP (see clauses 6.2 and 6.3).
29	ICC replacement is logged by the card bureau or CA (or RA) in an audit log.
	ICC Termination
30	All ICCs returned to the ICC or CA (or RA) are deactivated or securely destroyed to prevent unauthorized use.
31	CDF termination is controlled by the CA, as the card issuer.
32	ICC termination is logged by the card bureau or CA (or RA) in an audit log.

5.4 Requirements for Subscriber Key Management

Criteria:

The certification authority (CA) maintains controls to provide reasonable assurance that

- requirements for protection of subscriber keys are communicated to subscribers, and
- any subscriber key management tools provided by the CA support the requirements of the CA's business practices disclosure.

Illustrative Controls:

Subscriber Key Generation	
1	The certificate policy (CP) specifies the appropriate ISO 15782-1/ FIPS 140-2 level requirement for cryptographic modules used for subscriber key generation.
2	The CP specifies the key generation algorithm(s) that is used for subscriber key generation.
3	The CP specifies the acceptable key sizes for subscriber key generation.
Subscriber Key Storage, Backup, and Recovery	
4	The CA or registration authority (RA) provides, or makes available, the mechanisms to allow the subscriber to access (that is, private key owner verification method), manage, and control the usage of their private keys.
5	The CP specifies the private key protection requirements for stored subscriber private keys.
6	The CP states the circumstances and authority of when the subscriber's private key will be restored and the control processes.
7	The CP specifies the private key protection requirements for backup copies of subscriber private keys stored by the subscriber.
Subscriber Key Usage	
8	Subscriber agreements describe the required processes to be followed by the subscriber of any use of the cryptographic mechanism (for example, hardware security module [HSM] or integrated circuit card [ICC] and software application).
9	The CP specifies the acceptable uses for subscriber key pairs.
10	The CP specifies the requirements for subscriber key usage.
Subscriber Key Archival	
11	The CP specifies the private key protection requirements for archived subscriber private keys.
12	The CP specifies the requirements for destruction of archived subscriber keys at the end of the archive period.

(continued)

Illustrative Controls:	
	Subscriber Key Destruction
13	The CP specifies the means through which subscriber key destruction is performed.
14	The CP or certification practice statement specifies the requirements for destruction of all copies and fragments of the subscriber’s private key at the end of the key pair life cycle.
	Subscriber Cryptographic Hardware Life Cycle Management
15	If required, the CP specifies the requirements for use and handling of cryptographic hardware and subscriber authentication processes (and subsequent actions) when the cryptographic hardware is in other physical locations (that is, an HSM attached to a mainframe or remote server).
	Subscriber Key Compromise
16	The CP specifies the requirements for notification of the CA or RA in the event of subscriber key compromise.

6. Certificate Life Cycle Management Controls

.60 The certification authority (CA) maintains effective controls to provide reasonable assurance that subscriber information was properly authenticated (for the registration activities performed by ABC Certification Authority, Inc.).

6.1 Subscriber Registration

Criteria:	
	The certification authority (CA) maintains controls to provide reasonable assurance that
	<ul style="list-style-type: none"> • for authenticated certificates <ul style="list-style-type: none"> — subscribers are accurately identified in accordance with the CA’s disclosed business practices and — subscribers’ certificate requests are accurate, authorized, and complete. • for domain validated certificates <ul style="list-style-type: none"> — subscribers’ domain names are accurately validated in accordance with the CA’s disclosed business practices and — subscribers’ certificate requests are accurate and complete.

Illustrative Controls:	
	Identification and authentication
1	For authenticated certificates, the CA verifies or requires that the registration authority (RA) verify the credentials presented by a subscriber, as evidence of identity or authority, to perform a specific role in accordance with the requirements of the certificate policy (CP): <ul style="list-style-type: none"> a. For individual end entity certificates, the CA or registration authority (RA) verifies the identity of the person whose name is to be included in the subscriber distinguished name field of the certificate. An unauthenticated individual name is not included in the subscriber distinguished name field.

Illustrative Controls:	
	<p>b. For organizational certificates (including role based, server, network resource, code signing, and so forth), the CA or RA verifies the legal existence of the organization's name and the authority of the requesting party to be included in the organization attribute in the subscriber distinguished name field of the certificate. An unauthenticated organization name is not included in a certificate.</p> <p>c. For organizational certificates containing a domain name of an organization, the CA or RA verifies the organization's ownership, control, or right to use the domain name and the authority of the requesting party included in the common name attribute of the subscriber distinguished name field of the certificate. An unauthenticated domain name is not included in a certificate.</p>
2	For domain-validated certificates, the CA validates or requires that the RA validate (as determined by the CP) the organization's ownership, control, or right to use the domain name.
3	The CA or RA verifies the accuracy of the information included in the requesting entity's certificate request in accordance with the CP.
4	The CA or RA checks the certificate request for errors or omissions in accordance with the CP.
5	For end entity certificates, the CA uses the RA's public key contained in the requesting entity's certificate request to verify the signature on the certificate request submission.
6	The CA verifies the uniqueness of the subscriber's distinguished name within the boundaries or community defined by the CP.
7	Encryption and access controls are used to protect the confidentiality and integrity of registration data in transit and in storage.
8	At the point of registration (before certificate issuance), the RA or CA informs the subscriber of the terms and conditions regarding use of the certificate.
9	Before certificate issuance, the CA informs the subscriber of the terms and conditions regarding use of the certificate.
	Certificate Request
10	The CA requires that an entity requesting a certificate must prepare and submit the appropriate certificate request data (registration request) to an RA (or the CA) as specified in the CP.
11	<p>The CA requires that the requesting entity submit its public key in a self-signed message to the CA for certification. The CA requires that the requesting entity digitally sign the registration request using the private key that relates to the public key contained in the registration request in order to</p> <p>a. allow the detection of errors in the certificate application process and</p>

(continued)

Illustrative Controls:	
	b. prove possession of the companion private key for the public key being registered.
12	The certificate request is treated as acceptance of the terms of conditions by the requesting entity to use that certificate as described in the subscriber agreement.
13	The CA validates the identity of the RA authorized to issue registration requests under a specific CP.
14	The CA requires that RAs submit the requesting entity’s certificate request data to the CA in a message (certificate request) signed by the RA. The CA verifies the RA’s signature on the certificate request.
15	The CA requires that the RA secure that part of the certificate application process for which it (the RA) assumes responsibility in accordance with the CA’s certification practice statement (CPS).
16	The CA requires that RAs record their actions in an audit log.
17	The CA verifies the authenticity of the submission by the RA in accordance with the CA’s CPS.

6.2 Certificate Renewal (if supported)

Criteria:
The certificate authority (CA) maintains controls to provide reasonable assurance that certificate renewal requests are accurate, authorized, and complete.

Illustrative Controls:	
	Certificate Renewal Request
1	The certificate renewal request includes at least the subscriber’s distinguished name, the serial number of the certificate (or other information that identifies the certificate), and the requested validity period. (The CA will only renew certificates that were issued by the CA itself.)
2	The CA requires that the requesting entity digitally sign the certificate renewal request using the private key that relates to the public key contained in the requesting entity’s existing public key certificate.
3	The CA issues a new certificate using the subscriber’s previously certified public key, only if its cryptographic security is still sufficient for the new certificate’s intended lifetime, and no indications exist that the subscriber’s private key has been compromised.
4	For renewal of authenticated certificates, the CA or the registration authority (RA) processes the certificate renewal data

<i>Illustrative Controls:</i>	
	to verify the identity of the requesting entity and to identify the certificate to be renewed.
5	For domain-validated certificates, the CA or the RA processes the certificate renewal data to revalidate the domain in accordance with the requirements of the certificate policy (CP).
6	The CA or the RA validates the signature on the certificate renewal request.
7	The CA verifies the existence and validity of the certificate to be renewed. The CA does not renew certificates that have been revoked, expired, or suspended.
8	The CA or the RA verifies that the request, including the extension of the validity period, meets the requirements defined in the CP.
9	The CA requires that RAs submit the certificate renewal data to the CA in a message (certificate renewal request) signed by the RA.
10	The CA requires that the RA secures that part of the certificate renewal process for which it (the RA) assumes responsibility in accordance with the CP.
11	The CA requires that RAs record their actions in an audit log.
12	The CA verifies the authenticity of the submission by the RA.
13	The CA verifies the RA's signature on the certificate renewal request.
14	The CA checks the certificate renewal request for errors or omissions. This function may be delegated explicitly to the RA.
15	The CA or RA notifies subscribers prior to the expiration of their certificate of the need for renewal in accordance with the CP.
16	The CA issues a signed notification indicating that the certificate renewal has been successful.
17	The CA makes the new certificate available to the end entity in accordance with the CP.

6.3 Certificate Rekey

<i>Criteria:</i>
The certification authority (CA) maintains controls to provide reasonable assurance that certificate rekey requests, including requests following certificate revocation or expiration, are accurate, authorized, and complete.

<i>Illustrative Controls:</i>	
1	A certificate rekey request includes, at least, the subscriber's distinguished name, the serial number of the certificate, and the requested validity period to allow the CA or the registration authority (RA) to identify the certificate to rekey.
2	The CA requires that the requesting entity digitally sign, using the existing private key, the certificate rekey request containing the new public key.
3	For authenticated certificates, the CA or the RA processes the certificate rekey request to verify the identity of the requesting entity and identify the certificate to be rekeyed.
4	For domain-validated certificates, the CA or the RA processes the certificate rekey request to revalidate the domain in accordance with the requirements of the CP.
5	The CA or the RA validates the signature on the certificate rekey request.
6	The CA or the RA verifies the existence and validity of the certificate to be rekeyed.
7	The CA or the RA verifies that the certificate rekey request meets the requirements defined in the relevant CP.
8	If an external RA is used, the CA requires that RAs submit the entity's certificate rekey request to the CA in a message signed by the RA.
9	If an external RA is used, the CA requires that the RA secure that part of the certificate rekey process for which it (the RA) assumes responsibility.
10	If an external RA is used, the CA requires that external RAs record their actions in an audit log.
11	If an external RA is used, the CA verifies the RA's signature on the certificate rekey request.
12	The CA or the RA checks the certificate rekey request for errors or omissions.
13	The CA or RA notifies subscribers prior to the expiration of their certificate of the need for rekey.
14	Prior to the generation and issuance of rekeyed certificates, the CA or RA verifies the following: <ol style="list-style-type: none"> a. The signature on the certificate rekey data submission b. The existence and validity supporting the rekey request c. That the request meets the requirements defined in the CP

<i>Criteria:</i>
The certification authority (CA) maintains controls to provide reasonable assurance that certificate rekey requests following certificate revocation or expiration are accurate, authorized, and complete.

Illustrative Controls:	
1	Following the revocation or expiration of a subscriber's existing certificate, the subscriber is required to follow the CA's subscriber registration procedures to obtain a new certificate.

6.4 Certificate Issuance

Criteria:	
The certification authority (CA) maintains controls to provide reasonable assurance that certificates are generated and issued in accordance with the CA's disclosed business practices.	

Illustrative Controls:	
1	The CA generates certificates using certificate request data and manufactures the certificate as defined by the appropriate certificate profile in accordance with ISO 9594/X.509 and ISO 15782-1 formatting rules as disclosed within the certificate policy (CP).
2	Validity periods are set in the CP and are formatted in accordance with ISO 9594/X.509 and ISO 15782-1 as disclosed within the CP.
3	Extension fields are formatted in accordance with ISO 9594/X.509 and ISO 15782-1 as disclosed within the CP.
4	The CA signs the end entity's public key and other relevant information with the CA's private signing key.
5	The CA publishes the certificate after the certificate has been accepted by the requesting entity as disclosed in the CA's business practices.
6	When a registration authority (RA) is used, the CA notifies the RA when a certificate is issued to a subscriber for whom the RA submitted a certificate request.
7	Certificates are issued based on approved subscriber registration, certificate renewal, or certificate rekey requests in accordance with the CP.
8	The CA issues a signed notification to the RA when a certificate is issued to a subscriber for whom the RA submitted a certificate request.
9	The CA issues an out-of-band notification to the subscriber when a certificate is issued. When this notification includes initial activation data, then control processes ensure safe delivery to the subscriber.
10	Whether certificates expire, are revoked, or are suspended, copies of certificates are retained for the appropriate period of time specified in the CP.

6.5 Certificate Distribution

Criteria:

The certification authority (CA) maintains controls to provide reasonable assurance that upon issuance, complete and accurate certificates are available to subscribers and relying parties in accordance with the CA's disclosed business practices.

Illustrative Controls:

1	The CA makes the certificates issued by the CA available to relevant parties using an established mechanism (for example, a repository, such as a directory) in accordance with the certificate policy.
2	Only authorized CA personnel administer the CA's repository or alternative distribution mechanism.
3	The performance of the CA's repository or alternative distribution mechanism is monitored and managed.
4	The integrity of the repository or alternative distribution mechanism is maintained and administered.
5	When required under privacy legislation, certificates are made available for retrieval only in those cases for which the subscriber's consent is obtained.

6.6 Certificate Revocation

Criteria:

The certification authority (CA) maintains controls to provide reasonable assurance that certificates are revoked based on authorized and validated certificate revocation requests within the time frame in accordance with the CA's disclosed business practices.

Illustrative Controls:

1	The CA provides a means of rapid communication to facilitate the secure and authenticated revocation of the following: <ol style="list-style-type: none"> a. One or more certificates of one or more subscribers b. The set of all certificates issued by a CA based on a single public and private key pair used by a CA to generate certificates c. All certificates issued by a CA, regardless of the public and private key pair used
2	The CA verifies or requires that the registration authority (RA) verify the identity and authority of the entity requesting revocation of a certificate in accordance with the certificate policy (CP).

Illustrative Controls:	
3	If an external RA accepts revocation requests, the CA requires that the RA submit signed certificate revocation requests to the CA in an authenticated manner in accordance with the CP.
4	If an external RA accepts and forwards revocation requests to the CA, the CA provides a signed acknowledgement of the revocation request and confirmation of actions to the requesting RA.
5	The CA updates the certificate revocation list and other certificate status mechanisms in the time frames specified within the CP and in accordance with the format defined in ISO 9594/X.509 and ISO 15782-1.
6	The CA records all certificate revocation requests and their outcome in an audit log.
7	The CA or RA may provide an authenticated acknowledgement (signature or similar) of the revocation to the entity who perpetrated the revocation request.
8	When certificate renewal is supported and when a certificate is revoked, all valid instances of the certificate are also revoked and are not reinstated.
9	The subscriber of a revoked or suspended certificate is informed of the change of status of its certificate.

6.7 Certificate Suspension (if supported)

Criteria:
The certificate authority (CA) maintains controls to provide reasonable assurance that certificates are suspended based on authorized and validated certificate suspension requests within the time frame in accordance with the CA's disclosed business practices.

Illustrative Controls:	
1	The CA provides a means of rapid communication to facilitate the secure and authenticated suspension of the following: <ol style="list-style-type: none"> a. One or more certificates of one or more subscribers b. The set of all certificates issued by a CA based on a single public and private key pair used by a CA to generate certificates c. All certificates issued by a CA, regardless of the public and private key pair used
2	The CA verifies or requires that the external registration authority (RA) verify the identity and authority of the entity requesting suspension and reactivation of a certificate in accordance with the certificate policy (CP).
3	If an external RA accepts suspension requests, the RA submits signed certificate suspension requests to the CA in an authenticated manner in accordance with the CP.

(continued)

<i>Illustrative Controls:</i>	
4	The CA or RA notifies the subscriber in the event of a certificate suspension.
5	Certificate suspension requests are processed and validated in accordance with the requirements of the CP.
6	The CA updates the certificate revocation list (CRL) and other certificate status mechanisms upon certificate suspension. Changes in certificate status are completed in a time frame determined by the CP.
7	Certificates are suspended only for the allowable length of time in accordance with the CP.
8	Once a certificate suspension (hold) has been issued, the suspension is handled in one of the following three ways: <ol style="list-style-type: none"> a. An entry for the suspended certificate remains on the CRL with no further action. b. The CRL entry for the suspended certificate is replaced by a revocation entry for the same certificate. c. The suspended certificate is explicitly released and the entry removed from the CRL.
9	A certificate suspension (hold) entry remains on the CRL until the expiration of the underlying certificate or the expiration of the suspension, whichever is first.
10	The CA updates the CRL and other certificate status mechanisms upon the lifting of a certificate suspension in accordance with the CA's CP.
11	The CA verifies or requires that the external RA verify the identity and authority of the entity requesting that the suspension of a certificate be lifted.
12	Certificate suspensions, and the lifting of certificate suspensions, are recorded in an audit log.

6.8 Certificate Validation

Criteria:

The certification authority (CA) maintains controls to provide reasonable assurance that timely, complete, and accurate certificate status information (including certificate revocation lists [CRL] and other certificate status mechanisms) is made available to relevant entities (subscribers and relying parties or their agents) in accordance with the CA's disclosed business practices.

Illustrative Controls:

1	<p>The CA makes certificate status information available to relevant entities (relying parties or their agents) using an established mechanism in accordance with the certificate policy (CP). This is achieved using the following:</p> <p><i>a. Request Response Method.</i> A request signed by the relying party to the certificate status provider's responder. In turn, the certificate status provider's responder responds with the certificate status duly signed. (Online certificate status protocol [OCSP] is an example protocol using this method.)</p> <p><i>b. Delivery Method.</i> A CRL signed by the CA and published within the policy's time frame.</p>
	The following control procedures are applicable when CRLs are used:
2	The CA digitally signs each CRL that it issues so that entities can validate the integrity of the CRL and the date and time of issuance.
3	The CA issues CRLs at regular intervals, as specified in the CP, even if no changes have occurred since the last issuance.
4	At a minimum, a CRL entry identifying a revoked certificate remains on the CRL until the end of the certificate's validity period.
5	If certificate suspension is supported, a certificate suspension (hold) entry, with its original action date and expiration date, remains on the CRL until the normal expiration of the certificate or until the suspension is lifted.
6	CRLs are archived in accordance with the requirements of the CP, including the method of retrieval.
7	CAs include a monotonically increasing sequence number for each CRL issued by that CA.
8	The CRL contains entries for all revoked unexpired certificates issued by the CA.
9	Old CRLs are retained for the appropriate period of time specified in the CA's CP.

(continued)

<i>Illustrative Controls:</i>	
10	Whether certificates expire, are revoked, or are suspended, copies of certificates are retained for the appropriate period of time as disclosed in the CP.
	The following control procedures are applicable when online certificate status mechanisms (for example, OCSP) are used:
11	If an online certificate status collection method (for example, OCSP) is used, the CA requires that certificate status inquiries (for example, OCSP requests) contain all required data in accordance with the CP.
12	<p>Upon the receipt of a certificate status request (for example, an OCSP request) from a relying party or its agent, the CA returns a definitive response to the relying party or its agent if</p> <ol style="list-style-type: none"> the request message is well formed; the certificate status provider responder is configured to provide the requested service; the request contains the information (that is, certificate identity, for example, serial number, object identifier, and so forth) needed by the certificate status provider responder in accordance with the CP; and the certificate status provider's responder is able to locate the certificate and interpret its status. <p>When these conditions are met, the CA or certificate status provider produces a signed response message indicating the certificate's status in accordance with the CP. If any of the previous conditions are not met, then a status of unknown may be returned.</p>
13	All response messages are digitally signed and include all required data in accordance with the CP.

7. Subordinate CA Certificate Life Cycle Management Controls

.61 The certification authority (CA) maintains effective controls to provide reasonable assurance that subordinate CA certificate requests are accurate, authenticated, and approved.

7.1 Subordinate CA Certificate Life Cycle Management

Criteria:	
The parent certification authority (CA) maintains controls to provide reasonable assurance that	
<ul style="list-style-type: none"> • subordinate CA certificate requests are accurate, authenticated, and approved; • subordinate CA certificate replacement (renewal and rekey) requests are accurate, authorized, and complete; • new, renewed, and rekeyed subordinate CA certificates are generated and issued in accordance with the CA's disclosed business practices; • upon issuance, complete and accurate subordinate CA certificates are available to relevant entities (subscribers and relying parties) in accordance with the CA's disclosed business practices; • subordinate CA certificates are revoked based on authorized and validated certificate revocation requests; and • timely, complete, and accurate certificate status information (including certificate revocation lists [CRLs] and other certificate status mechanisms) is made available to any entity in accordance with the CA's disclosed business practices. 	

Illustrative Controls:	
Subordinate CA (sub-CA) Registration	
1	The parent certificate policy (CP) specifies the requirements for submission of sub-CA certification requests.
2	The parent CA authenticates the sub-CA certificate request in accordance with the parent's CP.
3	The parent CA performs an assessment of the sub-CA certificate applicant's compliance with the requirements of the parent CA's CP before approving a sub-CA certificate request or, alternatively, the sub-CA presents its certification practice statement for assessment.
Sub-CA Renewal	
4	When sub-CA certificate renewal is permitted, the parent CA's CP specifies the requirements for submission of sub-CA renewal requests.
5	When sub-CA certificate renewal is permitted, the parent CA authenticates the sub-CA certificate renewal request in accordance with the CA's CP.
Sub-CA Rekey	
6	The parent CA's CP specifies the requirements for submission of sub-CA rekey requests.
7	The parent CA authenticates the sub-CA certificate rekey request in accordance with the CP.

(continued)

<i>Illustrative Controls:</i>	
Sub-CA Certificate Issuance	
8	The parent CA generates certificates <ol style="list-style-type: none"> a. using the appropriate certificate profile in accordance with the CP and ISO 9594/X.509 and ISO 15782-1 formatting rules; b. with the validity periods formatted in accordance with ISO 9594/X.509, ISO 15782-1, and the CP; and c. when extensions are used, with extension fields formatted in accordance with ISO 9594/X.509, ISO 15782-1, and the CP.
9	The parent CA signs the sub-CA certificate with the parent CA's private signing key.
Sub-CA Certificate Distribution	
10	The parent CA makes sub-CA certificates available to relevant entities (for example, relying parties) using an established mechanism (for example, a repository, such as a directory) in accordance with the parent CA's CP.
Sub-CA Certificate Revocation	
11	The parent CA verifies the identity and authority of the entity requesting revocation of a sub-CA certificate in accordance with the parent CA's CP.
12	The parent CA updates the CRL and other sub-CA certificate status mechanisms upon certificate revocation in accordance with the parent CA's CP.
Sub-CA Certificate Status Information Processing	
13	The parent CA makes sub-CA certificate status information available to relying parties using an established mechanism (for example, CRL, online certificate status protocol, and so forth) in accordance with the parent CA's CP.

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Appendix A — RFC 3647, RFC 2527, and *WebTrust® Program for Certification Authorities v1 Business Practices*

A1. The certification authority maintains controls to provide reasonable assurance that its certificate policy and certification practice statement address the topics from RFC 3647, Internet X.509 Public Key Infrastructure Certificate Policy and Certification Practices Framework—Request For Comments Draft (RFC 2527), or *WebTrust® Program for Certification Authorities v1*, listed as follows.

Section 1 — RFC 3647

<i>Section No.</i>	<i>RFC 3647 Section</i>
1	Introduction
1.1	Overview
1.2	Document Name and Identification
1.3	PKI Participants
1.3.1	Certification Authorities
1.3.2	Registration Authorities
1.3.3	Subscribers
1.3.4	Relying Parties
1.3.5	Other Participants
1.4	Certificate Usage
1.4.1	Appropriate Certificate Uses
1.4.2	Prohibited Certificate Uses
1.5	Policy Administration
1.5.1	Organization Administering the Document
1.5.2	Contact Person
1.5.3	Person Determining CPS Suitability for the Policy
1.5.4	CPS Approval Procedures
1.6	Definitions and Acronyms
2	Publication and Repository Responsibilities
2.1	Repositories
2.2	Publication of Certification Information
2.3	Time or Frequency of Publication
2.4	Access Controls on Repositories
3	Identification and Authentication
3.1	Naming

(continued)

Section No.	<i>RFC 3647 Section</i>
3.1.1	Type of Names
3.1.2	Need for Names to be Meaningful
3.1.3	Anonymity or Pseudonymity of Subscribers
3.1.4	Rules for Interpreting Various Name Forms
3.1.5	Uniqueness of Names
3.1.6	Recognition, Authentication, and Role of Trademarks
3.2	Initial Identity Validation
3.2.1	Method to Prove Possession of Private Key
3.2.2	Authentication of Organization Identity
3.2.3	Authentication of Individual Identity
3.2.4	Non-Verified Subscriber Information
3.2.5	Validation of Authority
3.2.6	Criteria for Interoperation
3.3	Identification and Authentication for Rekey Requests
3.3.1	Identification and Authentication for Routine Rekey
3.3.2	Identification and Authentication for Rekey After Revocation
3.4	Identification and Authentication for Revocation Request
4	Certificate Life Cycle Operational Requirements
4.1	Certificate Application
4.1.1	Who Can Submit a Certificate Application
4.1.2	Enrollment Process and Responsibilities
4.2	Certificate Application Processing
4.2.1	Performing Identification and Authentication Functions
4.2.2	Approval or Rejection of Certificate Applications
4.2.3	Time to Process Certificate Applications
4.3	Certificate Issuance
4.3.1	CA Actions During Certificate Issuance
4.3.2	Notifications to Subscriber by the CA of Issuance of Certificate
4.4	Certificate Acceptance
4.4.1	Conduct Constituting Certificate Acceptance
4.4.2	Publication of the Certificate by the CA
4.4.3	Notification of Certificate Issuance by the CA to Other Entities
4.5	Key Pair and Certificate Usage
4.5.1	Subscriber Private Key and Certificate Usage
4.5.2	Relying Party Public Key and Certificate Usage
4.6	Certificate Renewal

Section No.	<i>RFC 3647 Section</i>
4.6.1	Circumstances for Certificate Renewal
4.6.2	Who May Request Renewal
4.6.3	Processing Certificate Renewal Requests
4.6.4	Notification of New Certificate Issuance to Subscriber
4.6.5	Conduct Constituting Acceptance of a Renewal Certificate
4.6.6	Publication of the Renewal Certificate by the CA
4.6.7	Notification of Certificate Issuance by the CA to Other Entities
4.7	Certificate Rekey
4.7.1	Circumstances for Certificate Rekey
4.7.2	Who May Request Certification of a New Public Key
4.7.3	Processing Certificate Rekeying Requests
4.7.4	Notification of New Certificate Issuance to Subscriber
4.7.5	Conduct Constituting Acceptance of a Rekeyed Certificate
4.7.6	Publication of the Rekeyed Certificate by the CA
4.7.7	Notification of Certificate Issuance by the CA to Other Entities
4.8	Certificate Modification
4.8.1	Circumstances for Certificate Modification
4.8.2	Who May Request Certificate Modification
4.8.3	Processing Certificate Modification Requests
4.8.4	Notification of New Certificate Issuance to Subscriber
4.8.5	Conduct Constituting Acceptance of Modified Certificate
4.8.6	Publication of the Modified Certificate by the CA
4.8.7	Notification of Certificate Issuance by the CA to Other Entities
4.9	Certificate Revocation and Suspension
4.9.1	Circumstances for Revocation
4.9.2	Who Can Request Revocation
4.9.3	Procedure for Revocation Request
4.9.4	Revocation Request Grace Period
4.9.5	Time Within Which CA Must Process the Revocation Request
4.9.6	Revocation Checking Requirements for Relying Parties
4.9.7	CRL Issuance Frequency
4.9.8	Maximum Latency for CRLs
4.9.9	Online Revocation/Status Checking Availability
4.9.10	Online Revocation Checking Requirements

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Section No.	<i>RFC 3647 Section</i>
4.9.11	Other Forms of Revocation Advertisements Available
4.9.12	Special Requirements Related to Key Compromise
4.9.13	Circumstances for Suspension
4.9.14	Who Can Request Suspension
4.9.15	Procedure for Suspension Request
4.9.16	Limits on Suspension Period
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4.10.3	Operational Features
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4.12.1	Key Escrow and Recovery Policy and Practices
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5	Facility, Management, and Operational Controls
5.1	Physical Controls
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5.1.3	Power and Air Conditioning
5.1.4	Water Exposures
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5.1.8	Off-Site Backup
5.2	Procedural Controls
5.2.1	Trusted Roles
5.2.2	Number of Persons Required per Task
5.2.3	Identification and Authentication for Each Role
5.2.4	Roles Requiring Separation of Duties
5.3	Personnel Controls
5.3.1	Qualifications, Experience, and Clearance Requirements
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Section 3 – WebTrust® Program for Certification Authorities v1

<i>No.</i>	<i>WebTrust® Program for Certification Authorities v1— Disclosures Criteria</i>
	General
1	Identification of each certificate policy (CP) and certification practice statement (CPS) for which the certification authority (CA) issues certificates
2	Community and applicability, including a description of the types of entities within the public key infrastructure (PKI) and the applicability of certificates issued by the CA
3	Contact details and administrative provisions, including the following: <ul style="list-style-type: none"> • Contact person • Identification of the policy authority • Street address • Version and effective date(s) of each CP and CPS
4	Any applicable provisions regarding apportionment of liability
5	Financial responsibility, including the following: <ul style="list-style-type: none"> • Indemnification by relying parties • Fiduciary relationships
6	Interpretation and enforcement, including the following: <ul style="list-style-type: none"> • Governing law • Severability, survival, merger, and notice • Dispute resolution procedures
7	Fees, including the following: <ul style="list-style-type: none"> • Certificate issuance or renewal fees • Certificate access fees • Revocation or status information access fees • Fees for other services, such as policy information • Refund policy
8	Publication and repository requirements, including the following: <ul style="list-style-type: none"> • Publication of CA information • Frequency of publication • Access controls

No.	<i>WebTrust® Program for Certification Authorities v1— Disclosures Criteria</i>
9	Compliance audit requirements, including the following: <ul style="list-style-type: none"> • Frequency of entity compliance audit • Auditor's relationship to the audited party • Topics covered by the audit • Actions taken as a result of deficiency • Communication of results
10	Description of the conditions for applicability of certificates issued by the CA that reference a specific CP, including the following: <ul style="list-style-type: none"> • Specific permitted uses for the certificates if such use is limited to specific applications • Limitations on the use of certificates if there are specified prohibited uses for such certificates
11	CA and/or registration authority (RA) obligations: <ul style="list-style-type: none"> • Notification of issuance of a certificate to the subscriber, who is the subject of the certificate being issued • Notification of issuance of a certificate to others than the subject of the certificate • Notification of revocation or suspension of a certificate to the subscriber whose certificate is being revoked or suspended • Notification of revocation or suspension of a certificate to others than the subject whose certificate is being revoked or suspended
12	RA obligations, including the following: <ul style="list-style-type: none"> • Identification and authentication of subscribers • Validation of revocation and suspension requests • Verification of subscriber renewal or rekey requests
13	Repository obligations, including timely publication of certificates and certificate revocation lists (CRLs)
14	Subscriber obligations, including the following: <ul style="list-style-type: none"> • Accuracy of representations in certificate application • Protection of the subscriber's private key • Restrictions on private key and certificate use • Notification upon private key compromise
15	Relying party obligations, including the following: <ul style="list-style-type: none"> • Purposes for which certificate is used • Digital signature verification responsibilities • Revocation and suspension checking responsibilities • Acknowledgment of applicable liability caps and warranties
16	Any applicable reliance or financial limits for certificate usage
Key Life Cycle Management	
17	CA key pair generation, including the following: <ul style="list-style-type: none"> • What key sizes are required • What key generation algorithm is required • Whether key generation is performed in hardware or software • What standards are required for the module used to generate the keys (for example, the required ISO 15782-1/FIPS 140-1/ANSI X9.66 level of the module) • For what purposes the key may be used • For what purposes usage of the key is restricted • The usage periods or active lifetimes for the CA public and private key, respectively

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No.	WebTrust® Program for Certification Authorities v1— Disclosures Criteria
18	CA private key protection, including the following: <ul style="list-style-type: none"> • What standards are required for the module used to store the CA private signature key (for example, the required ISO 15782-1/FIPS 140-1/ANSI X9.66 level of the module) • Whether the CA private key is maintained under <i>m</i> out of <i>n</i> multiperson control • Whether the CA private signature key is escrowed • Whether the CA private signing key is backed up • Whether the CA private and public signature keys are archived
19	Whether the CA provides subscriber key management services and a description of the services provided
20	CA public key distribution, including a description of how the CA's public key is provided securely to subscribers and relying parties
21	Key changeover, including a description of the procedures used to provide a new public key to a CA's users
22	Subscriber key pair generation (if the CA provides subscriber key pair generation services), including the following: <ul style="list-style-type: none"> • How the subscriber's private key is provided securely to the subscriber • What key sizes are required • What key generation algorithm is required • Whether key pair generation is performed in hardware or software • What standards are required for the module used to generate the keys (for example, the required ISO 15782-1/FIPS 140-1/ANSI X9.66 level of the module) • For what purposes the key may be used • For what purposes usage of the key is restricted
23	Subscriber private key protection (if the CA provides subscriber key management services), including the following: <ul style="list-style-type: none"> • Whether the subscriber's decryption private key is backed up • Whether the subscriber's decryption private key is archived • Under what conditions a subscriber's private key can be destroyed • Whether subscriber private decryption keys are escrowed by the CA
Certificate Life Cycle Management	
24	Whether certificate suspension is supported
25	Initial registration, including a description of the CA's requirements for the identification and authentication of subscribers and validation of certificate requests during entity registration or certificate issuance: <ul style="list-style-type: none"> • Types of names assigned to the subject and rules for interpreting various name forms • Whether names have to be meaningful or not • Whether names have to be unique • How name claim disputes are resolved • Recognition, authentication, and role of trademarks • If and how the subject must prove possession of the companion private key for the public key being provided for a certificate • How the subscriber's public key is provided securely to the CA for issuance of a certificate

No.	<i>WebTrust® Program for Certification Authorities v1— Disclosures Criteria</i>
	<ul style="list-style-type: none"> • Authentication requirements for organizational identity of subject • Authentication of individual identity • Required certificate request data • How the CA verifies the authority of the subscriber to request a certificate • How the CA verifies the accuracy of the information included in the subscriber's certificate request • Whether the CA checks certificate requests for errors or omissions
26	<p>Registration requirements when external registration authorities (RA) are used, including the CA's procedures for the following:</p> <ul style="list-style-type: none"> • Validating the identity of external registration authorities • Authorizing external registration authorities • Requirements for the external registration authority to secure that part of the certificate application, certificate renewal, and certificate rekey processes for which the RA assumes responsibility • How the CA verifies the authenticity of certificate request submissions received from an external RA
27	<p>Certificate renewal, including a description of the CA's procedures for the following:</p> <ul style="list-style-type: none"> • Notifying subscribers of the need for renewal • Identification and authentication • Renewal request verification
28	<p>Routine rekey, including a description of the identification and authentication and rekey request verification procedures</p>
29	<p>Rekey after revocation or expiration, including a description of the identification and authentication and rekey request verification procedures for rekey after the subject certificate has been revoked</p>
30	<p>Certificate issuance, including a description of the requirements regarding the following:</p> <ul style="list-style-type: none"> • Issuance of a certificate • Notification to the applicant of such issuance • Certificate format requirements • Validity period requirements • Extension field requirements (that is, what extension fields are honored and how they are to be populated)
31	<p>Certificate acceptance, including a description of the requirements regarding acceptance of an issued certificate and for consequent publication of certificates</p>
32	<p>Certificate distribution, including a description of the CA's established mechanism (for example, a repository such as a directory) for making available to relying parties the certificates and CRLs that it issues</p>
33	<p>Certificate revocation, including the following:</p> <ul style="list-style-type: none"> • Circumstances under which a certificate may or must be revoked • Identification and authentication procedures required for revocation requests

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No.	WebTrust® Program for Certification Authorities v1— Disclosures Criteria
	<ul style="list-style-type: none"> • Procedures used for initiation, authorization, and verification of certificate revocation requests • Revocation request grace period available to the subscriber • Any variations on the preceding stipulations in the event that the revocation is the result of private key compromise (as opposed to other reasons for revocation) • Procedures to provide a means of rapid communication to facilitate the secure and authenticated revocation of (1) one or more certificates of one or more entities; (2) the set of all certificates issued by a CA based on a single public and private key pair used by a CA to generate certificates; and (3) all certificates issued by a CA, regardless of the public and private key pair used • Procedures for notifying the subscriber upon revocation of the subscriber’s certificate • Whether the external RA is notified upon the revocation of a subscriber’s certificate for which the revocation request was processed by the external RA • How and when the subscriber’s certificate status information is updated upon certificate revocation
34	<p>Certificate suspension, including the following:</p> <ul style="list-style-type: none"> • Circumstances under which a certificate may or must be suspended • Identification and authentication procedures required for revocation requests • Procedures used for initiation, authorization, and verification of certificate suspension requests • How long the suspension may last • Circumstances under which the suspension of a certificate may or must be lifted • Authorization criteria to request the lifting of a certificate suspension • Any variations on the preceding stipulations if the suspension is the result of private key compromise (as opposed to other reasons for suspension) • Procedures to provide a means of rapid communication to facilitate the secure and authenticated suspension of (1) one or more certificates of one or more entities; (2) the set of all certificates issued by a CA based on a single public and private key pair used by a CA to generate certificates; and (3) all certificates issued by a CA, regardless of the public and private key pair used • Procedures for notifying the subscriber upon suspension of the subscriber’s certificate • Whether the external RA is notified upon the suspension of a subscriber’s certificate for which the suspension request was processed or submitted by the external RA • How and when the subscriber’s certificate status information is updated upon certificate suspension and the lifting of a certificate suspension
35	<p>Provision of certificate status information, including the following:</p> <ul style="list-style-type: none"> • What mechanism is used (CRLs, online certificate status protocol [OCSP], other) • If a CRL mechanism is used, the issuance frequency • Requirements on relying parties to check CRLs • Online revocation and status checking availability

No.	<i>WebTrust® Program for Certification Authorities v1— Disclosures Criteria</i>
	<ul style="list-style-type: none"> • Requirements on relying parties to perform online revocation and status checks • Other forms of revocation advertisements available • Requirements on relying parties to check other forms of revocation advertisements • Any variations on the previous stipulations when the suspension or revocation is the result of private key compromise (as opposed to other reasons for suspension or revocation) • The CA's requirements for archival and retention of CRLs or other certificate status information • Whether copies of all certificates issued (including all expired, revoked, or suspended certificates) are retained and disclosure of the retention period • If an online status mechanism is used (for example, OCSP), certificate status request content requirements • If an online status mechanism is used (for example, OCSP), definitive response message data content requirements • What key is used to digitally sign definitive response messages • Whether the CA signs error messages when returned in response to certificate status requests
36	<p>Certificate profile, including the following:</p> <ul style="list-style-type: none"> • Version number(s) supported • Certificate extensions populated and their criticality • Cryptographic algorithm object identifiers • Name forms (that is, naming hierarchy used to ensure that the certificate subject can be uniquely identified, if required) used for the CA, RA, and subscribers' names • Name constraints used and the name forms used in the name constraints • Applicable Certificate Policy Object Identifier(s) • Usage of the policy constraints extension • Policy qualifiers syntax and semantics • Processing semantics for the critical CP extension
37	<p>CRL profile, including the following:</p> <ul style="list-style-type: none"> • Version numbers supported for CRLs • CRL and CRL entry extensions populated and their criticality
38	<p>Integrated circuit card (ICC) life cycle management, including the following:</p> <ul style="list-style-type: none"> • Whether ICCs are issued by the CA (or RA) • If supported, a description of the CA's ICC life cycle management processes, including a description of the ICC distribution process
CA Environmental Controls	
39	<p>CPS and CP administration:</p> <ul style="list-style-type: none"> • CPS and CP change control procedures • Publication and notification policies • CPS and CP approval procedures
40	<p>CA termination, including a description of the CA's procedures for termination and for termination notification of a CA or RA, including the identity of the custodian of CA and RA archival records</p>

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No.	<i>WebTrust® Program for Certification Authorities v1— Disclosures Criteria</i>
41	Confidentiality, including the following: <ul style="list-style-type: none"> • Applicable statutory or regulatory requirements to keep information confidential • Kinds of information to be kept confidential • Kinds of information not considered confidential • Disclosure of information concerning certificate revocation and suspension • Release to law enforcement officials • Release as part of civil discovery • Disclosure upon owner's request • Other information release circumstances
42	Intellectual property rights
43	Physical security controls, including the following: <ul style="list-style-type: none"> • Site location and construction • Physical access controls, including authentication controls to control and restrict access to CA facilities • Power and air conditioning • Water exposures • Fire prevention and protection • Media storage • Waste disposal • Off-site backup
44	Business continuity management controls, including the following: <ul style="list-style-type: none"> • Whether the CA has business continuity plans to maintain or restore the CA's business operations in a reasonably timely manner following interruption to, or failure of, critical business processes • Whether the CA's business continuity plans define an acceptable system outage and recovery time and disclosure of the defined time period(s) • How frequently backup copies of essential business information and software are taken • Proximity of recovery facilities to the CA's main site
45	Event logging, including the following: <ul style="list-style-type: none"> • How frequently the CA archives event journal data • How frequently event journals are reviewed

Appendix B — Illustrative Examples of Practitioner Reports

B1. This appendix presents four illustrative reports for WebTrust® for Certification Authorities engagements, which are performed under AT section 101, *Attest Engagements* (AICPA, *Professional Standards*), using the Trust Services Criteria for Certification Authorities.

B2. Paragraph .09 of AT section 101 states that a practitioner may report on a written assertion or directly on the subject matter. Examples of both kinds of reports are included in this appendix.

Example 1 — Reporting on Management’s Assertion, Unqualified Opinion, All of the Trust Services Criteria for Certification Authorities Are Applicable

Report of Independent Accountant

To the Management of
ABC Certification Authority, Inc.:

We have examined the assertion by the management of ABC Certification Authority, Inc. (ABC-CA) [*link to management’s assertion*] that in providing its Certification Authority (CA) services at [*location*], ABC-CA, during the period [*date*] through [*date*], it

- disclosed its Business, Key Life Cycle Management, Certificate Life Cycle Management, and CA Environmental Control practices in its
 - Certification Practice Statement, and
 - Certificate Policy (if applicable)
- maintained effective controls to provide reasonable assurance that
 - ABC-CA’s Certification Practice Statement is consistent with its Certificate Policy (if applicable)
 - ABC-CA provides its services in accordance with its Certificate Policy (if applicable) and Certification Practice Statement
- maintained effective controls to provide reasonable assurance that
 - the integrity of keys and certificates it manages is established and protected throughout their life cycles;
 - the integrity of subscriber keys and certificates it manages is established and protected throughout their life cycles;
 - the Subscriber information is properly authenticated (for the registration activities performed by ABC-CA); and
 - subordinate CA certificate requests are accurate, authenticated, and approved
- maintained effective controls to provide reasonable assurance that
 - logical and physical access to CA systems and data is restricted to authorized individuals;
 - the continuity of key and certificate management operations is maintained; and

- CA systems development, maintenance, and operations are properly authorized and performed to maintain CA systems integrity

for the *[list CAs and roots that are subject to examination]*, based on the AICPA/CICA *Trust Services Criteria for Certification Authorities* *[link to Trust Services Criteria for Certification Authorities]*.

ABC-CA's management is responsible for its assertion. 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 (1) obtaining an understanding of ABC-CA's key and certificate life cycle management business practices and its controls over key and certificate integrity, over the authenticity and privacy of subscriber and relying party information, over the continuity of key and certificate life cycle management operations, and over the development, maintenance, and operation of systems integrity; (2) selectively testing transactions executed in accordance with disclosed key and certificate life cycle management business practices; (3) testing and evaluating the operating effectiveness of the controls; and (4) performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

The relative effectiveness and significance of specific controls at ABC-CA and their effect on assessments of control risk for subscribers and relying parties are dependent on their interaction with the controls and other factors present at individual subscriber and relying party locations. We have performed no procedures to evaluate the effectiveness of controls at individual subscriber and relying party locations.

Because of the nature and inherent limitations of controls, ABC-CA's ability to meet the aforementioned criteria may be affected. For example, controls may not prevent, or detect and correct, error, fraud, unauthorized access to systems and information, or failure to comply with internal and external policies or requirements. Also, 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.

In our opinion, for the period *[date]* through *[date]*, ABC-CA management's assertion, as set forth in the first paragraph, is fairly stated, in all material respects, based on the AICPA/CICA *Trust Services Criteria for Certification Authorities*.

This report does not include any representation as to the quality of ABC-CA's services beyond those covered by the *Trust Services Criteria for Certification Authorities*, nor the suitability of any of ABC-CA's services for any customer's intended purpose.

[Name of CPA firm]

Certified Public Accountants

[City, State]

[Date]

Example 2 — Reporting on Management’s Assertion, Unqualified Opinion, Certification Authority Uses External Registration Authorities for Specific Subscriber Registration Activities as Disclosed in ABC-CA’s Business Practice Disclosures. Report Does Not Extend to the Controls Exercised by the External Registration Authorities

Report of Independent Accountant

To the Management of
ABC Certification Authority, Inc.:

We have examined the assertion by the management of ABC Certification Authority, Inc. (ABC-CA) [*link to management’s assertion*] that in providing its Certification Authority (CA) services at [*location*], ABC-CA, during the period [*date*] through [*date*], management of ABC-CA

- disclosed its Business, Key Life Cycle Management, Certificate Life Cycle Management, and CA Environmental Control practices in its
 - Certification Practice Statement and
 - Certificate Policy (if applicable)
- maintained effective controls to provide reasonable assurance that
 - ABC-CA’s Certification Practice Statement is consistent with its Certificate Policy (if applicable)
 - ABC-CA provides its services in accordance with its Certificate Policy (if applicable) and Certification Practice Statement
- maintained effective controls to provide reasonable assurance that
 - the integrity of keys and certificates it manages is established and protected throughout their life cycles;
 - the integrity of subscriber keys and certificates it manages is established and protected throughout their life cycles;
 - the Subscriber information is properly authenticated (for the registration activities performed by ABC-CA); and
 - subordinate CA certificate requests are accurate, authenticated, and approved
- maintained effective controls to provide reasonable assurance that
 - logical and physical access to CA systems and data is restricted to authorized individuals;
 - the continuity of key and certificate management operations is maintained; and
 - CA systems development, maintenance, and operations are properly authorized and performed to maintain CA systems integrity

for the [*list CAs and roots that are subject to examination*], based on the AICPA/CICA *Trust Services Criteria for Certification Authorities* [*link to Trust Services Criteria for Certification Authorities*].

ABC-CA’s management is responsible for its assertion. Our responsibility is to express an opinion on management’s assertion based on our examination.

ABC-CA makes use of external registration authorities for specific subscriber registration activities as disclosed in ABC-CA’s business practice disclosures.

Our examination did not extend to the controls exercised by the external registration authorities.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants, and accordingly, included (1) obtaining an understanding of ABC-CA's key and certificate life cycle management business practices and its controls over key and certificate integrity, over the authenticity and privacy of subscriber and relying party information, over the continuity of key and certificate life cycle management operations, and over the development, maintenance, and operation of systems integrity; (2) selectively testing transactions executed in accordance with disclosed key and certificate life cycle management business practices; (3) testing and evaluating the operating effectiveness of the controls; and (4) performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

The relative effectiveness and significance of specific controls at ABC-CA and their effect on assessments of control risk for subscribers and relying parties are dependent on their interaction with the controls and other factors present at individual subscriber and relying party locations. We have performed no procedures to evaluate the effectiveness of controls at individual subscriber and relying party locations.

Because of the nature and inherent limitations of controls, ABC-CA's ability to meet the aforementioned criteria may be affected. For example, controls may not prevent, or detect and correct, error, fraud, unauthorized access to systems and information, or failure to comply with internal and external policies or requirements. Also, 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.

In our opinion, for the period [date] through [date], ABC-CA management's assertion, as set forth in the first paragraph, is fairly stated, in all material respects, based on the AICPA/CICA *Trust Services Criteria for Certification Authorities*.

This report does not include any representation as to the quality of ABC-CA's services beyond those covered by the *Trust Services Criteria for Certification Authorities*, nor the suitability of any of ABC-CA's services for any customer's intended purpose.

[Name of CPA firm]

Certified Public Accountants

[City, State]

[Date]

Example 3 — Reporting on the Subject Matter, Unqualified Opinion, All of the Trust Services Criteria for Certification Authorities Are Applicable

Report of Independent Accountant

To the Management of
ABC Certification Authority, Inc.:

We have examined, for its [location], ABC Certification Authority, Ltd.'s (ABC-CA) disclosure of its Business, Key Life Cycle Management, Certificate Life Cycle Management, and CA Environmental Controls on its website, the consistency of its Certification Practice Statement with its Certificate Policy (if applicable) and the provision of services in accordance with its Certificate Policy (if applicable) and Certification Practice Statement and the effectiveness of its controls over key and certificate integrity, over the authenticity and privacy of subscriber and relying party information, over the continuity of key and certificate life cycle management operations, and over the development, maintenance, and operation of systems integrity for the [list CAs and roots that are subject to examination], during the period [date] through [date]. These disclosures and controls are the responsibility of the ABC-CA's management. Our responsibility is to express an opinion 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 (1) obtaining an understanding of ABC-CA's key and certificate life cycle management business practices and its controls over key and certificate integrity, over the authenticity and privacy of subscriber and relying party information, over the continuity of key and certificate life cycle management operations, and over the development, maintenance, and operation of systems integrity; (2) selectively testing transactions executed in accordance with disclosed key and certificate life cycle management business practices; (3) testing and evaluating the operating effectiveness of the controls; and (4) performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

The relative effectiveness and significance of specific controls at ABC-CA and their effect on assessments of control risk for subscribers and relying parties are dependent on their interaction with the controls and other factors present at individual subscriber and relying party locations. We have performed no procedures to evaluate the effectiveness of controls at individual subscriber and relying party locations.

Because of the nature and inherent limitations of controls, ABC-CA's ability to meet the aforementioned criteria may be affected. For example, controls may not prevent, or detect and correct, error, fraud, unauthorized access to systems and information, or failure to comply with internal and external policies or requirements. Also, 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.

In our opinion, during the period [date] through [date], ABC-CA, in all material respects

- disclosed its Key and Certificate Life Cycle Management business practices and provided such services in accordance with its disclosed practices;

- maintained effective controls to provide reasonable assurance that ABC-CA's Certification Practice Statement is consistent with its Certificate Policy (if applicable) and that ABC-CA provides its services in accordance with its Certificate Policy (if applicable) and Certification Practice Statement;
- maintained effective controls to provide reasonable assurance that subscriber information was properly authenticated (for the registration activities performed by ABC-CA) and the integrity of keys and certificates it managed was established and protected throughout their life cycles; and
- maintained effective controls to provide reasonable assurance that subscriber and relying party information was restricted to authorized individuals and protected from uses not specified in the CA's business practices disclosure; the continuity of key and certificate life cycle management operations was maintained; and CA systems development, maintenance, and operations were properly authorized and performed to maintain CA systems integrity

based on the AICPA/CICA *Trust Services Criteria for Certification Authorities* [[link to Trust Services Criteria for Certification Authorities](#)].

This report does not include any representation as to the quality of ABC-CA's services beyond those covered by the *Trust Services Criteria for Certification Authorities*, nor the suitability of any of ABC-CA's services for any customer's intended purpose.

[Name of CPA firm]

Certified Public Accountants

[City, State]

[Date]

Example 4 — Reporting on Management’s Assertion With Respect to Reporting to Federal Authorities, (U.S. Federal Public Key Infrastructure Requirements and Bridge Certification A Scenarios) Unqualified Opinion, All of the Trust Services Criteria for Certification Authorities Are Applicable

Report of Independent Accountant

To the Management of
ABC Certification Authority, Inc.:

We have examined the assertion by the management of ABC Certification Authority, Inc. (ABC-CA) [*link to management’s assertion*] that in providing its Certification Authority (CA) services at [*location*], ABC-CA, during the period [*date*] through [*date*], management of ABC-CA

- disclosed its Business, Key Life Cycle Management, Certificate Life Cycle Management, and CA Environmental Control practices in its
 - ABC-CA Certificate Policy Version ## dated [*date*] [*link*] (ABC-CA CP) (including sections 1, 2, 3, 4, 5, 6, 7, 8, and 9)
 - ABC-CA Certification Practices Statement Version ## dated [*date*] [*link*]¹ (ABC-CA CPS⁹) that is consistent with the ABC-CA CP (including sections 1, 2, 3, 4, 5, 6, 7, 8 and 9)
 - (if applicable) Memorandum of Agreement dated [*date*] between the Federal PKI Policy Authority and ABC-CA (ABC-MOA) (including all [or specified] sections except ###)
- provided its CA services in accordance with its disclosed practices including
 - ABC-CA CP (including sections 1, 2, 3, 4, 5, 6, 7, 8, and 9)
 - ABC-CA CPS that is consistent with the ABC-CP (including sections 1, 2, 3, 4, 5, 6, 7, 8, and 9)
 - (if applicable) ABC-MOA (including all [or specified] sections)
- maintained effective controls to provide reasonable assurance that
 - the integrity of keys and certificates it manages is established and protected throughout their life cycles;
 - the integrity of subscriber keys and certificates it manages is established and protected throughout their life cycles;
 - the Subscriber information is properly authenticated (for the registration activities performed by ABC-CA); and
 - subordinate CA certificate requests are accurate, authenticated, and approved;
- maintained effective controls to provide reasonable assurance that
 - logical and physical access to CA systems and data is restricted to authorized individuals;
 - the continuity of key and certificate management operations is maintained; and

¹ Include the text (*restricted to ABC-CA Participants*) or similar language if the certification practice statement is not publicly disclosed.

- CA systems development, maintenance and operations are properly authorized and performed to maintain CA systems integrity

for the *[list CAs and roots that are subject to examination]*, based on the AICPA/CICA *Trust Services Criteria for Certification Authorities* [\[link to Trust Services Principle for Certification Authorities Criteria\]](#).

ABC-CA's management is responsible for its assertion. Our responsibility is to express an opinion on management's assertion based on our examination.

Our examination, which commenced on *[date]* and ended on *[date field work ended]*, was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants, and accordingly, included (1) obtaining an understanding of ABC-CA's key and certificate life cycle management business practices and its controls over key and certificate integrity, over the authenticity and privacy of subscriber and relying party information, over the continuity of key and certificate life cycle management operations, and over the development, maintenance, and operation of systems integrity; (2) selectively testing transactions executed in accordance with disclosed key and certificate life cycle management business practices; (3) testing and evaluating the operating effectiveness of the controls; and (4) performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

The relative effectiveness and significance of specific controls at ABC-CA and their effect on assessments of control risk for subscribers and relying parties are dependent on their interaction with the controls, and other factors present at individual subscriber and relying party locations. We have performed no procedures to evaluate the effectiveness of controls at individual subscriber and relying party locations.

Because of the nature and inherent limitations of controls, ABC-CA's ability to meet the aforementioned criteria may be affected. For example, controls may not prevent, or detect and correct, error, fraud, unauthorized access to systems and information, or failure to comply with internal and external policies or requirements. Also, 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.

In our opinion, for the period *[date]* through *[date]*, ABC-CA management's assertion, as set forth in the first paragraph, is fairly stated, in all material respects, based on the AICPA/CICA *Trust Services Criteria for Certification Authorities*.

This report does not include any representation as to the quality of ABC-CA's services beyond those covered by the *Trust Services Criteria for Certification Authorities*, nor the suitability of any of ABC-CA's services for any customer's intended purpose.

This report is intended solely for the information and use of ABC-CA and the Federal PKI Policy Authority and is not intended to be, and should not be, used by anyone other than ABC-CA and the Federal PKI Policy Authority.

[Name of CPA firm]

Certified Public Accountants

[City, State]

[Date]

Appendix C — Illustrative Examples of Management's Assertion

Example 1 — Assertion by Management of a Certification Authority, All of the Trust Services Criteria for Certification Authorities Are Applicable

Assertion by Management of ABC Certification Authority, Inc. Regarding Its Disclosure of Its Business Practices and Its Controls Over Its Certification Authority Operations During the Period [Date] Through [Date]

[Date]

ABC Certification Authority, Inc. operates as a Certification Authority (CA) known as ABC-CA. ABC-CA, as a Root CA [or as a subordinate CA of DEF Certification Authority, Inc.], provides the following certification authority services:

- Subscriber key management services
- Subscriber registration
- Certificate renewal
- Certificate rekey
- Certificate issuance
- Certificate distribution (using an online repository)
- Certificate revocation
- Certificate suspension
- Certificate status information processing (using an online repository)
- Integrated circuit card life cycle management

Management of ABC-CA is responsible for establishing and maintaining effective controls over its CA operations, including CA business practices disclosure [[link to CA Business Practices Disclosure](#)], service integrity (including key and certificate life cycle management controls), and CA environmental controls. These controls contain monitoring mechanisms, and actions are taken to correct deficiencies identified.

Controls have inherent limitations, including the possibility of human error and the circumvention or overriding of controls. Accordingly, even effective controls can provide only reasonable assurance with respect to ABC-CA's Certification Authority operations. Furthermore, because of changes in conditions, the effectiveness of controls may vary over time.

Management has assessed the controls over its CA operations. Based on that assessment, in ABC Certification Authority, Inc. (ABC-CA) Management's opinion, in providing its Certification Authority (CA) services at [location], ABC-CA, during the period [date] through [date]

- disclosed its Business, Key Life Cycle Management, Certificate Life Cycle Management, and CA Environmental Control practices in its
 - Certification Practice Statement and
 - Certificate Policy (if applicable)

- maintained effective controls to provide reasonable assurance that
 - ABC-CA's Certification Practice Statement is consistent with its Certificate Policy (if applicable)
 - ABC-CA provides its services in accordance with its Certificate Policy (if applicable) and Certification Practice Statement
- maintained effective controls to provide reasonable assurance that
 - the integrity of keys and certificates it manages is established and protected throughout their life cycles;
 - the integrity of subscriber keys and certificates it manages is established and protected throughout their life cycles;
 - the Subscriber information is properly authenticated (for the registration activities performed by ABC-CA); and
 - subordinate CA certificate requests are accurate, authenticated, and approved
- maintained effective controls to provide reasonable assurance that
 - logical and physical access to CA systems and data is restricted to authorized individuals;
 - the continuity of key and certificate management operations is maintained; and
 - CA systems development, maintenance, and operations are properly authorized and performed to maintain CA systems integrity

for the *[list CAs and roots that are subject to examination]*, in accordance with on the AICPA/CICA *Trust Services Criteria for Certification Authorities* *[link to Trust Services Criteria for Certification Authorities]* including the following:

CA Business Practices Disclosure

CA Business Practices Management
 Certification Practice Statement Management
 Certificate Policy Management

Service Integrity

CA Key Life Cycle Management Controls
 CA Key Generation
 CA Key Storage, Backup, and Recovery
 CA Public Key Distribution
 CA Key Usage
 CA Key Archival and Destruction
 CA Key Compromise
 CA Cryptographic Hardware Life Cycle Management
 CA-Key Escrow (if applicable)

Subscriber Key Life Cycle Management Controls
 CA-Provided Subscriber Key Generation Services (if supported)
 CA-Provided Subscriber Key Storage and Recovery Services (if supported)
 Integrated Circuit Card Life Cycle Management (if supported)

Certificate Life Cycle Management Controls
 Subscriber Registration
 Certificate Renewal (if supported)
 Certificate Rekey
 Certificate Issuance

Certificate Distribution
Certificate Revocation
Certificate Suspension (if supported)
Certificate Validation

CA Environmental Controls

Security Management
Asset Classification and Management
Personnel Security
Physical and Environmental Security
Operations Management
System Access Management
Systems Development and Maintenance
Business Continuity Management
Monitoring and Compliance
Audit Logging

[Name]

[Title]

Example 2 — Assertion by Management of a Certification Authority, All of the Trust Services Criteria for Certification Authorities Are Applicable, Certification Authority Uses External Registration Authorities and Does Not Support Key Escrow, Certificate Renewal, Certificate Suspension, the Use of Integrated Circuit Cards, or the Provision of Subscriber Key Management Services)

Assertion by Management of ABC Certification Authority, Inc. Regarding Its Disclosure of Its Business Practices and Its Controls Over Its Certification Authority Operations During the Period [Date] through [Date]

[Date]

ABC Certification Authority, Inc. operates as a Certification Authority (CA) known as ABC-CA. ABC-CA, as a Root CA [or as a subordinate CA of DEF Certification Authority, Inc.], provides the following certification authority services:

- Certificate rekey
- Certificate issuance
- Certificate distribution (using an online repository)
- Certificate revocation
- Certificate status information processing (using an online repository)

ABC-CA makes use of external registration authorities for specific subscriber registration activities as disclosed in ABC-CA's business practice disclosures.

Management of ABC-CA is responsible for establishing and maintaining effective controls over its Certification Authority operations, including CA business practices disclosure [link to CA Business Practices Disclosure], service integrity (including key and certificate life cycle management controls), and CA environmental controls. These controls contain monitoring mechanisms, and actions are taken to correct deficiencies identified.

Controls have inherent limitations, including the possibility of human error and the circumvention or overriding of controls. Accordingly, even effective internal control can provide only reasonable assurance with respect to ABC-CA's Certification Authority operations. Furthermore, because of changes in conditions, the effectiveness of controls may vary over time.

Management has assessed the controls over its CA operations. Based on that assessment, to the best of our knowledge and belief, we confirm that in providing its Certification Authority (CA) services at [location], ABC-CA, during the period [date] through [date], ABC-CA

- disclosed its Business, Key Life Cycle Management, Certificate Life Cycle Management, and CA Environmental Control practices in its
 - Certification Practice Statement and
 - Certificate Policy (if applicable)
- maintained effective controls to provide reasonable assurance that
 - ABC-CA's Certification Practice Statement is consistent with its Certificate Policy (if applicable)

- ABC-CA provides its services in accordance with its Certificate Policy (if applicable) and Certification Practice Statement
- maintained effective controls to provide reasonable assurance that
 - the integrity of keys and certificates it manages is established and protected throughout their life cycles;
 - the integrity of subscriber keys and certificates it manages is established and protected throughout their life cycles;
 - the Subscriber information is properly authenticated (for the registration activities performed by ABC-CA); and
 - subordinate CA certificate requests are accurate, authenticated, and approved
- maintained effective controls to provide reasonable assurance that
 - logical and physical access to CA systems and data is restricted to authorized individuals;
 - the continuity of key and certificate management operations is maintained; and
 - CA systems development, maintenance, and operations are properly authorized and performed to maintain CA systems integrity

for the *[list CAs and roots that are subject to examination]*, in accordance with the AICPA/CICA *Trust Services Criteria for Certification Authorities* *[link to Trust Services Criteria for Certification Authorities]* including the following:

CA Business Practices Disclosure

CA Business Practices Management
Certification Practice Statement Management
Certificate Policy Management

Service Integrity

CA Key Life Cycle Management Controls
CA Key Generation
CA Key Storage, Backup, and Recovery
CA Public Key Distribution
CA Key Usage
CA Key Archival and Destruction
CA Key Compromise
CA Cryptographic Hardware Life Cycle Management
CA-Key Escrow (if applicable)

Subscriber Key Life Cycle Management Controls
CA-Provided Subscriber Key Generation Services (if supported)
CA-Provided Subscriber Key Storage and Recovery Services (if supported)
Integrated Circuit Card Life Cycle Management (if supported)

Certificate Life Cycle Management Controls
Subscriber Registration
Certificate Renewal (if supported)
Certificate Rekey
Certificate Issuance
Certificate Distribution
Certificate Revocation
Certificate Suspension (if supported)
Certificate Validation

CA Environmental Controls

- Security Management
- Asset Classification and Management
- Personnel Security
- Physical and Environmental Security
- Operations Management
- System Access Management
- Systems Development and Maintenance
- Business Continuity Management
- Monitoring and Compliance
- Audit Logging

[Name]

[Title]

Appendix D – Illustrative Example of Management’s Representation

Example 1 – Management Representation Letter for a Certification Authority, All of the Trust Services Criteria for Certification Authorities Are Applicable

[Date]

[Name of CPA or Chartered Accountant firm] [Address]

Dear Members of the Firm:

Management confirms its understanding that your examination of our assertion related to ABC Certification Authority, Inc.’s (ABC-CA) business practices disclosure and controls over its Certification Authority operations during the period [date] through [date], was made for the purpose of expressing an opinion on whether our assertion is fairly presented, in all material respects, and that your opinion is based on criteria for effective controls as stated in our assertion document. We are responsible for our assertion. In connection with your examination, management of ABC-CA

- a. acknowledges its responsibility for establishing and maintaining effective controls over its Certification Authority (CA) operations at [location], including CA business practices disclosure, service integrity (including key and certificate life cycle management controls), and CA environmental controls.
- b. has performed an assessment and believes that ABC-CA’s CA business practices disclosure, service integrity (including key and certificate life cycle management controls), and CA environmental controls met the minimum requirement of the criteria described in our assertion document during the period [date] through [date].
- c. believes the stated criteria against which our assertion has been assessed are reasonable and appropriate.
- d. has disclosed to you that there are no significant deficiencies in the design or operation of the controls, which could adversely affect ABC-CA’s ability to comply with the control criteria related to ABC-CA’s CA business practices disclosure, service integrity (including key and certificate life cycle management controls), and CA environmental controls, consistent with our assertions.
- e. has made available to you all significant information and records related to our assertion.
- f. has responded fully to all inquiries made to us by you during your examination.
- g. has disclosed to you any changes occurring, or planned to occur, subsequent to [date field work ended], in controls or other factors that might significantly affect the controls, including any corrective actions taken by management with regard to significant deficiencies.

In management’s opinion, ABC-CA, in providing its Certification Authority (CA) services at [location], ABC-CA, during the period [date] through [date]

- disclosed its key and certificate life cycle management business practices and provided such services in accordance with its disclosed practices
- maintained effective controls to provide reasonable assurance that
 - subscriber information was properly authenticated (for the registration activities performed by ABC-CA) and
 - the integrity of keys and certificates it managed was established and protected throughout their life cycles
- maintained effective controls to provide reasonable assurance that
 - subscriber and relying party information was restricted to authorized individuals and protected from uses not specified in the CA's business practices disclosure;
 - the continuity of key and certificate life cycle management operations was maintained; and
 - CA systems development, maintenance, and operations were properly authorized and performed to maintain CA systems integrity

for the *[list CAs and roots that are subject to examination]*, based on the AICPA/CICA *Trust Services Criteria for Certification Authorities* including the following:

CA Business Practices Disclosure

CA Business Practices Management
 Certification Practice Statement Management
 Certificate Policy Management

Service Integrity

CA Key Life Cycle Management Controls
 CA Key Generation
 CA Key Storage, Backup, and Recovery
 CA Public Key Distribution
 CA Key Usage
 CA Key Archival and Destruction
 CA Key Compromise
 CA Cryptographic Hardware Life Cycle Management
 CA-Key Escrow (if applicable)

Subscriber Key Life Cycle Management Controls
 CA-Provided Subscriber Key Generation Services (if supported)
 CA-Provided Subscriber Key Storage and Recovery Services (if supported)
 Integrated Circuit Card Life Cycle Management (if supported)

Certificate Life Cycle Management Controls
 Subscriber Registration
 Certificate Renewal (if supported)
 Certificate Rekey
 Certificate Issuance
 Certificate Distribution
 Certificate Revocation
 Certificate Suspension (if supported)
 Certificate Validation

CA Environmental Controls

Security Management
Asset Classification and Management
Personnel Security
Physical and Environmental Security
Operations Management
System Access Management
Systems Development and Maintenance
Business Continuity Management
Monitoring and Compliance
Audit Logging

Very truly yours,

[Name]

[Title]

Example 2 — Management Representation Letter for a Certification Authority That Uses External Registration Authorities and Does Not Support Key Escrow, Certificate Renewal, Certificate Suspension, Use of Integrated Circuit Cards, or Provision of Subscriber Key Management Services

[Date]

[Name of CPA or Chartered Accountant firm] [Address]

Dear Members of the Firm:

Management confirms its understanding that your examination of our assertion related to ABC Certification Authority, Inc.'s (ABC-CA) business practices disclosure and controls over its Certification Authority (CA) operations during the period [date] through [date], was to enable you to express an opinion on whether our assertion is fairly presented, in all material respects, based on the AICPA/CICA *Trust Services Criteria for Certification Authorities*, and that your opinion is based on criteria for effective controls as stated in our assertion document. ABC-CA makes use of external registration authorities for specific subscriber registration activities, as disclosed in ABC-CA's business practice disclosures. We are responsible for our assertion. In connection with your examination, management

- a. acknowledges its responsibility for establishing and maintaining effective controls over its CA operations, including CA business practices disclosure, service integrity (including key and certificate life cycle management controls), and CA environmental controls.
- b. has performed an assessment and believes that ABC-CA's CA business practices disclosure, service integrity (including key and certificate life cycle management controls), and CA environmental controls, met the minimum requirement of the criteria described in our assertion document during the period [date] through [date].
- c. believes the stated criteria against which our assertion has been assessed are reasonable and appropriate.
- d. has disclosed to you that there are no significant deficiencies in the design or operation of the controls, which could adversely affect the Company's ability to comply with the control criteria related to ABC-CA's CA business practices disclosure, service integrity (including key and certificate life cycle management controls), and CA environmental controls, consistent with the assertions of management.
- e. has made available to you all significant information and records related to our assertion.
- f. has responded fully to all inquiries made to us by you during your examination.
- g. has disclosed to you any changes occurring, or planned to occur, subsequent to [date], in controls or other factors that might significantly affect the controls, including any corrective actions taken by management with regard to significant deficiencies.

In management's opinion, ABC-CA, in providing its Certification Authority (CA) services at [location], ABC-CA, during the period [date] through [date]

- disclosed its key and certificate life cycle management business practices and provided such services in accordance with its disclosed practices

- maintained effective controls to provide reasonable assurance that
 - subscriber information was properly authenticated (for the registration activities performed by ABC-CA) and
 - the integrity of keys and certificates it managed was established and protected throughout their life cycles
- maintained effective controls to provide reasonable assurance that
 - subscriber and relying party information was restricted to authorized individuals and protected from uses not specified in the CA's business practices disclosure;
 - the continuity of key and certificate life cycle management operations was maintained; and
 - CA systems development, maintenance, and operations were properly authorized and performed to maintain CA systems integrity

for the *[list CAs and roots that are subject to examination]*, based on the AICPA/CICA *Trust Services Criteria for Certification Authorities*, including the following:

CA Business Practices Disclosure

CA Business Practices Management
 Certification Practice Statement Management
 Certificate Policy Management

Service Integrity

CA Key Life Cycle Management Controls
 CA Key Generation
 CA Key Storage, Backup, and Recovery
 CA Public Key Distribution
 CA Key Usage
 CA Key Archival and Destruction
 CA Key Compromise
 CA Cryptographic Hardware Life Cycle Management
 CA-Key Escrow (if applicable)

Subscriber Key Life Cycle Management Controls

CA-Provided Subscriber Key Generation Services (if supported)
 CA-Provided Subscriber Key Storage and Recovery Services (if supported)
 Integrated Circuit Card Life Cycle Management (if supported)

Certificate Life Cycle Management Controls

Subscriber Registration
 Certificate Renewal (if supported)
 Certificate Rekey
 Certificate Issuance
 Certificate Distribution
 Certificate Revocation
 Certificate Suspension (if supported)
 Certificate Validation

CA Environmental Controls

Security Management
 Asset Classification and Management
 Personnel Security
 Physical and Environmental Security

Operations Management
System Access Management
Systems Development and Maintenance
Business Continuity Management
Monitoring and Compliance
Audit Logging

Very truly yours,

[Name]

[Title]

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XBR**PRINCIPLES AND CRITERIA FOR
XBRL-FORMATTED INFORMATION**

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XBR Section

Principles and Criteria for XBRL-Formatted Information

Notice to Readers

The *Principles and Criteria for XBRL-Formatted Information* present criteria established by the Assurance Services Executive Committee (ASEC) of the AICPA for use by preparers of XBRL-formatted information and practitioners when providing attestation or consulting services to evaluate XBRL-formatted information. ASEC, in establishing and developing these principles and criteria, followed due process procedures, including exposure of the proposed principles and criteria for public comment. Under BL section 360, *Committees* (AICPA, *Professional Standards*), ASEC has been designated as a senior committee and has been given authority to make public statements and publish measurement criteria without clearance from Council or the board of directors.

Background and Applicability

.01 The AICPA Assurance Services Executive Committee (ASEC) has developed a set of principles and criteria for preparers, reviewers, practitioners, and users of information formatted in eXtensible Business Reporting Language (XBRL) to use in evaluating the completeness of the XBRL files, evaluating the mapping of the source information, evaluating the consistency of the XBRL files with the source information, and evaluating the structure of the XBRL files (XBRL principles and criteria). XBRL is a global standard that provides unique electronically readable codes (tags) for each business reporting concept in financial statements or other business reports. (These reports are referred to as source information because they are the origin of the information that will be formatted.) The term *XBRL-formatted information* means information that has been represented using XBRL and included in one or more electronic files (commonly referred to as *tagged information*).

.02 This document presents the principles and related criteria to be used for evaluating XBRL-formatted information and provides the basis for ASEC's conclusions that the criteria are suitable. Regardless of who establishes or develops the criteria, the preparer (responsible party) is responsible for selecting the criteria and determining that such criteria are appropriate for his or her purposes. ASEC focused on areas that would require judgment, could not be automatically validated, and may have a significant impact on users of XBRL files (instance document and related files, including taxonomy extension schema, label linkbase, calculation linkbase, presentation linkbase, and definition linkbase documents). The XBRL principles and criteria have been developed for multijurisdictional use and are based on key concepts from best practices and significant local requirements. However, compliance with this set of principles and criteria may not necessarily result in compliance with the laws, regulations, or other requirements of an entity's reporting environment. The exhibit, "Application Guidance of the eXtensible Business Reporting Language Principles and Criteria for eXtensible Business Reporting Language Exhibits Submitted to the Securities Exchange Commission," of this document aligns certain requirements of the Securities and Exchange Commission (SEC)

rules¹ for preparing and submitting XBRL files that include financial statements, including the notes, and required schedules that are submitted to the SEC with the related XBRL principles and criteria herein. However, the XBRL principles and criteria are not intended to be complete for purposes of evaluating compliance with the SEC rules² and regulations; therefore, complying with these principles and criteria is not a sufficient basis for a preparer to assert that the entity has complied with all the SEC rules and regulations.

.03 The XBRL principles and criteria focus on the use of the XBRL 2.1 Specification for financial statement reporting and do not address all possible implementations of the XBRL standard. As a result, some options and features have not been addressed in this document. For example, the XBRL principles and criteria cover the more commonly used decimal attribute (used to convey the accuracy for a given amount) rather than the less common option of using the precision attribute. Similarly, some features addressed in this document may not be used in certain implementations.

Use of the Criteria

.04 The XBRL principles and criteria represent a means for assessing the quality of XBRL files and, therefore, provide a consistent basis for evaluating the completeness, mapping, consistency, and structure of the XBRL-formatted information. Prior to applying these XBRL principles and criteria, management needs to determine that the underlying source information to be tagged is complete and accurate and that it includes all required content and is prepared in conformity with its reporting framework (for example, U.S. generally accepted accounting principles). Therefore, the XBRL principles and criteria only relate to the XBRL-formatted information, not the underlying source information (for example, deficiencies in the underlying source information with respect to its reporting framework are not addressed by these principles and criteria).

.05 The XBRL principles and criteria were written in general terms with the intent of applying them across a variety of XBRL reporting environments. In addition to applying these XBRL principles and criteria, management may perform validation tests to determine whether the XBRL files will be accepted for submission (for example, will pass validation tests provided by the regulator or requesting party). The XBRL principles and criteria focus on areas that both require judgment by management in preparing the XBRL files and would likely have a significant effect on user decisions and, therefore, may not include all requirements of an entity's reporting environment. Management should comply with the XBRL principles and criteria taken as a whole. It would not be appropriate for management merely to assert compliance with individual principles and criteria. Notwithstanding, a preparer may be requested by a practitioner, in connection with services provided by the practitioner, to provide specific written representations with respect to certain principles or criteria.

.06 The process for preparing financial statements and other business reports and mapping the information to standardized XBRL taxonomies is complex and requires judgment. Knowledge of the XBRL language and specific

¹ The Securities and Exchange Commission (SEC) adopted final rules that require issuers to provide their financial statements, including the notes, and required schedules to the SEC and on their corporate websites in an interactive data format using eXtensible Business Reporting Language (XBRL) (Release Nos. 33-9002, 34-59324, and 39-2461; IC-28609; and File No. S7-11-08 issued January 30, 2009).

² Additional *EDGAR Filer Manual* requirements exist for XBRL-formatted information that are not included herein.

requirements for submitting XBRL-formatted information is needed to properly create XBRL files. For this reason, entities may use the criteria to evaluate the quality of their XBRL-formatted information. They also may decide to engage a CPA to provide attestation or consulting services related to their XBRL-formatted information.

CPA Services

.07 Attestation services under the AICPA's Statements on Standards for Attestation Engagements or the Public Company Accounting Oversight Board's interim attestation standards include examination, review,³ and agreed-upon procedures engagements. In the attestation standards, the CPA performing an attest engagement is known as a practitioner. Examples of attestation standards that may be applied to perform engagements related to XBRL-formatted information include AT section 101, *Attest Engagements*, and AT section 201, *Agreed-Upon Procedures Engagement* (AICPA, *Professional Standards*).

.08 In examination engagements, the practitioner provides a report that expresses an opinion (for example, the practitioner reports on whether the XBRL-formatted information meets the criteria for completeness, mapping, consistency, and structure in all material respects). The XBRL principles and criteria are not designed for measuring compliance with the laws, regulations, or other requirements related to an entity's XBRL reporting obligations. Accordingly, when conducting examination engagements, evaluation of compliance with these XBRL principles and criteria alone does not provide an adequate basis for determining that the entity has complied with all its XBRL reporting requirements. In order to make clear that the practitioner's report does not cover the entity's compliance with all its XBRL reporting requirements, the practitioner will ordinarily want to include additional explanatory language within his or her attest reports to emphasize that the practitioner is not forming a conclusion on whether the entity is in compliance with all its XBRL reporting requirements.

.09 In an agreed-upon procedures engagement, the practitioner does not express an opinion but, rather, performs procedures agreed upon by the specified parties and reports the findings in a report restricted to the use of those specified parties.

.10 Consulting services include developing findings, conclusions, and recommendations for client consideration and decision making. The practitioner does not express an opinion or form a conclusion about the reliability of the subject matter in these engagements. Clients may engage practitioners to perform various tasks using the XBRL principles and criteria, which may include providing observations and recommendations to management on its XBRL project management plan, implementation process, or supporting documentation prepared by the client, including comments on the client's mapping of its financial statements to the elements in the applicable taxonomy. Practitioners providing such services follow CS section 100, *Consulting Services: Definitions and Standards* (AICPA, *Professional Standards*).

³ Review engagements generally consist of the performance of inquiries and analytical procedures designed to provide a moderate level of assurance (that is, negative assurance). However, a practitioner ordinarily could not perform meaningful analytical procedures on information formatted in XBRL sufficient to achieve this level of assurance, and it is uncertain what other procedures could be identified that, when combined with inquiry procedures, could form the basis for a review engagement. Accordingly, the feasibility of a review engagement related to XBRL formatting is uncertain.

Suitability and Availability of Criteria

.11 The XBRL principles and criteria included herein address the completeness of the XBRL files, the mapping of the source information, the consistency of the XBRL files with the source information, and the structure of the XBRL files. These four attributes of XBRL-formatted information are known as *principles*, which are broad statements of objectives. The following four principles have been developed for use in evaluating the quality of XBRL-formatted information and should be applied in accordance with the requirements of the entity's reporting environment:⁴

- *Completeness of the XBRL files.* All required information is formatted at the required levels of detail, as defined by the entity's reporting environment. Only permitted information is included in the XBRL files.
- *Mapping of the source information.* The elements selected are consistent with the meaning of the corresponding business reporting concepts in the source information in accordance with the requirements of the entity's reporting environment.
- *Consistency of the XBRL files with the source information.* All formatted information in the XBRL files is consistent with the source information and formatted in accordance with the requirements of the entity's reporting environment.
- *Structure of the XBRL files.* XBRL files are structured in accordance with the associated criteria.

.12 *Criteria* are benchmarks used to measure and present the subject matter and against which the practitioner evaluates the subject matter. AT section 101, *Attest Engagements*,⁵ in *AICPA Professional Standards* and *PCAOB Standards and Related Rules* states that suitable criteria must have each of the following attributes:

- *Objectivity.* Criteria should be free from bias.
- *Measurability.* Criteria should permit reasonably consistent measurements, qualitative or quantitative, of subject matter.
- *Completeness.* Criteria should be sufficiently complete so that those relevant factors that would alter a conclusion about subject matter are not omitted.
- *Relevance.* Criteria should be relevant to the subject matter.

.13 ASEC has concluded that the XBRL criteria have all the attributes of suitable criteria. In addition to being suitable, AT section 101 also indicates that the criteria must be available to users of the practitioner's report. The publication of the principles and criteria following exposure makes the criteria available to users.

Reporting Environment

.14 In an attest service in which a conclusion is expressed, a practitioner will report on compliance with all the principles and related criteria. In an

⁴ More information on the requirements of the entity's reporting environment is provided in paragraph .15.

⁵ This and all subsequent mentions of AT section 101 refer to AT section 101, *Attest Engagements*, in *AICPA Professional Standards* and *PCAOB Standards and Related Rules*.

agreed-upon procedures engagement, practitioners and specified parties agree on the procedures to be performed, and specified parties take responsibility for the sufficiency of those procedures for their purposes. In such an engagement, the procedures may not address all the principles and criteria.

.15 Several principles and criteria included herein refer to consistency with the requirements of the entity's reporting environment. The entity's reporting environment includes the requirements, rules, and regulations for which the entity provides the XBRL files (for example, securities regulators or tax authorities). It is beyond the scope of this document to include all applicable rules, regulations, and technical requirements related to the intended purpose of the XBRL submissions. Notwithstanding, preparers are responsible for identification of, and compliance with, all requirements of the entity's reporting environment in which XBRL files are submitted and may choose to request that a practitioner perform procedures with respect to such requirements.

XBRL-Related Principles and Criteria

.16 This section represents the principles and related criteria for XBRL-formatted information. The lettered statements represent the criteria related to each principle, and the lettered rows contained within the table in the exhibit of this document also correspond to the lettered criteria presented in this section.

Completeness of the XBRL Files

.17 All required information is formatted at the required levels of detail, as defined by the entity's reporting environment. Only permitted information⁶ is included in the XBRL files.

- a. All information that is required to be formatted, as defined by the entity's reporting environment, is formatted at the appropriate levels of detail in the XBRL files.
- b. The XBRL files contain only facts or presentation or calculation relationships that are included in the source information⁷ and other required or permitted information (such as document and entity information⁸) and contain only unused elements and linkbase information that are used intermittently unless otherwise prohibited.⁹

Mapping of the Source Information

.18 The elements¹⁰ selected are consistent with the meaning of the corresponding business reporting concepts in the source information in accordance with the requirements of the entity's reporting environment.

⁶ In a case in which an entity elects to format permitted information in addition to the required information, preparers should consider to what level of detail to format such information so that it is not misleading to the user.

⁷ *Source information* is the original data set (which may be in electronic format) for which the information is to be formatted in XBRL files (for example, financial statements, including the notes, and required schedules; sustainability reports; or the "Risk/Return Summary" section of the mutual fund prospectuses).

⁸ Document and entity information includes information that may be outside the financial statements, such as public float or central index key.

⁹ The entity may carry forward unused elements or presentation, definition, or calculation relationships that are used intermittently (for example, elements or relationships reflected in annual financial statements but not used in quarterly financial statements).

¹⁰ Elements include line items and combinations of line items, domain members, and axes.

- c. Elements used in XBRL files, considering their attributes;¹¹ definitions (for example, documentation labels in the label linkbase); and references, are consistent with the corresponding business reporting concepts in the underlying source information.
- d. The most specific elements or dimensional combination of elements across the entire taxonomy whose attributes; definitions (for example, documentation labels in the label linkbase); and references are consistent with the corresponding business reporting concepts have been used.
- e. Use of selected elements is permitted (for example, the selected element is not deprecated).
- f. The same business reporting concepts appearing multiple times in the source information are formatted once using the same element or combination of elements throughout the XBRL files, when appropriate.¹²
- g. The same elements are used consistently to report the same business reporting concepts, including for each period for which such concepts appear in the underlying source information.¹³
- h. Extension elements are created only when both of the following conditions are met: no suitable elements exist in the selected taxonomy, and extensions are permitted by the entity's reporting environment.
- i. Definitions, if provided (for example, documentation labels in the label linkbase) for extension elements used in the instance document, are consistent with the source information.

Consistency of the XBRL Files With the Source Information

.19 All formatted information¹⁴ in the XBRL files is consistent with the source information and formatted in accordance with the requirements of the entity's reporting environment.

¹¹ The basic element attributes include (a) abstract; (b) data type (that is, whether the content is expected to conform to a certain type of content, such as block text, a monetary value, or other numeric value); (c) period type (that is, whether it is a point in time or a period of time); and (d) balance type (that is, whether it is normally a debit or credit).

¹² Exceptions exist when business reporting concepts will be formatted using different line item and member combinations or when the related guidance requires different elements to be used based on the level of granularity of the source data item being formatted (for example, in situations when concepts must use both dimensional and nondimensional approaches, such as Treasury stock presented on the balance sheet without dimensions and presented on the statement of stockholders equity with dimensions). The appropriate use of duplicate elements should be considered.

¹³ Although the source information may contain different values (for example, positive, negative, or zero) in one period as compared with another (for example, net income [loss]) or represent an ending balance in one period and the beginning balance in the next, the same element should be used in all periods presented. Notwithstanding, there may be certain situations when the taxonomy may include different elements to reflect positive and negative values (for example, certain elements relating to tax assets and liabilities in the US GAAP Taxonomy).

¹⁴ Formatted information includes data (for example, amounts, text, dates); contextual information (for example, monetary units); and relationships (for example, presentation order and calculations).

- j.* Formatted amounts in the XBRL files reflect the entire numbers of the corresponding business reporting concepts (that is, the XBRL amounts are not scaled¹⁵).
- k.* Formatted amounts have the appropriate signs based on the nature of the values in the source information, balance attributes, and definitions (documentation labels in the label linkbase) of the elements.
- l.* All text, dates, and uniform resource identifiers in the XBRL files are consistent with the underlying source information.
- m.* Extension elements included in the instance document of the XBRL files for monetary amounts include debit or credit balance attributes or documentation labels with an indication of the meaning of positive or negative values, when applicable, that are consistent with the nature of the business reporting concepts in the underlying source information.
- n.* The context periods¹⁶ are consistent with the source information (for example, second calendar quarter 2012 is expressed as “2012-04-01 to 2012-06-30”).
- o.* The decimal attribute values are consistent with the degree of accuracy of the amounts as represented in the source information (for example, 23.5 million is rounded to the hundred thousandths).
- p.* The units defined in the instance document are consistent with the measurements represented in the source information (for example, U.S. dollars are defined as “iso4217:USD,” as properly defined in XBRL Specification 2.1).
- q.* The entity identifier in the instance document properly represents the reporting entity (for example, the central index key) in accordance with the requirements of the entity’s reporting environment.
- r.* When text block information is used, its format and layout are consistent with the format and layout of the content in the source information.
- s.* When a presentation linkbase is used, the order and hierarchy (that is, arrangement of appropriate abstracts and line items) reflected in the presentation linkbase are consistent¹⁷ with the requirements of the entity’s reporting environment.
- t.* Labels are consistent¹⁸ with the captions or meanings in the source information, as applicable.

¹⁵ Amounts in financial statements are often presented in various formats (for example, rounded to millions) and may represent a different scale. However, amounts formatted in XBRL must be entered without such presentational formatting. For example, 23.5 million would be entered as 23500000, and 14.3 percent would be entered as .143.

¹⁶ Context periods for a roll-forward format use the same “instant” context for the beginning balance of the current period as for the ending balance of the previous period.

¹⁷ When using dimensions to format information, it may not be possible to present this information in the same order and hierarchy (for example, transposed or intermingled axes for line items and domain members may occur).

¹⁸ *Consistent* means the same as the captions in the source information, when required, or within the scope of variances otherwise permitted.

- u. Calculations reflected in the source information are included in the calculation linkbase in accordance with the requirements of the entity's reporting environment to the extent possible within the technical limitations¹⁹ of XBRL.

Structure of the XBRL Files

.20 XBRL files are structured²⁰ in accordance with the following listed criteria.

- v. Taxonomies, including versions, referenced in the XBRL files are permitted for the entity's reporting environment.
- w. Presentation groupings are consistent with the titles and order of the components of the underlying source information and in accordance with the requirements of the entity's reporting environment.
- x. The entity scheme for each context throughout the instance document is in accordance with the requirements of the entity's reporting environment.
- y. New table structures are only created when no suitable table structure exists in the applicable standard taxonomy's definition linkbase.
- z. The names of extension elements contain no prohibited information.
- aa. The XBRL files include all files required by the entity's reporting environment (for example, an instance, schemas, and linkbases).
- bb. The language of the information in the XBRL files uses a permitted (or required) language (for example, English).

Basis for Conclusions

Basis for Principles and Criteria Overview

.21 The quality of XBRL files is an important concern to users of these files. Errors in the XBRL files will have varying consequences. During the development of the XBRL principles and criteria, potential errors that could occur when preparing XBRL files were considered, and it is believed that the criteria address many of these errors. Further, the principles and criteria meet the requirements under AT section 101, as previously discussed in paragraphs .11–.13, and, thus, are considered to be suitable for a practitioner to perform an attestation engagement. An important component of producing high-quality XBRL files is to have a sound preparation process in place that includes controls (including adequate documentation and review procedures) designed both to comply with requirements of an entity's reporting environment and to prepare files in an appropriately consistent manner from period to period. It also is important to create the XBRL files in a manner so that they will be accepted upon submission. In some reporting environments, presubmission validation tests may be provided by the regulator and performed prior to submitting the XBRL files.

¹⁹ Due to the current limitations of XBRL, calculations cannot be performed across different contexts; accordingly, it is currently not possible to include such calculations in the XBRL files.

²⁰ It is beyond the scope of these principles and criteria to include all applicable rules, regulations, and technical requirements related to the intended purpose of the XBRL submissions. Notwithstanding, preparers are responsible for identification of, and compliance with, all the requirements of the entity's reporting environment in which XBRL files are submitted, and a preparer may choose to request that a practitioner perform procedures with respect to such requirements.

.22 It is critical that the underlying source information to be formatted is complete and accurate (that is, the underlying source information includes all required content and is prepared in conformity with its own criteria) in order for users to appropriately rely on the XBRL files.

.23 An analysis of the potential errors and effects on users resulted in the determination that the most important attributes of quality XBRL files are the completeness of the XBRL files, the mapping of the source information, the consistency of the XBRL files with the source information, and the structure of the XBRL files. These attributes have become the four principles by which to measure the quality of the XBRL files; the criteria were developed to achieve each of these principles.

Completeness of the XBRL Files

.24 It is important that entities format all the required information at the required levels of detail in their XBRL files. Missing information will result in incomplete reporting and will impact users' ability to access information. Additionally, when formatting information that is permitted but not required, entities should ascertain that the information is included in the source information and formatted at a level of detail that is not misleading to users. For example, the current SEC rules do not require dates included in a note to be individually formatted in the XBRL files. However, if an entity opts to format this information separately and formats some but not all the dates included in the note, users may question why certain information was not formatted.

Mapping of the Source Information

.25 Elements communicate the meaning of the information being reported; accordingly, selecting the most appropriate element (or combination of elements) is important because it will better enable users to properly analyze and compare disclosures among entities. Selecting the element from the appropriate taxonomy(ies) that best depicts the corresponding business reporting concept is required, except when extensions are necessary to differentiate information in order to effectively communicate with users of XBRL files. Incorrect element selections or inappropriate extensions will affect users' ability to access and compare the data among entities, thereby increasing the risk of inefficient and possibly inaccurate analyses.

Consistency of the XBRL Files With the Source Information

.26 The XBRL files must contain information that is consistent with the source information. Although the use of incorrect amounts and dates has obvious effects on the usefulness of data, other contextual information also is important. User analyses of the formatted amounts are affected by incorrect information, such as units of measure, decimals, sign values, and calculations. It is important that any extensions are appropriately created with the proper attributes because the attributes can change the meaning and value of a reported concept.

Structure of the XBRL Files

.27 It is essential to structure XBRL files in accordance with the requirements of the entity's reporting environment. Failure to comply with such requirements may prohibit those files from operating within the requesting party's system. For example, under the SEC's interactive data program for financial statements, files that do not comply with SEC requirements may not pass the SEC's validation process and will not be uploaded through the SEC's

Electronic Data-Gathering, Analysis, and Retrieval system. Other structural errors may cause XBRL files to be materially inconsistent with the HTML version of the source information or not usable by other XBRL software applications. It is beyond the scope of this document to include all applicable rules, regulations, and technical requirements related to the intended purpose of the XBRL submissions. Notwithstanding, preparers are responsible for identification of, and compliance with, all requirements of the entity's reporting environment in which XBRL files are submitted and may choose to request that a practitioner perform procedures with respect to such requirements.

Glossary

- abstract.** An attribute of an element to primarily indicate that the element is used only in a hierarchy to group related elements together or to provide headings in a rendering. An abstract element cannot be used to tag data in an instance document.
- attribute.** A property of an element that indicates the kind of data that can be tagged to the concept, such as its data type, period type, and whether the element is abstract.
- axis (pl. axes).** An instance document contains facts; an axis (and domain member) differentiates facts, and each axis represents a way the facts may be classified. For example, revenue for a period might be reported along a business unit axis, country axis, product axis, and so forth.
- balance type.** An attribute of a monetary item type designated as debit or credit; a designation, should be the natural or most expected balance of the element—credit or debit—and, thus, indicates how calculation relationships involving the element may be assigned a weight attribute (–1 or 1), as well as how numbers should be entered into the instance document.
- calculation linkbase.** A taxonomy file that defines weighted summation, aggregating relationships between numeric items expressed as parent-child hierarchies.
- caption.** Explanatory text provided to describe facts presented in a report.
- context.** Entity- and report-specific information (reporting period, segment information, and so forth) required by eXtensible Business Reporting Language (XBRL) that allows tagged data to be understood in relation to other information.
- decimal.** Fact attribute used to express the number of decimal places to which numbers have been rounded.
- deprecated element.** An element within a taxonomy that has been declared not to be used in instance documents for various reasons (for example, superseded, redundant, or incorrect).
- domain.** An element that represents an entire set of other elements that are used to further describe line items; the domain and its members are used to classify facts along the axis of a table. For example, “Arkansas” could be a domain member in the domain “States” and would be used to classify elements, such as revenues and assets, in Arkansas as distinct from other states. When a fact does not have any domain member specified, that means it applies to the entire domain.
- domain member.** An element representing one of the classifications within a domain. A domain member categorizes the information to which it is applied.
- element.** An XBRL component, such as a line item, domain member, and dimension (a dimension is called an axis in the US GAAP Taxonomy). The representation of a business reporting concept, including line items in the face of the financial statements, important narrative disclosures, and rows and columns in tables are all examples of elements in a taxonomy. The terms *concept*, *element*, and *tag* (noun) are often used interchangeably in XBRL.

- element definition.** A description of a reporting concept, most commonly a documentation label in the label linkbase.
- extension element.** An element that is created in an extension taxonomy to define business reporting concepts that have not previously been defined in a standard taxonomy.
- extension taxonomy.** A taxonomy in which users can add additional entity-specific elements and indicate additional relationships to a standard taxonomy in order to define business reporting concepts or element relationships and aspects (presentation, calculation, labels, and so forth) to reflect their own unique reporting characteristics.
- fact.** The occurrence of an amount or other information tagged in an instance document by a taxonomy element or combination of elements.
- formatted information.** Information represented using XBRL and included in one or more electronic files. Commonly referred to as tagged data or structured data.
- hierarchy.** An organizational treelike structure to present relationships between elements (such as order and indentation of elements in linkbases).
- instance or instance document.** A file that contains business reporting information and represents a collection of business facts and report-specific information using elements from one or more XBRL taxonomies.
- label.** Name or description for an element for presentation purposes; under the SEC mandate, for example, each element has, at a minimum, a standard label in U.S. English (such as, cash and cash equivalents) and is unique across the taxonomy.
- label type.** A distinguishing name for each distinct label indicating the circumstances in which it should be used; each is given a separate defining role to use in different presentation situations (for example, beginning, ending, and so forth).
- line item.** Elements that conventionally appear on the vertical axis (rows) of a table or columnar presentation. Line items represent the primary business reporting concepts of tagged data in the instance document.
- linkbase.** A taxonomy file that contains additional defining information and relationships for taxonomy elements. The primary taxonomy linkbases in XBRL are calculation, definition, label, presentation, and reference.
- mapping.** Process of identifying the elements that correspond to lines, columns, and tables in the source information to elements in the taxonomy.
- name.** An attribute that uniquely identifies an element in a schema.
- namespace.** Every element is associated with a universal resource identifier that may identify the organization that maintains the taxonomy. In the 2012 US GAAP Financial Reporting Taxonomy, namespaces start with *http://xbrl.fasb.org/us-gaap/2012*.
- negated label.** A negated label is a special label type that can be referenced in the presentation linkbase. A negated label role is a convention used to indicate that the sign for a tagged amount should be reversed when presented in a rendering.

- nil.** An attribute of an element that, when marked as “true” in an instance document, reflects a concept tagged without a value.
- period type.** An attribute of an element that reflects whether it is reported as a point in time (an instant) or period of time (duration).
- presentation linkbase.** A taxonomy file that defines presentation order of elements in the taxonomy. The presentation linkbase also suggests which label type should be used at each point of presentation.
- render or rendering.** To process an instance document into a layout that facilitates readability and understanding of its contents.
- scaling.** A process that automatically adjusts numeric data to present a specific format, thus saving time of entering zeros during the entry or creation process. The XBRL specification does not support the scaling of numeric values (all values must be reported in their entirety); however, it is a feature commonly found in instance document creation software.
- segment.** Tag that allows additional information to be included in the context of an instance document; this information captures segment information, such as an entity’s business units, type of debt, and type of other income.
- sign value.** Denotes whether a numeric fact in an instance has an implied positive (no sign) or a negative (–) value.
- source information.** The information (which may be in electronic format) that is to be formatted in XBRL files (for example, financial statements, including the notes, and required schedules; sustainability reports; or the “Risk/Return Summary” section of the mutual fund prospectuses).
- table.** Generally, a presentation of rows and columns also known as a hypercube. In the presentation linkbase, an element that organizes a set of axes and set of line items to indicate that each fact of one of the line items could be further characterized along one or more of its axes. For example, if a line item is “Sales,” and an axis is “Scenario,” this means that an instance document could have facts that are either for an unspecified scenario or a specific scenario, such as “forecast.”
- tag (noun).** The terms *element* and *tag* are often used interchangeably in XBRL. The tag is the structure that brings together the content being tagged with the associated element from the taxonomy and additional attributes to related contexts, units, and other information.
- tag (verb).** To apply tags to business reporting concepts.
- taxonomy(ies).** Electronic “dictionary” of elements used to report business data, their definitions, and interrelationships.
- type or data type.** Attribute that defines type (for example, monetary, string, share, decimal) of data that an element represents.
- unit of measure.** The units in which numeric items have been measured, such as U.S. dollars (iso4217:USD); shares (xbrli:shares); euros (iso4217:EUR); or compound units, such as U.S. dollars per share.
- validation.** Process of checking that instance documents and taxonomies correctly meet the rules of the XBRL specification and certain requirements of the entity’s reporting environment.

XBRL files. Electronic files that may include the instance document, taxonomy extension schema, label linkbase, calculation linkbase, presentation linkbase, and definition linkbase documents (or other linkbases)

XBRL footnote link. Additional information that is attached to an element used to tag information in superscript footnotes.

Exhibit — Application Guidance of the eXtensible Business Reporting Language Principles and Criteria for eXtensible Business Reporting Language Exhibits Submitted to the Securities and Exchange Commission

The Securities and Exchange Commission (SEC) issued a release adopting final rules, *Interactive Data to Improve Financial Reporting* (SEC rules¹), that requires issuers to submit their financial statements, including the notes, and required schedules to the SEC and to post them on their corporate websites in an interactive data format using eXtensible Business Reporting Language (XBRL). The SEC rules do not require auditor involvement on the XBRL files; however, issuers may obtain third-party services voluntarily.

This exhibit aligns certain SEC requirements for XBRL exhibits submitted to the SEC with the related XBRL principles and criteria applicable to XBRL files that include financial statements, including the notes, and required schedules that are submitted to the SEC under the SEC rules. Accordingly, the term “entity’s reporting environment” has been replaced with the “SEC’s requirements” throughout this exhibit in order to make it specific to SEC filers. The XBRL principles and criteria are not designed for measuring compliance with the SEC rules and regulations. Additional *EDGAR Filer Manual* (EFM) requirements exist for XBRL-formatted information that are not included herein. For example, the SEC requirements include certain requirements that are checked in an automated manner by using the Electronic Data-Gathering, Analysis, and Retrieval XBRL validation process. Therefore, compliance with this set of principles and criteria does not result in compliance with all SEC requirements. Accordingly, when conducting examination engagements, evaluation of compliance with these XBRL principles and criteria alone does not provide an adequate basis for determining that the entity has complied with all the SEC’s XBRL reporting requirements. In order to make clear that the practitioner’s report does not cover the entity’s compliance with all the SEC’s XBRL reporting requirements, the practitioner will ordinarily want to include additional explanatory language within his or her attest reports to emphasize that the practitioner is not forming a conclusion on whether the entity is in compliance with all the SEC’s XBRL reporting requirements.

The letters in the following table correspond to the XBRL criteria that were included in the “XBRL-Related Principles and Criteria” section of this document, and the numbers associated with certain lettered criteria relate to specific requirements under the SEC rules. The table also provides references to relevant guidance (for example, EFM section or other source) that are applicable to the principles. Additionally, some of the SEC requirements may be applicable to multiple principles. This table identifies secondary principles to which these requirements may also apply (C=Completeness, M=Mapping, CO=Consistency, and S=Structure).

¹ Release Nos. 33-9002, 34-59324, and 39-2461; IC-28609; and File No. S7-11-08 issued January 30, 2009.

		<i>EFM (V.20 or Guidance Reference²)</i>	<i>C</i>	<i>M</i>	<i>CO</i>	<i>S</i>
	Completeness of the XBRL Files—All required information is formatted at the required levels of detail, as defined by the SEC's requirements. Only permitted information³ is included in the XBRL files.					
A	All information that is required to be formatted, as defined by the SEC's requirements, is formatted at the appropriate levels of detail in the XBRL files.		X			
A(1)	All information (including parenthetical information) on the face of the financial statements in the source information ⁴ is formatted in the XBRL files, including facts that represent zero or do not have amounts.	6.6.12, 6.6.14, Staff Observations November 2010	X			
A(2)	All required document and entity information (DEI) is formatted in the XBRL files.	6.5.20, 6.5.21, 6.5.26, 6.6.7, 6.6.8, 6.6.9, 6.6.10	X			
A(3)	Each complete note and required schedule under Regulation S-X are formatted separately using a text block element.	6.6.16	X		X	

² The numbered references in this column refer to sections of the *EDGAR Filer Manual* (EFM). Other references include the Securities and Exchange Commission (SEC) Division of Corporation Finance's Compliance and Disclosure Interpretations (C&DIs), staff interpretations and frequently asked questions from the SEC Office of Interactive Disclosure (OID), and the OID's *Staff Observations From Review of Interactive Data Financial Statements (from November 1, 2010)*. These documents are available on the SEC's website. Because the EFM is updated frequently, filers should check the SEC's website at <http://xbrl.sec.gov> for the most current version.

³ In a case in which an entity elects to format permitted information in addition to the required information, preparers should consider to what level of detail to format such information so that is not misleading to the user.

⁴ Source information, for purposes of submission to the SEC, is the electronic or paper-based financial statements, including the notes; required schedules under Regulation S-X; and document and entity information (DEI) (which includes document type, document period end date, registrant name, central index key [CIK], fiscal year-end date, public float, fiscal year, fiscal period, filer category, and reporting status, as well as an indication of whether an amendment flag exists [if so, include an amendment description], whether the filer is not required to file reports, and whether the filer is a well-known seasoned issuer).

		<i>EFM (V.20 or Guidance Reference²)</i>	<i>C</i>	<i>M</i>	<i>CO</i>	<i>S</i>
A(4)	Each significant accounting policy (whether included in the accounting policies note or elsewhere within the notes to the financial statements) is formatted separately using a text block ⁵ element.	6.6.19, C&DI 146.15	X		X	
A(5)	Each table within each note is formatted separately using a text block element.	6.6.20	X		X	
A(6)	Each amount ⁶ disclosed in the notes and required schedules under Regulation S-X (including amounts written as words) is formatted separately.	6.6.22, 6.6.23, C&DI 146.16	X		X	
A(7)	Each amount included in the superscript footnotes is formatted separately.	6.6.22, 6.6.39	X		X	
A(8)	Text that is shown on the face of the financial statements at the bottom of the page or bottom of a table preceded by a superscript is formatted using XBRL footnote links. ⁷	6.6.39, 6.6.40	X		X	
B	The XBRL files contain only facts or presentation or calculation relationships that are included in the source information and other required or permitted information (such as DEI ⁸ required by the SEC) and contain only unused elements and linkbase information that are used intermittently unless otherwise prohibited. ⁹	6.6.17	X			

(continued)

⁵ The US GAAP Taxonomy has adopted a convention for distinguishing between text block elements intended for use in tagging accounting policies, tables, and disclosures.

⁶ Not all amounts are required to be formatted (for example, no need to format 2 in 2 percent milk) (see C&DI 146.16, located on the SEC's website, for additional examples).

⁷ The EFM only requires this for the face of the financial statements.

⁸ DEI includes information that may be outside the financial statements, such as public float and CIK.

⁹ The entity may carry forward unused elements or presentation, definition, or calculation relationships that are used intermittently (for example, elements or relationships reflected in annual financial statements [Form 10-K] but not used in quarterly financial statements [Form 10-Q]).

		<i>EFM (V.20 or Guidance Reference²)</i>	<i>C</i>	<i>M</i>	<i>CO</i>	<i>S</i>
	Mapping of the Source Information—The elements¹⁰ selected are consistent with the meaning of the corresponding business reporting concepts in the source information in accordance with the SEC's requirements.					
C	Elements used in XBRL files, considering their attributes; ¹¹ definitions (for example, documentation labels in the label linkbase); and references, are consistent with the corresponding business reporting concepts in the underlying source information.	6.6.23, 6.6.24, 6.6.25, 6.6.26 6.6.27, 6.6.29, 6.8.12, 6.8.13, Staff Observations November 2010		X	X	
C(1)	Headings in the source information are represented as abstract elements.	6.8.8, 6.13.3		X	X	
D	The most specific elements or dimensional combination of elements across the entire taxonomy whose attributes; definitions (for example, documentation labels in the label linkbase); and references are consistent with the corresponding business reporting concepts have been used.	6.6.5, 6.6.7, 6.6.8, FAQ E.17		X	X	
D(1)	Certain elements required for use by the SEC (for example, DEI elements or elements for reporting consolidating entities) have been used, if applicable.	6.5.20, 6.5.21, 6.6.5, 6.6.7, 6.6.8, FAQ E.17		X	X	
E	Use of selected elements is permitted (for example, the selected element is not deprecated).	Staff Observations November 2010		X		

¹⁰ Elements include line items and combinations of line items, domain members, and axes.

¹¹ The basic element attributes include (a) abstract; (b) data type (that is, whether the content is expected to conform to a certain type of content, such as block text, a monetary value, or other numeric value); (c) period type (that is, whether it is a point in time or a period of time); and (d) balance type (that is, whether it is normally a debit or credit). The balance attribute is currently not a primary consideration in selecting elements in the SEC program.

		<i>EFM (V.20 or Guidance Reference²)</i>	<i>C</i>	<i>M</i>	<i>CO</i>	<i>S</i>
F	The same business reporting concepts appearing multiple times in the source information are formatted once using the same elements or combination of elements throughout the XBRL files, when appropriate. ¹²	6.5.7, 6.5.8, 6.5.9, 6.5.12		X		
G	The same elements are used consistently to report the same business reporting concepts, including for each period for which such concepts appear in the underlying source information. ¹³	6.6.13, 6.8.10		X		
H	Extension elements are created only when both of the following conditions are met: no suitable elements exist in the selected taxonomy, and extensions are permitted in accordance with the SEC's rules.	6.8.4, 6.8.16, 6.8.17, 6.8.18, 6.8.20, 6.8.21, 6.8.23, 6.10.5, Staff Observations November 2010		X		
I	Definitions, if provided (for example, documentation labels in the label linkbase) for extension elements used in the instance document, are consistent with the source information.			X		

(continued)

¹² Exceptions exist when business reporting concepts will be formatted using different line item and member combinations or when the related guidance requires different elements to be used based on the level of granularity of the source data item being formatted (for example, in situations when concepts must use both dimensional and nondimensional approaches, such as Treasury stock presented on the balance sheet without dimensions and presented on the statement of stockholders equity with dimensions). The appropriate use of duplicate elements should be considered, and redundantly formatted facts should be eliminated.

¹³ Although the source information may contain different values (for example, positive, negative, or zero) in one period as compared with another (for example, net income [loss]) or represent an ending balance in one period and the beginning balance in the next, the same element should be used in all periods presented. Notwithstanding, there may be certain situations when the taxonomy may include different elements to reflect positive and negative values (for example, certain elements relating to tax assets and tax liabilities in the US GAAP Taxonomy).

		<i>EFM (V.20 or Guidance Reference²)</i>	<i>C</i>	<i>M</i>	<i>CO</i>	<i>S</i>
	Consistency of the XBRL Files With the Source Information—All formatted information¹⁴ in the XBRL files is consistent with the source information and formatted in accordance with the SEC's requirements.					
J	Formatted amounts in the XBRL files reflect the entire numbers of the corresponding business reporting concepts (that is, the XBRL amounts are not scaled ¹⁵).	6.6.31, 6.6.32			X	
K	Formatted amounts have the appropriate signs based on the nature of the values in the source information, balance attributes, and definitions (documentation labels in the label linkbase) of the elements.	6.6.30, Staff Observations November 2010			X	
L	All text, dates, and uniform resource identifiers in the XBRL files are consistent with the underlying source information.	Reg. S-T §232.405(c)			X	
L(1)	Nil attribute ¹⁶ is used only to convey business reporting concepts reported that have no amounts associated but are not zero (for example, commitments and contingencies).	6.6.15			X	

¹⁴ Formatted information includes data (for example, amounts, text, dates); contextual information (for example, monetary units); and relationships (for example, presentation order and calculations).

¹⁵ Amounts in financial statements are often presented in various formats (for example, rounded to millions) and may represent a different scale. However, amounts formatted in XBRL must be entered without such presentational formatting. For example, 23.5 million would be entered as 23500000, and 14.3 percent would be entered as .143.

¹⁶ Nil attribute is used only to convey business reporting concepts that have no amounts, text, dates, or uniform resource identifiers in the source information, but the elements are used in the instance document and presentation.

		<i>EFM (V.20 or Guidance Reference²)</i>	<i>C</i>	<i>M</i>	<i>CO</i>	<i>S</i>
M	Extension elements included in the instance document of the XBRL files for monetary amounts include debit or credit balance attributes or documentation labels with an indication of the meaning of positive or negative values, when applicable, that are consistent with the nature of the business reporting concepts in the underlying source information.	6.11.5, Staff Observations November 2010			X	
M(1)	Extension elements included in the XBRL files for monetary amounts of balance sheet or income statement concepts include balance attributes (debit or credit) that are consistent with the nature of the underlying source information.	6.8.11, Staff Observations November 2010			X	X
N	The context periods ¹⁷ are consistent with the source information (for example, second calendar quarter 2012 is expressed as “2012-04-01 to 2012-06-30”).	6.5.9, 6.5.19, 6.11.7, FAQ E.19, Staff Observations November 2010			X	
N(1)	The required DEI elements use the Required Context. ¹⁸	6.5.20			X	
O	The decimal attribute values are consistent with the degree of accuracy of the amounts as represented in the source information (for example, 23.5 million is rounded to the hundred thousandths).	6.6.32			X	

(continued)

¹⁷ Context periods for a roll-forward format use the same “instant” context for the beginning balance of the current period as for the ending balance of the previous period.

¹⁸ The *Required Context* is defined in the EFM as the context when the dates cover the reporting period, and no segment or scenario information (that is, dimensional information) is included.

		<i>EFM (V.20 or Guidance Reference²)</i>	<i>C</i>	<i>M</i>	<i>CO</i>	<i>S</i>
P	The units defined in the instance document are consistent with the measurements represented in the source information (for example, U.S. dollars are defined as “iso4217: USD,” as properly defined in XBRL Specification 2.1).	6.5.35, 6.6.35			X	
Q	The entity identifier in the instance document properly represents the reporting entity (for example, central index key [CIK]) in accordance with the SEC’s requirements.				X	
Q(1)	Only one CIK code is used throughout the XBRL files.	6.5.2			X	
R	The format and layout of the text block information are consistent ¹⁹ with the format and layout of the content in the source information.	6.6.16			X	X
S	The order and hierarchy (that is, arrangement of appropriate abstracts and line items) reflected in the presentation linkbase are consistent ²⁰ with the SEC’s requirements.	6.8.8, 6.12.3, 6.13.3			X	X
T	Labels ²¹ are consistent ²² with the captions or meanings in the source information, as applicable.	6.11.1, 6.11.2			X	
T(1)	The appropriate label roles (in the label linkbase) are specified in presentation groupings and are consistent with the source information, as applicable. For example, negated labels are used to reverse the sign of numeric values for presentation purposes.	6.11.4, 6.11.6, 6.11.7			X	X

¹⁹ The EFM requires the same format and layout in text blocks as the underlying source information.

²⁰ When using dimensions to format information, it may not be possible to present this information in the same order and hierarchy (for example, transposed or intermingled axes for line items and domain members may occur).

²¹ Labels in the label linkbase for the SEC program must be the same as the captions in the source information, including parenthetical information.

²² *Consistent* means the same as the captions in the source information, when required, or within the scope of variances otherwise permitted.

		<i>EFM (V.20 or Guidance Reference²³)</i>	<i>C</i>	<i>M</i>	<i>CO</i>	<i>S</i>
U	Calculations reflected in the source information are included in the calculation linkbase in accordance with the SEC's requirements to the extent possible within the technical limitations ²³ of XBRL.	6.6.33, 6.15.2			X	X
	Structure of the XBRL Files—XBRL files are structured²⁴ in accordance with the following listed criteria.					
V	Taxonomies, including versions, referenced in the XBRL files are permitted by the SEC's requirements.	6.3.9		X	X	X
W	Presentation groupings are consistent with the titles and order of the components of the underlying source information and in accordance with the SEC's requirements.	6.7.12, FAQ B.12				X
W(1)	Separate note presentation groupings (base sets) are created for each required level (I, II, III, and IV) and ordered in accordance with the SEC's requirements.	6.7.12, FAQ B.12			X	X
W(2)	Titles of presentation groupings are in accordance with the SEC's formatting requirements.	6.7.12, FAQ B.12			X	X
X	The entity scheme (for example, www.sec.gov/CIK) for each context throughout the instance document is in accordance with the SEC's requirements.	6.5.1, 6.5.2, 6.5.3, FAQ E.17				X
Y	New table structures are only created when no suitable table structure exists in the applicable standard taxonomy's definition linkbase.	FAQ E.16, Staff Observations November 2010				X

(continued)

²³ Due to the current limitations of XBRL, calculations cannot be performed across different contexts; accordingly, it is currently not possible to include such calculations in the XBRL files.

²⁴ It is beyond the scope of these principles and criteria to include all applicable rules, regulations, and technical requirements related to the intended purpose of the XBRL submissions. Notwithstanding, preparers are responsible for identification of, and compliance with, all the SEC's requirements, and a preparer may choose to request that a practitioner perform procedures with respect to such requirements.

		<i>EFM (V.20 or Guidance Reference²)</i>	<i>C</i>	<i>M</i>	<i>CO</i>	<i>S</i>
Z	The names of extension elements contain no prohibited information.					X
Z(1)	The names of extension elements (excluding domain members) do not include company- or period-specific information.	6.8.6				X
AA	The XBRL files include all files required by the SEC (for example, an instance, schemas, and linkbases).	6.3.2				X
BB	The language of the information in the XBRL files uses a permitted (or required) language (for example, English).					X
BB(1)	Elements must include fact values and labels expressed in U.S. English.	6.5.14, 6.10.1				X

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STATEMENT OF POSITION ACCOUNTING

Introduction

As explained in the “Special Note About Financial Accounting Standards Board *Accounting Standards Codification*TM” section of this publication, Financial Accounting Standards Board (FASB) *Accounting Standards Codification*TM (ASC) codified thousands of nongovernmental accounting pronouncements (including those of the FASB, EITF, and the AICPA) into FASB ASC, which reduces the generally accepted accounting principles (GAAP) hierarchy to two levels: one that is authoritative (in FASB ASC) and one that is not (not in FASB ASC). FASB ASC codifies all AICPA accounting SOPs. This guidance becomes nonauthoritative on July 1, 2009, in its native form, but we have included it here for archive purposes. The authoritative source of this guidance beginning July 1, 2009 is FASB ASC.

Although AICPA Statement of Position (SOP) 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*, was codified for nongovernmental entities as FASB ASC 958-720, it remains authoritative in its native form for governmental entities. Governmental Accounting Standards Board (GASB) Statement No. 55, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*, identifies AICPA Statements of Positions that have specifically been made applicable to state and local governmental entities by the AICPA and cleared by GASB as sources of established accounting principles in category *b* of the GAAP hierarchy for state and local governmental entities. GASB previously made this SOP, as originally issued, applicable to governmental entities; as such, it is still authoritative for those entities. The SOP is presented here for application by governmental entities as authoritative guidance permitted by GASB.

Statements of Position of the Accounting Standards Division present the conclusions of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting.

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ACC Section 10,000**STATEMENT OF POSITION—ACCOUNTING**

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Section 10,730

Statement of Position 98-2 Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising

March 11, 1998

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. AU section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, identifies AICPA Statements of Position that have been cleared by either the Financial Accounting Standards Board (for financial statements of nongovernmental entities) or the Governmental Accounting Standards Board (for financial statements of state and local governmental entities), as sources of established accounting principles in category b of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Summary

This Statement of Position (SOP) applies to all nongovernmental not-for-profit organizations (NPOs) and all state and local governmental entities that solicit contributions.

This SOP requires—

- If the criteria of purpose, audience, and content as defined in this SOP are met, the costs of joint activities that are identifiable with a particular function should be charged to that function and joint costs should be allocated between fund raising and the appropriate program or management and general function.
- If any of the criteria of purpose, audience, and content are not met, all costs of the activity should be reported as fund-raising costs, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, subject to the exception in the following sentence. Costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund raising.

- Certain financial statement disclosures if joint costs are allocated.
- Some commonly used and acceptable allocation methods are described and illustrated although no methods are prescribed or prohibited.

This SOP amends existing guidance in AICPA Audit and Accounting Guides *Health Care Organizations*, *Not-for-Profit Organizations* (which was issued in August 1996 and supersedes SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, because the provisions of SOP 87-2 are incorporated into the Guide), and *Audits of State and Local Governmental Units*.*

This SOP is effective for financial statements for years beginning on or after December 15, 1998. Earlier application is encouraged in fiscal years for which financial statements have not been issued. If comparative financial statements are presented, retroactive application is permitted but not required.

Foreword

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB) and the Governmental Accounting Standards Board (GASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB and the GASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if at least five of the seven FASB members and three of the five GASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.†

The criteria applied by the FASB and the GASB in their review of proposed projects and proposed documents include the following:

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

* The AICPA Audit and Accounting Guide *State and Local Governments* supersedes the 1994 AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* and subsequent editions of that Guide with conforming changes made by the AICPA staff. The AICPA Audit and Accounting Guide *State and Local Governments* provides guidance on the application of this Statement of Position (SOP) to state and local governments. [Footnote added, June 2004, to reflect conforming changes necessary due to the issuance of the AICPA Audit and Accounting Guide *State and Local Governments*.]

† This document was cleared prior to July 1, 1997. In July 1997, the GASB increased to seven members. Documents considered by the GASB after July 1, 1997 are cleared if at least four of the seven GASB members do not object. [Footnote renumbered, June 2004, to reflect conforming changes necessary due to the issuance of the AICPA Audit and Accounting Guide *State and Local Governments*.]

In many situations, prior to clearance, the FASB and the GASB will propose suggestions, many of which are included in the documents.

Introduction

.01 Some nongovernmental not-for-profit organizations (NPOs) and some state and local governmental entities,¹ such as governmental colleges and universities and governmental health care providers, solicit support through a variety of **fund-raising activities**.² These **activities** include direct mail, telephone solicitation, door-to-door canvassing, telethons, special events, and others. Sometimes fund-raising activities are conducted with activities related to other functions, such as **program activities** or supporting services, such as **management and general activities**.³ Sometimes fund-raising activities include components that would otherwise be associated with program or supporting services, but in fact support fund raising.

.02 External users of financial statements—including contributors, creditors, accreditation agencies, and regulators—want assurance that fund-raising costs, as well as program costs and management and general costs, are stated fairly.

.03 In 1987, the AICPA issued Statement of Position (SOP) 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*.⁴ SOP 87-2 required that all circumstances concerning informational materials and activities that include a fund-raising appeal be considered in accounting for **joint costs** of those materials and activities and that certain criteria be applied

¹ This Statement of Position (SOP) uses the term *entity* to refer to both nongovernmental not-for-profit organizations (NPOs) and state and local governments.

² Terms that appear in the Glossary [paragraph .30] are set in **boldface type** the first time they appear.

³ The functional classifications of fund raising, program, and management and general are discussed throughout this SOP for purposes of illustrating how the guidance in this SOP would be applied by entities that use those functional classifications. Some entities have a functional structure that does not include fund raising, program, or management and general, or that includes other functional classifications, such as **membership development**. This SOP is not intended to require reporting the functional classifications of fund raising, program, and management and general. In circumstances in which entities that have a functional structure that includes other functional classifications conduct joint activities, all costs of those joint activities should be charged to fund raising (or the category in which fund raising is reported—see the following two parenthetical sentences), unless the purpose, audience, and content of those joint activities are appropriate for achieving those other functions. (An example of an entity that reports fund raising in a category other than fund raising is a state and local governmental entity applying the accounting and financial reporting principles in the AICPA Industry Audit Guide *Audits of Colleges and Universities*, as amended by SOP 74-8. As discussed in paragraph D.5 of this SOP [paragraph .24], those entities are required to report fund raising as part of the “institutional support” function. See also footnote ** to paragraph D.5.) [Footnote revised, June 2004, to reflect conforming changes necessary due to the issuance of GASB Statements No. 34 and No. 35.]

⁴ In August 1996, the AICPA issued the Audit and Accounting Guide *Not-for-Profit Organizations*. The Guide supersedes SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, because the provisions of SOP 87-2 are incorporated into paragraphs 13.36 to 13.45 of *Not-for-Profit Organizations*. *Not-for-Profit Organizations* applies to all nongovernmental NPOs other than those required to follow the Audit and Accounting Guide *Health Care Organizations*. The discussion in this SOP of SOP 87-2 refers to both SOP 87-2 and the guidance included in paragraphs 13.36 to 13.45 of *Not-for-Profit Organizations*. Also, SOP 87-2 was not applicable to entities that are within the scope of Governmental Accounting Standards Board (GASB) Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*.

in determining whether joint costs of those materials and activities should be charged to fund raising or allocated to program or management and general. Those criteria include requiring verifiable indications of the reasons for conducting the activity, such as the content, audience, and action, if any, requested of the participant, as well as other corroborating evidence. Further, SOP 87-2 required that all joint costs of those materials and activities be charged to fund raising unless the appeal is designed to motivate its audience to action other than providing financial support to the organization.

.04 The provisions of SOP 87-2 have been difficult to implement and have been applied inconsistently in practice. (Appendix B [paragraph .22], “Background,” discusses this further.)

.05 This SOP establishes financial accounting standards for accounting for **costs of joint activities**. In addition, this SOP requires financial statement disclosures about the nature of the activities for which joint costs have been allocated and the amounts of joint costs. Appendix F [paragraph .26] provides explanations and illustrations of some acceptable allocation methods.

Scope

.06 This SOP applies to all nongovernmental NPOs and all state and local governmental entities that solicit **contributions**.

Conclusions

Accounting for Joint Activities

.07 If the criteria of purpose, audience, and content are met, the costs of a **joint activity** that are identifiable with a particular function should be charged to that function and joint costs should be allocated between fund raising and the appropriate program or management and general function. If any of the criteria are not met, all costs of the joint activity should be reported as fund-raising costs, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, subject to the exception in the following sentence. Costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund raising.

Purpose

.08 The purpose criterion is met if the purpose of the joint activity includes accomplishing program or management and general functions. (Paragraphs .09 and .10 provide guidance that should be considered in determining whether the purpose criterion is met. Paragraph .09 provides guidance pertaining to program functions only. Paragraph .10 provides guidance pertaining to both program and management and general functions.)

.09 *Program functions.* To accomplish program functions, the activity should call for specific action by the audience that will **help accomplish the entity’s mission**. For purposes of applying the guidance in this SOP, the following are examples of activities that do and do not call for specific action by the audience that will help accomplish the entity’s mission:

- An entity’s mission includes improving individuals’ physical health. For that entity, motivating the audience to take specific action that will improve their physical health is a call for specific action by the audience that will help accomplish the entity’s mission. An example of an activity that motivates the audience to take specific action that will improve their physical health is sending the audience a brochure that urges them to stop smoking and suggests specific methods, instructions, references, and resources that may be used to stop smoking.
- An entity’s mission includes educating individuals in areas other than the causes, conditions, needs, or concerns that the entity’s programs are designed to address (referred to hereafter in this SOP as “causes”). For that entity, educating the audience in areas other than causes or motivating the audience to otherwise engage in specific activities that will educate them in areas other than causes is a call for specific action by the audience that will help accomplish the entity’s mission. Examples of entities whose mission includes educating individuals in areas other than causes are universities and possibly other entities. An example of an activity motivating individuals to engage in education in areas other than causes is a university inviting individuals to attend a lecture or class in which the individuals will learn about the solar system.
- Educating the audience about causes or motivating the audience to otherwise engage in specific activities that will educate them about causes is not a call for specific action by the audience that will help accomplish the entity’s mission. Such activities are considered in support of fund raising. (However, some educational activities that might otherwise be considered as educating the audience about causes may implicitly call for specific action by the audience that will help accomplish the entity’s mission. For example, activities that educate the audience about environmental problems caused by not recycling implicitly call for that audience to increase recycling. If the need for and benefits of the specific action are clearly evident from the educational message, the message is considered to include an implicit call for specific action by the audience that will help accomplish the entity’s mission.)
- Asking the audience to make contributions is not a call for specific action by the audience that will help accomplish the entity’s mission.

If the activity calls for specific action by the audience that will help accomplish the entity’s mission, the guidance in paragraph .10 should also be considered in determining whether the purpose criterion is met.

.10 Program and management and general functions. The following factors should be considered, in the order in which they are listed,⁵ to determine whether the purpose criterion is met:

- a. **Whether compensation or fees for performing the activity are based on contributions raised.** The purpose criterion is not met if a majority of compensation or fees for any party’s performance of any component

⁵ In considering the guidance in paragraph .10, the factor in paragraph .10a (the compensation or fees test) is the preeminent guidance. If the factor in paragraph .10a is not determinative, the factor in paragraph .10b (whether a similar program or management and general activity is conducted separately and on a similar or greater scale) should be considered. If the factor in paragraph .10b is not determinative, the factor in paragraph .10c (other evidence) should be considered.

of the discrete joint activity varies based on contributions raised for that discrete joint activity.^{6,7}

b. *Whether a similar program or management and general activity is conducted separately and on a similar or greater scale.* The purpose criterion is met if either of the following two conditions is met:

(1) *Condition 1:*

- The program component of the joint activity calls for specific action by the recipient that will help accomplish the entity's mission and
- A similar program component is conducted without the fund-raising component using the same **medium** and on a scale that is similar to or greater than the scale on which it is conducted with the fund raising.⁸

(2) *Condition 2:*

A management and general activity that is similar to the management and general component of the joint activity being accounted for is conducted without the fund-raising component using the same medium and on a scale that is similar to or greater than the scale on which it is conducted with the fund raising.

If the purpose criterion is met based on the factor in paragraph .10b, the factor in paragraph .10c should not be considered.

c. *Other evidence.* If the factors in paragraph .10a or .10b do not determine whether the purpose criterion is met, other evidence may determine whether the criterion is met. All available evidence, both positive and negative, should be considered to determine whether, based on the weight of that evidence, the purpose criterion is met.

.11 The following are examples of indicators that provide evidence for determining whether the purpose criterion is met:

a. Evidence that the purpose criterion may be met includes—

- *Measuring program results and accomplishments of the activity.* The facts may indicate that the purpose criterion is met if the entity measures program results and accomplishments of the activity (other than measuring the extent to which the public was educated about causes).

⁶ Some compensation contracts provide that compensation for performing the activity is based on a factor other than contributions raised, but not to exceed a specified portion of contributions raised. For example, a contract may provide that compensation for performing the activity is \$10 per contact hour, but not to exceed 60 percent of contributions raised. In such circumstances, compensation is not considered based on amounts raised, unless the stated maximum percentage is met. In circumstances in which it is not yet known whether the stated maximum percentage is met, compensation is not considered based on amounts raised, unless it is probable that the stated maximum percentage will be met.

⁷ The *compensation or fees test* is a negative test in that it either (a) results in failing the purpose criterion or (b) is not determinative of whether the purpose criterion is met. Therefore, if the activity fails the purpose criterion based on this factor (the compensation or fees test), the activity fails the purpose criterion and the factor in paragraph .10b should not be considered. If the purpose criterion is not failed based on this factor, this factor is not determinative of whether the purpose criterion is met and the factor in paragraph .10b should be considered.

⁸ Determining the scale on which an activity is conducted may be a subjective determination. Factors to consider in determining the scale on which an activity is conducted may include dollars spent, the size of the audience reached, and the degree to which the characteristics of the audience are similar to the characteristics of the audience of the activity being evaluated.

- *Medium.* The facts may indicate that the purpose criterion is met if the program component of the joint activity calls for specific action by the recipient that will help accomplish the entity's mission and if the entity conducts the program component without a significant fund-raising component in a different medium. Also, the facts may indicate that the purpose criterion is met if the entity conducts the management and general component of the joint activity without a significant fund-raising component in a different medium.
- b. Evidence that the purpose criterion may not be met includes—
- *Evaluation or compensation.* The facts may indicate that the purpose criterion is not met if (a) the evaluation of any party's performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity or (b) some, but less than a majority, of compensation or fees for any party's performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity.
- c. Evidence that the purpose criterion may be either met or not met includes—
- *Evaluation of measured results of the activity.* The entity may have a process to evaluate measured program results and accomplishments of the activity (other than measuring the extent to which the public was educated about causes). If the entity has such a process, in evaluating the effectiveness of the joint activity, the entity may place significantly greater weight on the activity's effectiveness in accomplishing program goals or may place significantly greater weight on the activity's effectiveness in raising contributions. The former may indicate that the purpose criterion is met. The latter may indicate that the purpose criterion is not met.
 - *Qualifications.* The qualifications and duties of those performing the joint activity should be considered.
 - If a third party, such as a consultant or contractor, performs part or all of the joint activity, such as producing brochures or making telephone calls, the third party's experience and the range of services provided to the entity should be considered in determining whether the third party is performing fund-raising, program (other than educating the public about causes), or management and general activities on behalf of the entity.
 - If the entity's employees perform part or all of the joint activity, the full range of their job duties should be considered in determining whether those employees are performing fund-raising, program (other than educating the public about causes), or management and general activities on behalf of the entity. For example, (a) employees who are not members of the fund-raising department and (b) employees who are members of the fund-raising department but who perform non-fund-raising activities are more likely to perform activities that include program or management

and general functions than are employees who otherwise devote significant time to fund raising.

- *Tangible evidence of intent.* Tangible evidence indicating the intended purpose of the joint activity should be considered. Examples of such tangible evidence include
 - The entity's written mission statement, as stated in its fund-raising activities, bylaws, or annual report.
 - Minutes of board of directors', committees', or other meetings.
 - Restrictions imposed by donors (who are not related parties) on gifts intended to fund the joint activity.
 - Long-range plans or operating policies.
 - Written instructions to other entities, such as script writers, consultants, or list brokers, concerning the purpose of the joint activity, audience to be targeted, or method of conducting the joint activity.
 - Internal management memoranda.

Audience

.12 A rebuttable presumption exists that the audience criterion is not met if the audience includes prior donors or is otherwise selected based on its ability or likelihood to contribute to the entity. That presumption can be overcome if the audience is also selected for one or more of the reasons in paragraph .13a, .13b, or .13c. In determining whether that presumption is overcome, entities should consider the extent to which the audience is selected based on its ability or likelihood to contribute to the entity and contrast that with the extent to which it is selected for one or more of the reasons in paragraph .13a, .13b, or .13c. For example, if the audience's ability or likelihood to contribute is a significant factor in its selection and it has a need for the action related to the program component of the joint activity, but having that need is an insignificant factor in its selection, the presumption would not be overcome.

.13 In circumstances in which the audience includes no prior donors and is not otherwise selected based on its ability or likelihood to contribute to the entity, the audience criterion is met if the audience is selected for one or more of the following reasons:

- a. The audience's need to use or reasonable potential for use of the specific action called for by the program component of the joint activity
- b. The audience's ability to take specific action to assist the entity in meeting the goals of the program component of the joint activity
- c. The entity is required to direct the management and general component of the joint activity to the particular audience or the audience has reasonable potential for use of the management and general component

Content

.14 The content criterion is met if the joint activity supports program or management and general functions, as follows:

- a. *Program.* The joint activity calls for specific action by the recipient that will help accomplish the entity's mission. If the need for and benefits of the action are not clearly evident, information describing the action and explaining the need for and benefits of the action is provided.

- b. Management and general.* The joint activity fulfills one or more of the entity's management and general responsibilities through a component of the joint activity.⁹

.15 Information identifying and describing the entity, causes, or how the contributions provided will be used is considered in support of fund raising.

Allocation Methods

.16 The cost allocation methodology used should be rational and systematic, it should result in an allocation of joint costs that is reasonable, and it should be applied consistently given similar facts and circumstances.

Incidental Activities

.17 Some fund-raising activities conducted in conjunction with program or management and general activities are incidental to such program or management and general activities. For example, an entity may conduct a fund-raising activity by including a generic message, "Contributions to Organization X may be sent to [address]" on a small area of a message that would otherwise be considered a program or management and general activity based on its purpose, audience, and content. That fund-raising activity likely would be considered incidental to the program or management and general activity being conducted. Similarly, entities may conduct program or management and general activities in conjunction with fund-raising activities that are incidental to such fund-raising activities. For example, an entity may conduct a program activity by including a generic program message such as "Continue to pray for [a particular cause]" on a small area of a message that would otherwise be considered fund raising based on its purpose, audience, and content. That program activity would likely be considered incidental to the fund-raising activity being conducted. Similarly, an entity may conduct a management and general activity by including a brief management and general message—"We recently changed our phone number. Our new number is 123-4567"—on a small area of a message that would otherwise be considered a program or fund-raising activity based on its purpose, audience, and content. That management and general activity would likely be considered incidental to the program or fund-raising activity being conducted. In circumstances in which a fund-raising, program, or management and general activity is conducted in conjunction with another activity and is incidental to that other activity, and the conditions in this SOP for allocation are met, joint costs are permitted but not required to be allocated and may therefore be charged to the functional classification related to the activity that is not the incidental activity. However, in circumstances in which the program or management and general activities are incidental to the fund-raising activities, it is unlikely that the conditions required by this SOP to permit allocation of joint costs would be met.

Disclosures

.18 Entities that allocate joint costs should disclose the following in the notes to their financial statements:

- a.* The types of activities for which joint costs have been incurred
- b.* A statement that such costs have been allocated

⁹ Some states or other regulatory bodies require that certain disclosures be included when soliciting contributions. For purposes of applying the guidance in this SOP, communications that include such required disclosures are considered fund-raising activities and are not considered management and general activities.

- c. The total amount allocated during the period and the portion allocated to each functional expense category
- .19 This SOP encourages, but does not require, that the amount of joint costs for each kind of joint activity be disclosed, if practical.

Effective Date

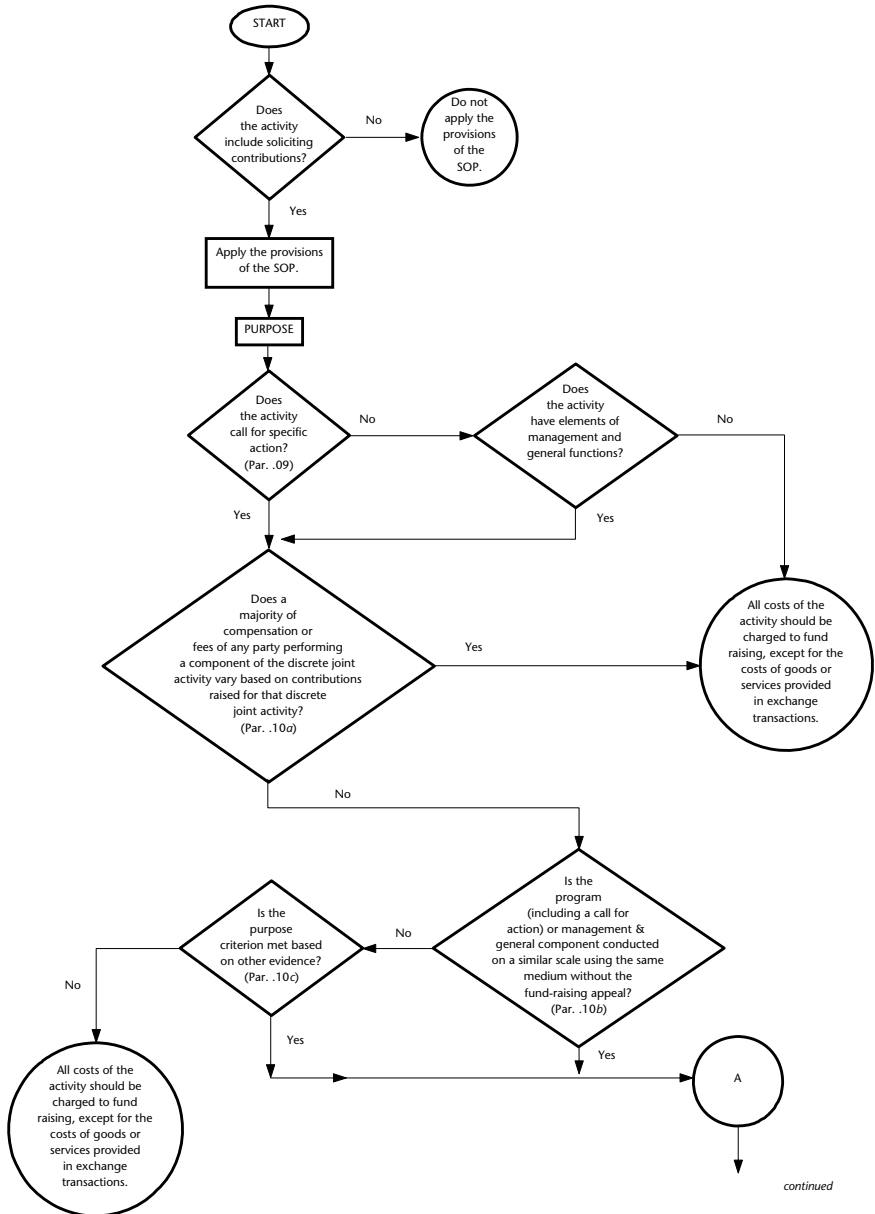
.20 This SOP is effective for financial statements for years beginning on or after December 15, 1998. Earlier application is encouraged in fiscal years for which financial statements have not been issued. If comparative financial statements are presented, retroactive application is permitted but not required.

<p>The provisions of this Statement of Position need not be applied to immaterial items.</p>

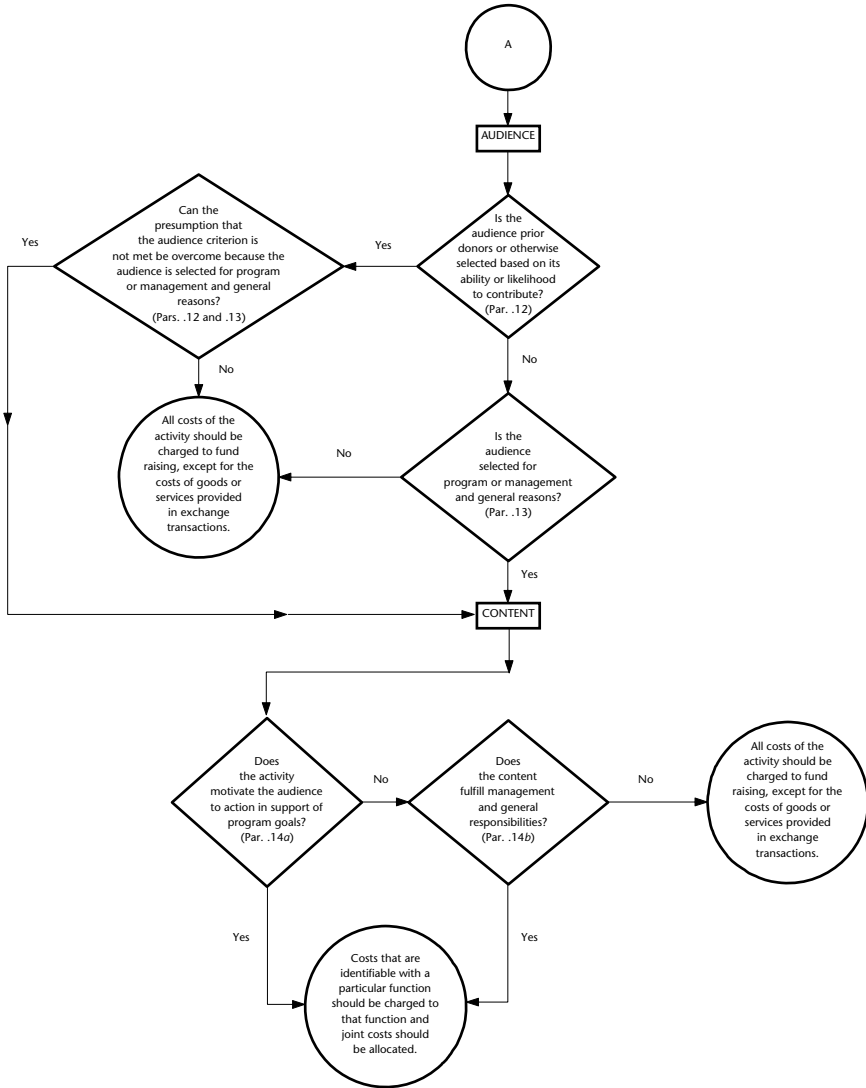
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Appendix A

Accounting for Joint Activities¹⁰



¹⁰ **Note:** This flowchart summarizes certain guidance in this SOP and is not intended as a substitute for the SOP.



Appendix B

Background

B.1. As stated in paragraph .04, the provisions of Statement of Position (SOP) 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, have been difficult to implement and applied inconsistently in practice. That difficulty has been due in part to the following:

- The second sentence of paragraph 1 of SOP 87-2 stated that “some of the costs incurred by such organizations are clearly identifiable with fundraising, such as the cost of fund-raising consulting services.” It is unclear whether activities that would otherwise be considered program activities should be characterized as program activities if they are performed or overseen by professional fund raisers. Also, it is unclear whether activities would be reported differently (for example, as program rather than fund raising) depending on whether the fund-raising consultant is compensated by a predetermined fee or by some other method, such as a percentage of contributions raised.
- SOP 87-2 was unclear about whether allocation of costs to fund-raising expense is required if the activity for which the costs were incurred would not have been undertaken without the fund-raising component.
- SOP 87-2 defined joint costs through examples, and it is therefore unclear what kinds of costs were covered by SOP 87-2. For example, it is unclear whether salaries and indirect costs can be joint costs.
- Some believe the guidance in SOP 87-2 was inadequate to determine whether joint activities, such as those that request contributions and also list the warning signs of a disease, are designed to motivate their audiences to action other than to provide contributions to the entity. It is unclear what attributes the targeted audience should possess in order to conclude that a program function is being conducted.

B.2. In 1992, the Accounting Standards Executive Committee (AcSEC) undertook a project to supersede SOP 87-2, to provide clearer guidance than that provided by SOP 87-2, as well as to provide guidance that would improve on the guidance in SOP 87-2. In September 1993, AcSEC released an exposure draft of a proposed SOP, *Accounting for Costs of Materials and Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include a Fund-Raising Appeal*, for public comment. AcSEC received more than 300 comment letters on the exposure draft. AcSEC redeliberated the issues based on the comments received.

B.3. In 1996, after redeliberating the issues based on the comments received and making certain revisions to the draft SOP, AcSEC conducted a field test of the draft SOP. The objectives of the field test were to determine whether the provisions of the draft SOP were sufficiently clear and definitive to generate consistent and comparable application of the SOP. Based on the field test results, AcSEC concluded that the provisions of the draft SOP, with certain revisions, were sufficiently clear and definitive to generate consistent and comparable application of the SOP.

B.4. Some respondents who commented on the exposure draft, as well as some interested parties who followed the project through its due process subsequent to the exposure draft, commented that the SOP should be reexposed for public comment. Reasons cited include:

- Approximately three years had passed between the end of the comment period and AcSEC's decision to issue the SOP.
- AcSEC made significant revisions to the SOP subsequent to releasing the exposure draft for comment.

Considering whether a proposed standard should be reexposed for public comment is inherently a subjective process. Factors that AcSEC considered include—

- The significance of changes made to the exposure draft and whether those changes result in guidance that the public did not have an opportunity to consider.
- Whether the scope was revised in such a way that affected entities did not have an opportunity to comment.
- New information about or changes in the nature of the transactions being considered, practice, or other factors.

AcSEC believes that the length of time between exposure and final issuance is not pertinent to whether the SOP should be reexposed for public comment.

B.5. Based on consideration of the factors identified, AcSEC believes that the SOP should not be reexposed for public comment. AcSEC notes that although the SOP has been revised based on comments received on the exposure draft, those revisions do not change the overall model in the SOP. Those revisions were made primarily to clarify the SOP and improve its operationality. Further, AcSEC believes that the project received a high level of attention from interested parties. AcSEC provided working drafts to interested parties and those parties provided input throughout the process, up to and including the Financial Accounting Standard Board's and the Governmental Accounting Standards Board's clearance of the SOP for issuance.

B.6. Appendix C [paragraph .23] discusses the key issues in the exposure draft and comments received on those issues, as well as the basis for AcSEC's conclusions on those and certain other issues.

Appendix C

Basis for Conclusions

C.1. This section discusses considerations that were deemed significant by members of the Accounting Standards Executive Committee (AcSEC) in reaching the conclusions in this Statement of Position (SOP). It includes reasons for accepting certain views and rejecting others. Individual AcSEC members gave greater weight to some factors than to others.

Overall Framework

C.2. This SOP uses the model in SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, as a starting point and clarifies guidance that was unclear, provides more detailed guidance, revises some guidance, and expands the scope of costs covered to include all costs of joint activities. The model established by SOP 87-2 was to account for joint costs as fund raising unless an entity could demonstrate that a program or management and general function had been conducted. SOP 87-2 used verifiable indications of the reasons for conducting the activity, such as content, audience, the action requested, if any, and other corroborating evidence as a basis for determining whether a program or management and general function had been conducted.

C.3. On an overall basis, the majority of respondents who commented on the September 1993 exposure draft of a proposed SOP, *Accounting for Costs of Materials and Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include a Fund-Raising Appeal*, opposed it, for various reasons, including the following:

- The guidance in SOP 87-2 is operational, results in sound financial reporting, and should be retained.
- The guidance in SOP 87-2 should be retained but clarified.
- The guidance proposed in the exposure draft should be revised. (Some commented that it overstates fund raising; others commented that it understates fund raising.)

C.4. AcSEC concluded that it supports the model in the exposure draft, subject to certain revisions. AcSEC believes that this SOP provides clear, detailed accounting guidance that, when applied, will increase comparability of financial statements. Those statements will also include more meaningful disclosures without incurring increased costs.

C.5. Some respondents commented that the model in the exposure draft would adversely affect entities both financially and operationally. Various reasons were given, including the following:

- It would inhibit the ability of entities, particularly small entities and entities that raise contributions through direct solicitations, to generate the necessary revenue to perform their program services.
- Most entities would not meet the criteria in this SOP for reporting costs of joint activities as program or management and general, because they must combine their mission statements, public informa-

tion and education, and fund-raising appeals due to a lack of resources. Some noted that this may result in unsatisfactory ratings from public watchdog groups.

AcSEC did not find these arguments compelling. This SOP provides accounting guidance; it provides no guidance concerning how entities should undertake their activities. Also, this SOP does not prohibit allocation merely because activities carrying out different functions are combined. In fact, this SOP provides guidance for reporting costs as program or management and general in circumstances in which those activities are combined with fund-raising. Moreover, actions taken by financial statement users are not the direct result of the requirements of this SOP. Rather, those actions may result from more relevant and useful information on which to base decisions.

C.6. Some respondents commented that the exposure draft is biased toward reporting expenses as fund raising. AcSEC believes that determining whether the costs of joint activities should be classified as program, management and general, or fund raising sometimes is difficult, and such distinctions sometimes are subject to a high degree of judgment. AcSEC believes that external financial statement users focus on and have perceptions about amounts reported as program, management and general, and fund raising. That focus and those perceptions provide incentives for entities to report expenses as program or management and general rather than fund raising. Therefore, in circumstances in which joint activities are conducted, a presumption exists that expenses should be reported as fund raising rather than as program or management and general. The criteria in this SOP provide guidance for entities to overcome that presumption.

Accounting for Joint Activities

C.7. This SOP requires that if any of the criteria of purpose, audience, and content are not met, all costs of the activity should be reported as fund raising, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, subject to the exception in the following sentence. Costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund raising. (This SOP expands on the model established by SOP 87-2 by including all costs of joint activities other than costs of goods or services provided in exchange transactions, rather than merely joint costs.) AcSEC believes that the criteria of purpose, audience, and content are each relevant in determining whether a joint activity should be reported as fund raising, program, or management and general because each provides significant evidence about the benefits expected to be obtained by undertaking the activity.

C.8. Some respondents commented that reporting costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity as fund raising is misleading and that the scope of the SOP should include only joint costs of joint activities. Some commented that reporting costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity as fund raising conflicts with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations*, which defines fund raising, program, and management and general and requires not-for-profit organizations (NPOs) to report information about expenses using those functional classifications.

C.9. AcSEC believes that the purpose for which costs other than joint costs are incurred may be fund raising, program, or management and general, depending on the context in which they are used in the activity undertaken. For example, a program-related pamphlet may be sent to an audience in need of the program. In that context, the pamphlet is used for program purposes. However, in order to demonstrate to potential donors that the entity's programs are worthwhile, that same pamphlet may be sent to an audience that is likely to contribute, but that has no need or reasonable potential for use of the program. In that context, the pamphlet is used for fund raising. AcSEC believes this broader scope will result in more comparability and more meaningful financial reporting by covering all costs of activities that include fund raising and by assigning those costs to the function for which they are incurred, consistent with the guidance in Statement No. 117.

C.10. AcSEC believes that costs of goods or services provided in exchange transactions should not be charged to fund raising because those costs are incurred in exchange for revenues other than contributions.

Criteria of Purpose, Audience, and Content

Call For Action

C.11. The definition of *program* in FASB Statement No. 117 includes public education. As noted in paragraph C.6, AcSEC believes that in circumstances in which joint activities are conducted, a presumption exists that expenses should be reported as fund raising rather than as program or management and general. AcSEC believes that in order to overcome that presumption, it is not enough that (a) the purpose of the activity include educating the public about causes, (b) the audience has a need or reasonable potential for use of any educational component of the activity pertaining to causes, or (c) the audience has the ability to assist the entity in meeting the goals of the program component of the activity by becoming educated about causes. Therefore, AcSEC concluded that for purposes of this SOP, in order to conclude that the criteria of purpose, audience, and content are met program activities are required to call for specific action by the recipient (other than becoming educated about causes) that will help accomplish the entity's mission. As discussed in paragraph .09, in certain circumstances educational activities may call for specific action by the recipient that will help accomplish the entity's mission.

Purpose

C.12. AcSEC believes meeting the purpose criterion demonstrates that the purpose of the activity includes accomplishing program or management and general functions. Inherent in the notion of a joint activity is that the activity has elements of more than one function. Accordingly, the purpose criterion provides guidance for determining whether the purpose of the activity includes accomplishing program or management and general functions in addition to fund raising.

Compensation and Evaluation Tests

C.13. The exposure draft proposed that all costs of the joint activity should be charged to fund raising if (a) substantially all compensation or fees for performing the activity are based on amounts raised or (b) the evaluation of the party performing the activity is based on amounts raised. Some respondents

commented that basing the method of compensation or evaluating the performance of the party performing the activity based on contributions raised should not lead to the conclusion that all costs of the activity should be charged to fund raising. Others commented that the method of compensation is unrelated to whether the purpose criterion is met. The reasons given included the following:

- It is counterintuitive to imply that those performing multipurpose activities that include fund raising would not be compensated or evaluated based on amounts raised.
- Such guidance would create a bias toward entities that use employees to raise contributions and against entities that hire professional fund raisers and public relations firms and is therefore not neutral.

Some respondents gave examples of circumstances in which substantially all compensation is based on contributions raised and asserted that the activity was nevertheless a program activity. In each of those examples, AcSEC considered all the facts presented and concluded that the activity was fund raising.

C.14. AcSEC continues to support the spirit of the proposed guidance, because AcSEC believes that basing a majority of compensation on funds raised is persuasive evidence that the activity is a fund-raising activity. Nevertheless, AcSEC believes that the proposed guidance was unclear and would be difficult to implement, primarily because of the broad definition of “based on contributions raised” included in the glossary of the exposure draft. In connection with that issue, AcSEC was concerned that any joint activities performed by a fund-raising department or by individuals whose duties include fund raising, such as executive officers of small NPOs who are employed based on their ability to raise contributions, would be required to be reported as fund raising because the compensation of the parties performing those activities is based on amounts raised. Also, AcSEC had concerns that it would be difficult to determine whether fixed contract amounts were negotiated based on expected contributions. Therefore, AcSEC concluded that the compensation test should be revised to provide that the purpose criterion is not met if a majority of compensation or fees for any party’s performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity. AcSEC believes that guidance is sound and is operational.

C.15. AcSEC believes that the guidance in paragraph .10a is not biased against entities that hire professional fund raisers, because it applies to the entity’s employees as well as professional fund raisers. For example, if a majority of an employee’s compensation or fees for performing a component of a discrete joint activity varies based on contributions raised for that discrete joint activity, the purpose criterion is not met.

Similar Function-Similar Medium Test

C.16. Some respondents misinterpreted the exposure draft as providing that, in order to meet the purpose criterion, the program or management and general activity must be conducted without the fund-raising component, using the same medium and on a scale that is similar to or greater than the program or management and general component of the activity being accounted for. That was not a requirement proposed by the exposure draft. The exposure draft proposed that meeting that condition would result in meeting the purpose criterion. Failing the criterion merely leads to consideration of other evidence, such as the indicators in paragraph .11. AcSEC has revised the SOP to state this more clearly.

Other Evidence

C.17. The compensation test and the similar function-similar medium test may not always be determinative because the attributes that they consider may not be present. Therefore, this SOP includes indicators that should be considered in circumstances in which the compensation test and the similar function-similar medium test are not determinative. The nature of those indicators is such that they may be present in varying degrees. Therefore, all available evidence, both positive and negative, should be considered to determine whether, based on the weight of that evidence, the purpose criterion is met.

Audience

C.18. The exposure draft proposed that if the audience for the materials or activities is selected principally on its ability or likelihood to contribute, the audience criterion is not met and all the costs of the activity should be charged to fund raising. Further, the exposure draft proposed that if the audience is selected principally based on its need for the program or because it can assist the entity in meeting its program goals other than by financial support provided to the entity, the audience criterion is met. Some respondents commented that that audience criterion is too narrow, because it is based on the principal reason for selecting the audience. They asserted that for some activities no principal reason exists for selecting an audience; entities select the audience for those activities for multiple reasons, such as both the audience's ability to contribute and its ability to help meet program goals. Some commented that for some activities, entities select audiences that have provided past financial support because, by providing financial support, those audiences have expressed an interest in the program.

C.19. AcSEC believes that meeting the audience criterion should demonstrate that the audience is selected because it is a suitable audience for accomplishing the activity's program or management and general functions. Therefore, the reasons for selecting the audience should be consistent with the program or management and general content of the activity. However, AcSEC believes it is inherent in the notion of joint activities that the activity has elements of more than one function, including fund raising, and acknowledges that it may be difficult to determine the principal reason for selecting the audience. Accordingly, AcSEC concluded that if the audience includes prior donors or is otherwise selected based on its ability or likelihood to contribute, a rebuttable presumption should exist that the audience was selected to raise funds. AcSEC believes that the reasons for selecting the audience that can overcome that presumption, which are included in paragraph .13 of this SOP, demonstrate that the audience is selected because it is a suitable audience for accomplishing the activity's program or management and general functions based on the program or management and general content of the activity.

Content

C.20. AcSEC believes that meeting the content criterion demonstrates that the content of the activity supports program or management and general functions. AcSEC believes that accounting guidance should not impose value judgments about whether the entity's mission, programs, and responsibilities are worthwhile. Therefore, whether the content criterion is met depends on the relationship of the content to the entity's mission, programs, and management and general responsibilities.

C.21. Paragraph .14 provides that, to meet the content criterion, program activities should call for specific action by the recipient that will help accom-

plish the entity's mission. The exposure draft proposed that slogans, general calls to prayer, and general calls to protest do not meet the content criterion; some respondents disagreed. AcSEC concluded that this SOP should be silent concerning whether slogans, general calls to prayer, and general calls to protest are calls to action that meet the content criterion. AcSEC believes that determining whether those items are calls to action that meet the content criterion requires judgments based on the particular facts and circumstances.

C.22. Some respondents commented that educating the public about causes without calling for specific action should satisfy the content criterion. They noted that this is particularly relevant for NPOs subject to Internal Revenue Code (IRC) Section 501(c)4, because those NPOs are involved in legislative reform. Also, some noted that it may be the entity's mission or goal to educate the public about causes. They believe that, in those cases, the NPO's program is to educate the public about causes without necessarily calling for specific action by the recipient.

C.23. As discussed in paragraph C.11, AcSEC concluded that education that does not motivate the audience to action is in fact done in support of fund raising. However, this SOP acknowledges that some educational messages motivate the audience to specific action, and those messages meet the content criterion. AcSEC believes that that provision will result in the activities of some NPOs subject to IRC Section 501(c)4 (and some other entities, whose mission or goal is to educate the public) meeting the content criterion.

C.24. Paragraph .13c provides that one way that the audience criterion is met is if the entity is required to direct the management and general component of the activity to the particular audience. Further, as discussed in paragraph D.13, in *Discussion of Conclusions*, an audience that includes prior donors and is selected because the entity is required to send them certain information to comply with requirements of the Internal Revenue Service (IRS) is an example of an audience that is selected because the entity is required to direct the management and general component of the activity to that audience. Paragraph .14b provides that one way that the content criterion is met is if the activity fulfills one or more of the entity's management and general responsibilities through a component of the joint activity. However, footnote 9 to paragraph .14b provides that disclosures made when soliciting contributions to comply with requirements of states or other regulatory bodies are considered fund-raising activities, and are not considered management and general activities. AcSEC considered whether it is inconsistent to conclude both that (a) activities conducted to comply with requirements of regulatory bodies concerning contributions that have been received are management and general activities, and that (b) activities conducted to comply with requirements of regulatory bodies concerning soliciting contributions are fund-raising activities. AcSEC believes that those provisions are not inconsistent. AcSEC believes there is a distinction between (a) requirements that must be met as a result of receiving contributions and (b) requirements that must be met in order to solicit contributions. AcSEC believes that activities that are undertaken as a result of receiving contributions are management and general activities while activities that are undertaken in order to solicit contributions are fund-raising activities.

Incidental Activities

C.25. Many entities conduct fund-raising activities in conjunction with program or management and general activities that are incidental to such pro-

gram or management and general activities. Similarly, entities may conduct program or management and general activities in conjunction with fund-raising activities that are incidental to such fund-raising activities. Such efforts may be a practical and efficient means for entities to conduct activities, although the principal purpose of the activity may be to fulfill either fund-raising, program, or management and general functions. The exposure draft proposed that incidental activities need not be considered in applying this SOP. Some respondents disagreed with that guidance, while others commented that it was confusing. AcSEC continues to support that guidance. AcSEC believes that guidance is necessary to avoid requiring complex allocations in circumstances in which the criteria of purpose, audience, and content are met but the activity is overwhelmingly either fund raising, program, or management and general.

Allocation Methods

C.26. Respondents had various comments concerning allocation methods, including the following:

- The SOP should focus on allocation methods rather than on circumstances in which entities should allocate.
- The SOP should prescribe allocation methods.
- The approach taken in the SOP—discussing, rather than requiring or prohibiting allocation methods—is sound.
- Certain allocation methods should be prohibited.
- The SOP should set maximum allocation percentages.

AcSEC believes that no particular allocation method or methods are necessarily more desirable than other methods in all circumstances. Therefore, this SOP neither prescribes nor prohibits any particular allocation methods. AcSEC believes entities should apply the allocation methods that result in the most reasonable cost allocations for their activities. Appendix F [paragraph .26] of this SOP illustrates several allocation methods, any one of which may result in a reasonable or unreasonable allocation of costs in particular circumstances. The methods illustrated are not the only acceptable methods. However, AcSEC believes that the methods illustrated in this SOP are among those most likely to result in meaningful cost allocations.

C.27. Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*, states in paragraph 7 that “the term *accounting principle* includes ‘not only accounting principles and practices but also the methods of applying them.’” APB Opinion 20 also states in paragraphs 15 and 16 that

. . . In the preparation of financial statements there is a presumption that an accounting principle once adopted should not be changed in accounting for events and transactions of a similar type . . . The presumption that an entity should not change an accounting principle may be overcome only if the enterprise justifies the use of an alternative acceptable accounting principle [*allocation method*] on the basis that it is preferable.

A change in cost allocation methodology may be a change in accounting principle for entities covered by this SOP. Accordingly, paragraph .16 of this SOP provides that the cost allocation methodology used should be applied consistently, given similar facts and circumstances.

Disclosures

C.28. Respondents made various comments concerning the required and encouraged disclosures, including recommendations for additional disclosures and recommendations that certain disclosures be deleted. AcSEC was not persuaded that the costs of the other disclosures recommended by respondents are justified by their benefits. AcSEC believes that, with the exception of one disclosure, the disclosures prescribed by the exposure draft provide relevant information about the kinds of activities for which joint costs have been incurred and the manner in which those costs are reported in the financial statements. In considering disclosures proposed by the exposure draft about the allocation method, AcSEC observed that there are no requirements to disclose methods of allocating other expenses and questioned the utility of disclosing the allocation method in this circumstance. AcSEC concluded that the requirement to disclose the allocation method should be deleted.

C.29. Paragraph .19 encourages, but does not require, certain disclosures. AcSEC believes those disclosures provide useful information but that they should be encouraged rather than required because the costs of making them may not be justified by the benefits in all cases.

Effective Date

C.30. Some respondents commented that the effective date should be deferred. AcSEC believes that the accounting systems required to implement this SOP are already in place and that implementation should be relatively straightforward. However, AcSEC acknowledges that some entities may change their operations based on the reporting that would result from this SOP. Therefore, AcSEC concluded that this SOP should be effective for financial statements for years beginning on or after December 15, 1998.

Cost-Benefit

C.31. Some respondents commented that the guidance would increase record keeping costs. AcSEC believes that implementing this SOP will not significantly increase record keeping costs, which are primarily the costs of documenting reasons for undertaking joint activities. Further, AcSEC believes that the costs of making the disclosures required by this SOP should be minimal, because entities should already have the information that is required to be disclosed. AcSEC believes that implementing this SOP will result in more relevant, meaningful, and comparable financial reporting and that the cost of implementing this SOP will be justified by its benefits.

Appendix D

Discussion of Conclusions

Scope

D.1. This Statement of Position (SOP) applies only to costs of joint activities. It does not address allocations of costs in other circumstances.

Reporting Models and Related Requirements

D.2. Paragraph 26 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations*, specifies that a statement of activities or notes to the financial statements should provide information about expenses reported by their functional classification, such as major classes of program services and supporting activities. Paragraph 13.34 of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*, provides that the financial statements of not-for-profit organizations (NPOs) should disclose the total fund-raising expenses. [Revised, June 2004, to reflect conforming changes necessary due to conforming changes made to the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*.]

D.3. Governmental Accounting Standards Board (GASB) Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*, provides that governmental entities should not change their accounting and financial reporting to apply the provisions of FASB Statements No. 116, *Accounting for Contributions Received and Contributions Made*, and No. 117. GASB Statement No. 29 permits governmental entities that have applied the accounting and financial reporting principles in SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*, or in the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* (modified by all applicable FASB pronouncements issued through November 30, 1989, and by most applicable GASB pronouncements) to continue to do so, pending GASB pronouncements on the accounting and financial reporting model for governmental entities. Alternatively, those governmental entities are permitted to change to the current governmental financial reporting model.[‡]

D.4. GASB Statement No. 15, *Governmental College and University Accounting and Financial Reporting Models*, requires governmental colleges and universities to use one of two accounting and financial reporting models. One model, referred to as the “AICPA College Guide Model,” encompasses the accounting and financial reporting guidance in the 1973 AICPA Industry

[‡] GASB Statement No. 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*, supersedes the provisions of GASB Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*, relating to the use of the AICPA Not-for-Profit model. See GASB Statement No. 34, including paragraph 147. The AICPA Audit and Accounting Guide *State and Local Governments* provides guidance on the application of this SOP to state and local governments. [Footnote revised, June 2004, to reflect conforming changes necessary due to the issuance of GASB Statement No. 34.]

Audit Guide *Audits of Colleges and Universities*, as amended by SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*, and as modified by applicable FASB pronouncements issued through November 30, 1989, and all applicable GASB pronouncements. (The other model, referred to as the “Governmental Model,” is based on the pronouncements of the National Council on Governmental Accounting [NCGA] and the GASB.)¹¹

D.5. For state and local governmental entities, some are required to report expenses by function using the functional classifications of program, management and general, and fund raising. Other state and local governmental entities that report expenses or expenditures by function have a functional structure that does not include fund raising, program, or management and general. Still other state and local governmental entities do not report expenses or expenditures by function. Examples of those various reporting requirements are as follows:[#]

- Entities applying the accounting and financial reporting principles in the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations*, as well as those that follow SOP 78-10 and that receive significant amounts of contributions from the public, are required to report separately the costs of the fund-raising, program, and management and general functions.
- Entities applying the accounting and financial reporting principles in the AICPA Industry Audit Guide *Audits of Colleges and Universities*, as amended by SOP 74-8, are required to report fund raising as part of the “institutional support” function.

D.6. As discussed in footnote 3 to paragraph .01 of this SOP, this SOP is not intended to require reporting the functional classifications of fund raising, program, and management and general. Rather, those functional classifications are discussed throughout this SOP for purposes of illustrating how the guidance in this SOP would be applied by entities that use those functional classifications. Entities that do not use the functional classifications of fund raising, program, and management and general should apply the guidance in this SOP for purposes of accounting for joint activities, using their reporting model. For example, some entities may conduct membership-development activities. As discussed in the Glossary [paragraph .30] of this SOP, if there are no significant benefits or duties connected with membership, the substance of the membership-development activities may, in fact, be fund raising. In such circumstances, the costs of those activities should be charged to fund raising. To the extent that member benefits are received, membership is an exchange transaction. In circumstances in which membership development is in part soliciting revenues from exchange transactions and in part soliciting contributions and the purpose, audience, and content of the activity are appropriate for achieving membership development, joint costs should be allocated between fund raising and the exchange transaction.

¹¹ GASB Statement No. 35, *Basic Financial Statements—and Management’s Discussion and Analysis—for Public Colleges and Universities*, supersedes GASB Statement No. 15, *Governmental College and University Accounting and Financial Reporting Models*. See GASB Statements No. 34 and No. 35. The AICPA Audit and Accounting Guide *State and Local Governments* provides guidance on the application of this SOP to governmental (public) colleges and universities. [Footnote revised, June 2004, to reflect conforming changes necessary due to the issuance of GASB Statement No. 35.]

[#] This discussion is no longer applicable. See footnotes ‡ and || in paragraphs D.3 and D.4, respectively. [Footnote added, June 2004, to reflect conforming changes necessary due to the issuance of GASB Statements No. 34 and No. 35.]

Assigning Costs of Joint Activities

D.7. Paragraph .07 provides: “If the criteria of purpose, audience, and content are met, the costs of a joint activity that are identifiable with a particular function should be charged to that function and joint costs should be allocated between fund raising and the appropriate program or management and general function. If any of the criteria are not met, all costs of the joint activity should be reported as fund-raising costs, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity. . . .” For example, if the criteria are met, the costs of materials that accomplish program goals and that are unrelated to fund raising, such as the costs of a program-related pamphlet included in a joint activity, should be charged to program, while joint costs, such as postage, should be allocated between fund raising and program. However, if the pamphlet is used in fund-raising packets and the criteria are not met, the costs of the pamphlets used in the fund-raising packets, as well as the joint costs, should be charged to fund raising. (If some pamphlets are used in program activities that include no fund raising, the cost of the pamphlets used in those separate program activities that include no fund raising should be charged to program.)

Educational Activities

D.8. Some entities have missions that include educating the public (students) in areas other than causes. Paragraph .09 provides that, for those entities, educating the audience in areas other than causes or motivating the audience to engage in specific activities, such as attending a lecture or class, that will educate them in areas other than causes is considered a call for specific action by the recipients that will help accomplish the entity’s mission. Educating the audience about causes or motivating the audience to engage in specific activities that will educate them about causes without educating them in other subjects is not considered a call for specific action by the audience that will help accomplish the entity’s mission. An example of a lecture or class that will educate students in an area other than causes is a lecture on the nesting habits of the bald eagle, given by the Save the Bald Eagle Society, an NPO whose mission is to save the bald eagle from extinction and educate the public about the bald eagle. An example of a lecture or class that will address particular causes is a lecture by the Bald Eagle Society on the potential extinction of bald eagles and the need to raise contributions to prevent their extinction. For purposes of applying the guidance in this SOP, motivating the audience to attend a lecture on the nesting habits of the bald eagle is a call for specific action that will help accomplish the entity’s mission. If the lecture merely addresses the potential extinction of bald eagles and the need to raise contributions to prevent their extinction, without addressing the nesting habits of the bald eagle, motivating the audience to attend the lecture is not considered a call for specific action by the recipient that will help accomplish the entity’s mission.

D.9. AcSEC notes that most transactions in which a student attends a lecture or class are exchange transactions and are not joint activities. Such transactions are joint activities only if the activity includes fund raising.

Audience

D.10. Paragraph .12 provides that a rebuttable presumption exists that the audience criterion is not met if the audience includes prior donors or is otherwise selected based on its ability or likelihood to contribute to the entity. That presumption can be overcome if the audience is also selected for the program or management and general reasons specified in paragraph .13. Further, paragraph .12 provides

that in determining whether that presumption is overcome, entities should consider the extent to which the audience is selected based on its ability or likelihood to contribute to the entity and contrast that with the extent to which it is selected for the reasons that may overcome that presumption. Some organizations conduct joint activities that are special events, such as symposia, dinners, dances, and theater parties, in which the attendee receives a direct benefit (for example, a meal or theater ticket) and for which the admission price includes a contribution. For example, it may cost \$500 to attend a dinner with a fair value of \$50. In that case, the audience is required to make a \$450 contribution in order to attend. In circumstances in which the audience is required to make a contribution to participate in a joint activity, such as attending a special event, the audience's ability or likelihood to contribute is a significant factor in its selection. Therefore, in circumstances in which the audience is required to make a contribution to participate in a joint activity, the extent to which the audience is selected for the program or management and general reasons in paragraph .13 must be overwhelmingly significant in order to rebut the presumption that the audience criterion is not met.

D.11. The source of the names and the characteristics of the audience should be considered in determining the reason for selecting the audience. Some entities use lists compiled by others to reach new audiences. The source of such lists may indicate the purpose or purposes for which they were selected. For example, lists acquired from entities with similar or related programs are more likely to meet the audience criterion than are lists acquired from entities with dissimilar or unrelated programs. Also, the characteristics of those on the lists may indicate the purpose or purposes for which they were selected. For example, a list based on a consumer profile of those who buy environmentally friendly products may be useful to an entity whose mission addresses environmental concerns and could therefore indicate that the audience was selected for its ability to take action to assist the entity in meeting program goals. However, a list based on net worth would indicate that the audience was selected based on its ability or likelihood to contribute, unless there was a correlation between net worth and the program or management and general components of the activity.

D.12. Some audiences may be selected because they have an interest in or affinity to the program. For example, homeowners may have an interest in the homeless because they are sympathetic to the plight of the homeless. Nevertheless, including homeowners in the audience of a program activity to provide services to the homeless would not meet the audience criterion, because they do not have a need or reasonable potential for use of services to the homeless.

D.13. Paragraph .13c provides that the audience criterion is met if the entity is required to direct the management and general component of the joint activity to the particular audience or the audience has reasonable potential for use of the management and general component. An example of a joint activity in which the audience is selected because the entity is required to direct the management and general component of the joint activity to the particular audience is an activity in which the entity sends a written acknowledgment or other information to comply with requirements of the Internal Revenue Service to prior donors and includes a request for contributions. An example of a joint activity in which the audience is selected because the audience has reasonable potential for use of the management and general component is an activity in which the entity sends its annual report to prior donors and includes a request for contributions.

Content

D.14. Paragraph .14 provides that, to meet the content criterion, program activities should call for specific action by the recipient that will help accomplish the entity's mission. As discussed in the Glossary [paragraph .30], the action should benefit the recipient or society. Examples of actions that benefit the recipient (such as by improving the recipient's physical, mental, emotional, or spiritual health and well-being) or society (such as by addressing societal problems) include the following:

- a. Actions that benefit the recipient:
 - *Stop smoking.* Specific methods, instructions, references, and resources should be suggested.
 - *Do not use alcohol or drugs.* Specific methods, instructions, references, and resources should be suggested.
- b. Actions that benefit society:
 - *Write or call.* The party to communicate with and the subject matter to be communicated should be specified.
 - *Complete and return the enclosed questionnaire.* The results of the questionnaire should help the entity achieve its mission. For example, if the entity discards the questionnaire, it does not help the entity achieve its mission.
 - *Boycott.* The particular product or company to be boycotted should be specified.

D.15. Paragraph .14b provides that to meet the content criterion, management and general functions are required to fulfill one or more of the entity's management and general responsibilities through a component of the joint activity. Some states or other regulatory bodies require that certain disclosures be included when soliciting contributions. Paragraph .14, footnote 9, of this SOP provides that for purposes of applying the guidance in this SOP, communications that include such required disclosures are considered fund-raising activities and are not considered management and general activities. Some examples of such disclosures include the following:

- Information filed with the attorney general concerning this charitable solicitation may be obtained from the attorney general of [*the state*] by calling 123-4567. Registration with the attorney general does not imply endorsement.
- A copy of the registration and financial information may be obtained from the Division of Consumer Services by calling toll-free, within [*the state*], 1-800-123-4567. Registration does not imply endorsement, approval, or recommendation by [*the state*].
- Information about the cost of postage and copying, and other information required to be filed under [*the state*] law, can be obtained by calling 123-4567.
- The organization's latest annual report can be obtained by calling 123-4567.

Allocation Methods

D.16. Paragraph .16 of this SOP states, "The cost allocation methodology used should be rational and systematic, it should result in an allocation of joint

costs that is reasonable, and it should be applied consistently given similar facts and circumstances.” The allocation of joint costs should be based on the degree to which costs were incurred for the functions to which the costs are allocated (that is, program, management and general, or fund raising). For purposes of determining whether the allocation methodology for a particular joint activity should be consistent with methodologies used for other particular joint activities, facts and circumstances that may be considered include factors related to the content and relative costs of the components of the activity. The audience should not be considered in determining whether the facts and circumstances are similar for purposes of determining whether the allocation methodology for a particular joint activity should be consistent with methodologies used for other particular joint activities.

Practicability of Measuring Joint Costs

D.17. The Glossary [paragraph .30] of this SOP includes a definition of joint costs. Some costs, such as utilities, rent, and insurance, commonly referred to as indirect costs, may be joint costs. For example, the telephone bill for a department that, among other things, prepares materials that include both fund-raising and program components may commonly be referred to as an indirect cost. Such telephone bills may also be joint costs. However, for some entities, it is impracticable to measure and allocate the portion of the costs that are joint costs. Considerations about which joint costs should be measured and allocated, such as considerations about materiality and the costs and benefits of developing and providing the information, are the same as considerations about cost allocations in other circumstances.

Appendix E

Illustrations of Applying the Criteria of Purpose, Audience, and Content to Determine Whether a Program or Management and General Activity Has Been Conducted

Illustration 1

Facts

E.1. Entity A's mission is to prevent drug abuse. Entity A's annual report states that one of its objectives in fulfilling that mission is to assist parents in preventing their children from abusing drugs.

E.2. Entity A mails informational materials to the parents of all junior high school students explaining the prevalence and dangers of drug abuse. The materials encourage parents to counsel children about the dangers of drug abuse and inform them about how to detect drug abuse. The mailing includes a request for contributions. Entity A conducts other activities informing the public about the dangers of drug abuse and encouraging parents to counsel their children about drug abuse that do not include requests for contributions and that are conducted in different media. Entity A's executive director is involved in the development of the informational materials as well as the request for contributions. The executive director's annual compensation includes a significant bonus if total annual contributions exceed a predetermined amount.

Conclusion

E.3. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.4. The activity calls for specific action by the recipient (encouraging parents to counsel children about the dangers of drug abuse and informing them about how to detect drug abuse) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10*a* or .10*b* is determinative of whether the purpose criterion is met. (Although Entity A's executive director's annual compensation varies based on annual contributions, the executive director's compensation does not vary based on contributions raised for this discrete joint activity.) Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (a) the program component of this activity calls for specific action by the recipient (encouraging parents to counsel children about the dangers of drug abuse) that will help accomplish the entity's mission, and it otherwise conducts the program activity in this illustration without a request for contributions, and (b) performing such programs helps accomplish Entity A's mission. (Note that had Entity A conducted the activity using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions, the purpose criterion would have been met under paragraph .10*b*.)

E.5. The audience criterion is met because the audience (parents of junior high school students) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

E.6. The content criterion is met because the activity calls for specific action by the recipient (encouraging parents to counsel children about the dangers of drug abuse and informing them about how to detect drug abuse) that will help accomplish the entity's mission (assisting parents in preventing their children from abusing drugs), and it explains the need for and benefits of the action (the prevalence and dangers of drug abuse).

Illustration 2

Facts

E.7. Entity B's mission is to reduce the incidence of illness from ABC disease, which afflicts a broad segment of the population. One of Entity B's objectives in fulfilling that mission is to inform the public about the effects and early warning signs of the disease and specific action that should be taken to prevent the disease.

E.8. Entity B maintains a list of its prior donors and sends them donor renewal mailings. The mailings include messages about the effects and early warning signs of the disease and specific action that should be taken to prevent it. That information is also sent to a similar-sized audience but without the request for contributions. Also, Entity B believes that recent donors are more likely to contribute than nondonors or donors who have not contributed recently. Prior donors are deleted from the mailing list if they have not contributed to Entity B recently, and new donors are added to the list. There is no evidence of a correlation between recent contributions and participation in the program component of the activity. Also, the prior donors' need to use or reasonable potential for use of the messages about the effects and early warning signs of the disease and specific action that should be taken to prevent it is an insignificant factor in their selection.

Conclusion

E.9. The purpose and content criteria are met. The audience criterion is not met.¹¹ All costs, including those that might otherwise be considered program or management and general costs if they had been incurred in a different activity, should be charged to fund raising.

E.10. The activity calls for specific action by the recipient (action that should be taken to prevent ABC disease) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. The purpose criterion is met because (a) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission (to reduce the incidence of illness from the disease), and (b) the program is also

¹¹ Paragraph .07 of this SOP provides that all costs of joint activities, except for costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should be charged to fund raising if any of the criteria of purpose, audience, or content are not met. Accordingly, if one or more criteria are not met, the other criteria need not be considered. However, the illustrations in this Appendix provide conclusions about whether each of the criteria would be met in circumstances in which one or more criteria are not met in order to provide further guidance.

conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (a similar mailing is done without the request for contributions, to a similar-sized audience).

E.11. The audience criterion is not met. The rebuttable presumption that the audience criterion is not met because the audience includes prior donors is not overcome in this illustration. Although the audience has a need to use or reasonable potential for use of the program component, that was an insignificant factor in its selection.

E.12. The content criterion is met because the activity calls for specific action by the recipient (actions to prevent ABC disease) that will help accomplish the entity's mission (to reduce the incidence of ABC disease), and it explains the need for and benefits of the action (to prevent ABC disease).

Illustration 3

Facts

E.13. Entity C's mission is to reduce the incidence of illness from ABC disease, which afflicts a broad segment of the population. One of Entity C's objectives in fulfilling that mission is to increase governmental funding for research about ABC disease.

E.14. Entity C maintains a list of its prior donors and its employees call them on the telephone reminding them of the effects of ABC disease, asking for contributions, and encouraging them to contact their elected officials to urge increased governmental funding for research about ABC disease. The callers are educated about ABC, do not otherwise perform fund-raising functions, and are not compensated or evaluated based on contributions raised. Entity C's research indicates that recent donors are likely to contact their elected officials about such funding while nonrecent donors are not. Prior donors are deleted from the calling list if they have not contributed to Entity C recently, and new donors are added to the list.

Conclusion

E.15. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.16. The activity calls for specific action by the recipient (contacting elected officials concerning funding for research about ABC disease) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10a or .10b is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (a) the qualifications and duties of the personnel performing the activity indicate that it is a program activity (the callers are educated about ABC and do not otherwise perform fund-raising functions), (b) the method of compensation for performing the activity does not indicate that it is a fund-raising activity (the employees are not compensated or evaluated based on contributions raised), and (c) performing such programs helps accomplish Entity C's mission.

E.17. The audience criterion is met because the audience (recent donors) is selected based on its ability to assist Entity C in meeting the goals of the program component of the activity (recent donors are likely to contact their elected officials about such funding while nonrecent donors are not).

E.18. The content criterion is met because the activity calls for specific action by the recipient (contacting elected officials concerning funding for research about ABC disease) that will help accomplish the entity's mission (to reduce the incidence of ABC disease), and it explains the need for and benefits of the action (to prevent ABC disease).

Illustration 4

Facts

E.19. Entity D's mission is to improve the quality of life for senior citizens. One of Entity D's objectives included in that mission is to increase the physical activity of senior citizens. One of Entity D's programs to attain that objective is to send representatives to speak to groups about the importance of exercise and to conduct exercise classes.

E.20. Entity D mails a brochure on the importance of exercise that encourages exercise in later years to residents over the age of sixty-five in three zip code areas. The last two pages of the four-page brochure include a perforated contribution remittance form on which Entity D explains its program and makes an appeal for contributions. The content of the first two pages of the brochure is primarily educational; it explains how seniors can undertake a self-supervised exercise program and encourages them to undertake such a program. In addition, Entity D includes a second brochure on various exercise techniques that can be used by those undertaking an exercise program.

E.21. The brochures are distributed to educate people in this age group about the importance of exercising, to help them exercise properly, and to raise contributions for Entity D. These objectives are documented in a letter to the public relations firm that developed the brochures. The audience is selected based on age, without regard to ability to contribute. Entity D believes that most of the recipients would benefit from the information about exercise.

Conclusion

E.22. The purpose, audience, and content criteria are met, and the joint costs should be allocated. (Note that the costs of the second brochure should be charged to program because all the costs of the brochure are identifiable with the program function.)

E.23. The activity calls for specific action by the recipient (exercising) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10a or .10b is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (a) performing such programs helps accomplish Entity D's mission, and (b) the objectives of the program are documented in a letter to the public relations firm that developed the brochure.

E.24. The audience criterion is met because the audience (residents over sixty-five in certain zip codes) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

E.25. The content criterion is met because the activity calls for specific action by the recipient (exercising) that will help accomplish the entity's mission

(increasing the physical activity of senior citizens), and the need for and benefits of the action are clearly evident (explains the importance of exercising).

Illustration 5

Facts

E.26. The facts are the same as those in Illustration 4, except that Entity E employs a fund-raising consultant to develop the first brochure and pays that consultant 30 percent of contributions raised.

Conclusion

E.27. The content and audience criteria are met. The purpose criterion is not met, however, because a majority of compensation or fees for the fund-raising consultant varies based on contributions raised for this discrete joint activity (the fund-raising consultant is paid 30 percent of contributions raised). All costs should be charged to fund raising, including the costs of the second brochure and any other costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity.

Illustration 6

Facts

E.28. Entity F's mission is to protect the environment. One of Entity F's objectives included in that mission is to take action that will increase the portion of waste recycled by the public.

E.29. Entity F conducts a door-to-door canvass of a community that recycles a low portion of its waste. The purpose of the activity is to help increase recycling by educating the community about environmental problems created by not recycling, and to raise contributions. Based on the information communicated by the canvassers, the need for and benefits of the action are clearly evident. The ability or likelihood of the residents to contribute is not a basis for communities selected, and all neighborhoods in the geographic area are covered if their recycling falls below a predetermined rate. The canvassers are selected from individuals who are well-informed about the organization's environmental concerns and programs and who previously participated as volunteers in program activities such as answering environmental questions directed to the organization and developing program activities designed to influence legislators to take actions addressing those concerns. The canvassers have not previously participated in fund-raising activities.

Conclusion

E.30. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.31. The activity calls for specific action by the recipient (implicitly—to help increase recycling) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10*a* or .10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (a) the qualifications and duties of the personnel performing the activity indicate that it is a program activity (the canvassers are selected from individuals who are well-informed about the organization's environmental concerns and programs and who previously participated as volunteers in program activities

such as answering environmental questions directed to the organization and developing program activities designed to influence legislators to take actions addressing those concerns), and (b) performing such programs helps accomplish Entity F's mission (to protect the environment).

E.32. The audience criterion is met because the audience (neighborhoods whose recycling falls below a predetermined rate) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

E.33. The content criterion is met because the activity calls for specific action by the recipient (implicitly—to help increase recycling) that will help accomplish the entity's mission (to protect the environment), and the need for and benefits of the action are clearly evident (increased recycling will help alleviate environmental problems).

Illustration 7

Facts

E.34. Entity G's mission is to provide summer camps for economically disadvantaged youths. Educating the families of ineligible youths about the camps is not one of the program objectives included in that mission.

E.35. Entity G conducts a door-to-door solicitation campaign for its camp programs. In the campaign, volunteers with canisters visit homes in middle-class neighborhoods to collect contributions. Entity G believes that people in those neighborhoods would not need the camp's programs but may contribute. The volunteers explain the camp's programs, including why the disadvantaged children benefit from the program, and distribute leaflets to the residents regardless of whether they contribute to the camp. The leaflets describe the camp, its activities, who can attend, and the benefits to attendees. Requests for contributions are not included in the leaflets.

Conclusion

E.36. The purpose, audience, and content criteria are not met. All costs should be charged to fund raising.

E.37. The activity does not include a call for specific action because it only educates the audience about causes (describing the camp, its activities, who can attend, and the benefits to attendees). Therefore, the purpose criterion is not met.

E.38. The audience criterion is not met, because the audience is selected based on its ability or likelihood to contribute, rather than based on (a) its need to use or reasonable potential for use of the action called for by the program component, or (b) its ability to take action to assist the entity in meeting the goals of the program component of the activity. (Entity G believes that people in those neighborhoods would not need the camp's programs but may contribute.)

E.39. The content criterion is not met because the activity does not call for specific action by the recipient. (The content educates the audience about causes that the program is designed to address without calling for specific action.)

Illustration 8

Facts

E.40. Entity H's mission is to educate the public about lifesaving techniques in order to increase the number of lives saved. One of Entity H's objec-

tives in fulfilling that mission, as stated in the minutes of the board's meetings, is to produce and show television broadcasts including information about lifesaving techniques.

E.41. Entity H conducts an annual national telethon to raise contributions and to reach the American public with lifesaving educational messages, such as summary instructions concerning dealing with certain life-threatening situations. Based on the information communicated by the messages, the need for and benefits of the action are clearly evident. The broadcast includes segments describing Entity H's services. Entity H broadcasts the telethon to the entire country, not merely to areas selected on the basis of giving potential or prior fund raising results. Also, Entity H uses national television broadcasts devoted entirely to lifesaving educational messages to conduct program activities without fund raising.

Conclusion

E.42. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.43. The activity calls for specific action by the recipient (implicitly—to save lives) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. The purpose criterion is met because (a) the program component of the activity calls for specific action by the recipient that will help accomplish Entity H's mission (to save lives by educating the public), and (b) a similar program activity is conducted without the fund raising using the same medium and on a scale that is similar to or greater than the scale on which it is conducted with the appeal (Entity H uses national television broadcasts devoted entirely to lifesaving educational messages to conduct program activities without fund raising).

E.44. The audience criterion is met because the audience (a broad segment of the population) is selected based on its need to use or reasonable potential for use of the action called for by the program activity.

E.45. The content criterion is met because the activity calls for specific action by the recipient (implicitly—to save lives) that will help accomplish the entity's mission (to save lives by educating the public), and the need for and benefits of the action are clearly evident (saving lives is desirable).

Illustration 9

Facts

E.46. Entity I's mission is to provide food, clothing, and medical care to children in developing countries.

E.47. Entity I conducts television broadcasts in the United States that describe its programs, show the needy children, and end with appeals for contributions. Entity I's operating policies and internal management memoranda state that these programs are designed to educate the public about the needs of children in developing countries and to raise contributions. The employees producing the programs are trained in audiovisual production and are familiar with Entity I's programs. Also, the executive producer is paid \$25,000 for this activity, with a \$5,000 bonus if the activity raises over \$1,000,000.

Conclusion

E.48. The purpose, audience, and content criteria are not met. All costs should be charged to fund raising.

E.49. The activity does not include a call for specific action because it only educates the audience about causes (describing its programs and showing the needy children). Therefore, the purpose criterion is not met. (Also, note that if the factor in paragraph .10*a* were considered, it would not be determinative of whether the purpose criterion is met. Although the executive producer will be paid \$5,000 if the activity raises over \$1,000,000, that amount would not be a majority of the executive producer's total compensation for this activity, because \$5,000 would not be a majority of the executive producer's total compensation of \$30,000 for this activity. Also, note that if other evidence, such as the indicators in paragraph .11, were considered, the purpose criterion would not be met based on the other evidence. Although the qualifications and duties of the personnel performing the activity indicate that the employees producing the program are familiar with Entity I's programs, the facts that some, but less than a majority, of the executive producer's compensation varies based on contributions raised, and that the operating policies and internal management memoranda state that these programs are designed to educate the public about the needs of children in developing countries [with no call for specific action by recipients] and to raise contributions, indicate that the purpose is fund raising.)

E.50. The audience criterion is not met because the audience is selected based on its ability or likelihood to contribute, rather than based on (a) its need to use or reasonable potential for use of the action called for by the program component, or (b) its ability to take action to assist the entity in meeting the goals of the program component of the activity. (The audience is a broad segment of the population of a country that is not in need of or has no reasonable potential for use of the program activity.)

E.51. The content criterion is not met because the activity does not call for specific action by the recipient that will help accomplish the entity's mission. (The content educates the audience about the causes without calling for specific action.)

Illustration 10

Facts

E.52. Entity J is a university that distributes its annual report, which includes reports on mission accomplishments, to those who have made significant contributions over the previous year, its board of trustees, and its employees. The annual report is primarily prepared by management and general personnel, such as the accounting department and executive staff. The activity is coordinated by the public relations department. Internal management memoranda indicate that the purpose of the annual report is to report on how management discharged its stewardship responsibilities, including the university's overall performance, goals, financial position, cash flows, and results of operations. Included in the package containing the annual report are requests for contributions and donor reply cards.

Conclusion

E.53. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.54. The activity has elements of management and general functions. Therefore, no call for specific action is required. Neither of the factors in paragraph .10*a* or .10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be

considered. The purpose criterion is met based on the other evidence, because (a) the employees performing the activity are not members of the fund-raising department and perform other non-fund-raising activities and (b) internal management memoranda indicate that the purpose of the annual report is to fulfill one of the university's management and general responsibilities.

E.55. The audience criterion is met because the audience is selected based on its reasonable potential for use of the management and general component. Although the activity is directed primarily at those who have previously made significant contributions, the audience was selected based on its presumed interest in Entity J's annual report (prior donors who have made significant contributions are likely to have an interest in matters discussed in the annual report).

E.56. The content criterion is met because the activity (distributing annual reports) fulfills one of the entity's management and general responsibilities (reporting concerning management's fulfillment of its stewardship function).

Illustration 11

Facts

E.57. Entity K is an NPO. In accordance with internal management memoranda documenting its policies requiring it to comply with Internal Revenue Service (IRS) regulations, it mails prior donors who have made quid pro quo payments in excess of \$75 documentation required by the IRS. The documentation is included on a perforated piece of paper. The information above the perforation line pertains to the documentation required by the IRS. The information below the perforation line includes a request for contributions and may be used as a donor reply card.

Conclusion

E.58. The purpose, audience, and content criteria are met, and the joint costs should be allocated. (Note that the costs of the information below the perforation line are identifiable with fund raising and therefore should be charged to fund raising.)

E.59. The activity has elements of management and general functions. Therefore, no call for specific action is required. Neither of the factors in paragraph .10a or .10b is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because internal management memoranda indicate that the purpose of the activity is to fulfill one of Entity K's management and general responsibilities.

E.60. The audience criterion is met because the entity is required to direct the management and general component of the activity to the particular audience. Although the activity is directed at those who have previously contributed, the audience was selected based on its need for the documentation.

E.61. The content criterion is met because the activity (sending documentation required by the IRS) fulfills one of the entity's management and general responsibilities (complying with IRS regulations).

Illustration 12

Facts

E.62. Entity L is an animal rights organization. It mails a package of material to individuals included in lists rented from various environmental and

other organizations that support causes that Entity L believes are congruent with its own. In addition to donor response cards and return envelopes, the package includes (a) materials urging recipients to contact their legislators and urge the legislators to support legislation to protect those rights, and (b) postcards addressed to legislators urging support for legislation restricting the use of animal testing for cosmetic products. The mail campaign is part of an overall strategy that includes magazine advertisements and the distribution of similar materials at various community events, some of which are undertaken without fund-raising appeals. The advertising and community events reach audiences similar in size and demographics to the audience reached by the mailing.

Conclusion

E.63. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.64. The activity calls for specific action by the recipient (mailing postcards to legislators urging support for legislation restricting the use of animal testing for cosmetic products) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10a or .10b is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (a) the program component of this activity calls for specific action by the recipient that will help accomplish the entity's mission, and it otherwise conducts the program activity in this illustration without a request for contributions, and (b) performing such programs helps accomplish Entity L's mission.

E.65. The audience criterion is met because the audience (individuals included in lists rented from various environmental and other organizations that support causes that Entity L believes are congruent with its own) is selected based on its ability to take action to assist the entity in meeting the goals of the program component of the activity.

E.66. The content criterion is met because the activity calls for specific action by the recipient (mailing postcards to legislators urging support for legislation restricting the use of animal testing for cosmetic products) that will help accomplish the entity's mission (to protect animal rights), and the need for and benefits of the action are clearly evident (to protect animal rights).

Illustration 13

Facts

E.67. Entity M is a performing arts organization whose mission is to make the arts available to residents in its area. Entity M charges a fee for attending performances and sends advertisements, including subscription forms, for the performances to residents in its area. These advertisements include a return envelope with a request for contributions. Entity M evaluates the effectiveness of the advertising based on the number of subscriptions sold as well as contributions received. In performing that evaluation, Entity M places more weight on the number of subscriptions sold than on the contributions received. Also, Entity M advertises the performances on local television and radio without a request for contributions but on a smaller scale than the mail advertising.

Conclusion

E.68. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.69. The activity calls for specific action by the recipient (attending the performances) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10*a* or .10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (a) the entity measures program results and accomplishments of the joint activity and in evaluating the effectiveness of the activity, the entity places significantly greater weight on the activity's effectiveness in accomplishing program goals than on the activity's effectiveness in raising contributions (Entity M evaluates the effectiveness of the advertising based on the number of subscriptions sold as well as contributions received and places more weight on the number of subscriptions sold than on the contributions received), (b) it otherwise conducts the program activity without a request for contributions, and (c) performing such programs helps accomplish Entity M's mission (to make the arts available to residents in its area).

E.70. The audience criterion is met because the audience (a broad segment of the population in Entity M's area) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

E.71. The content criterion is met because the activity calls for specific action by the recipient (attending the performances) that will help accomplish the entity's mission (making the arts available to area residents), and the need for and benefits of the action are clearly evident (attending the performance is a positive cultural experience). (Note that the purchase of subscriptions is an exchange transaction and, therefore, is not a contribution.)

Illustration 14**Facts**

E.72. Entity N is a university whose mission is to educate the public (students) in various academic pursuits. Entity N's political science department holds a special lecture series in which prominent world leaders speak about current events. The speakers command relatively high fees and, in order to cover costs and make a modest profit, the university sets a relatively expensive fee to attend. However, the tickets are priced at the fair value of the lecture and no portion of the ticket purchase price is a contribution. Entity N advertises the lectures by sending invitations to prior attendees and to prior donors who have contributed significant amounts, and by placing advertisements in local newspapers read by the general public. At some of the lectures, including the lecture being considered in this illustration, deans and other faculty members of Entity N solicit significant contributions from attendees. Other lectures in the series are conducted on a scale similar to the scale of the lecture in this illustration without requesting contributions. Entity N's records indicate that historically 75 percent of the attendees have attended prior lectures. Of the 75 percent who have attended prior lectures, 15 percent have made prior contributions to Entity N. Of the 15 percent who have made prior contributions to Entity N, 5 percent have made contributions in response to solicitations made at the events. (Therefore, one-half of one percent of attendees make contribu-

tions in response to solicitations made at the events. However, those contributions are significant.) Overall, the audience's ability or likelihood to contribute is an insignificant factor in its selection. Entity N evaluates the effectiveness of the activity based on the number of tickets sold, as well as contributions received. In performing that evaluation, Entity N places more weight on the number of tickets sold than on the contributions received.

Conclusion

E.73. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.74. The activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. The purpose criterion is met because (a) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and (b) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (other lectures in the series are conducted on a scale similar to the scale of the lecture in this illustration without requesting contributions).

E.75. The audience criterion is met. The rebuttable presumption that the audience criterion is not met because the audience includes prior donors is overcome in this illustration because the audience (those who have shown prior interest in the lecture series, prior donors, a broad segment of the population in Entity N's area, and those attending the lecture) is also selected for its reasonable potential for use of the program component (attending the lecture). Although the audience may make significant contributions, that was an insignificant factor in its selection.

E.76. The content criterion is met because the activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and the need for and benefits of the action are clearly evident (attending the lecture is a positive educational experience). (Note that the purchase of the tickets is an exchange transaction and, therefore, is not a contribution. As discussed in paragraph .07 of this SOP, costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event, should not be reported as fund raising.¹²)

Illustration 15

Facts

E.77. Entity O is a university whose mission is to educate the public (students) in various academic pursuits. Entity O's political science department holds a special lecture series in which prominent world leaders speak about current events. Admission is priced at \$250, which is above the \$50 fair value of the lecture and, therefore, \$200 of the admission price is a contribution. Therefore, the audience's likelihood to contribute to the entity is a significant factor in its selection. Entity O advertises the lectures by sending invitations

¹² Paragraphs 13.21–13.26 of the Audit and Accounting Guide *Not-for-Profit Organizations* provide guidance concerning reporting special events. [Footnote revised, June 2004, to reflect conforming changes necessary due to conforming changes made to the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*.]

to prior attendees and to prior donors who have contributed significant amounts, and by placing advertisements in local newspapers read by the general public. Entity O presents similar lectures that are priced at the fair value of those lectures.

Conclusion

E.78. The purpose and content criteria are met. The audience criterion is not met. All costs, including those that might otherwise be considered program or management and general costs if they had been incurred in a different activity, except for the costs of the direct donor benefit (the lecture), should be charged to fund raising.

E.79. The activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. The purpose criterion is met because (a) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and (b) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (other lectures in the series are conducted on a scale similar to the scale of the lecture in this illustration without including a contribution in the admission price.)

E.80. The audience criterion is not met. The rebuttable presumption that the audience criterion is not met because the audience is selected based on its likelihood to contribute to the entity is not overcome in this illustration. The fact that the \$250 admission price includes a \$200 contribution leads to the conclusion that the audience's ability or likelihood to contribute is an overwhelmingly significant factor in its selection, whereas there is no evidence that the extent to which the audience is selected for its need to use or reasonable potential for use of the action called for by the program component (attending the lecture) is overwhelmingly significant.

E.81. The content criterion is met because the activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and the need for and benefits of the action are clearly evident (attending the lecture is a positive educational experience). (Note that the purchase of the tickets is an exchange transaction and, therefore, is not a contribution. As discussed in paragraph .07 of this SOP, costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event, should not be reported as fund raising.¹³)

Illustration 16

Facts

E.82. Entity P's mission is to reduce the incidence of illness from ABC disease, which primarily afflicts people over sixty-five years of age. One of Entity P's objectives in fulfilling that mission is to have all persons over sixty-five screened for ABC disease.

E.83. Entity P rents space at events attended primarily by people over sixty-five years of age and conducts free screening for ABC disease. Entity P's

¹³ Paragraphs 13.21–13.26 of the Audit and Accounting Guide *Not-for-Profit Organizations* provide guidance concerning reporting special events. [Footnote revised, June 2004, to reflect conforming changes necessary due to conforming changes made to the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*.]

employees, who are educated about ABC disease and screening procedures and do not otherwise perform fund-raising functions, educate interested parties about the effects of ABC disease and the ease and benefits of screening for it. Entity P also solicits contributions at the events. The effectiveness of the activity is evaluated primarily based on how many screening tests are performed, and only minimally based on contributions raised. The employees are not compensated or evaluated based on contributions raised.

Conclusion

E.84. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.85. The activity calls for specific action by the recipient (being screened for ABC disease) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10a or .10b is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (a) a process exists to evaluate measured program results and accomplishments and in evaluating the effectiveness of the joint activity, the entity places significantly greater weight on the activity's effectiveness in accomplishing program goals than on the activity's effectiveness in raising contributions (Entity P evaluates the effectiveness of the activity based on the number of screening tests conducted as well as contributions received and places more weight on the number of tests conducted than on the contributions received); (b) the qualifications and duties of the personnel performing the activity indicate that it is a program activity (the employees are educated about ABC disease and the testing procedures and do not otherwise perform fund-raising functions); (c) the method of compensation for performing the activity does not indicate that it is a fund-raising activity (the employees are not compensated or evaluated based on contributions raised); and (d) performing such programs helps accomplish Entity P's mission (to prevent ABC disease).

E.86. The audience criterion is met because the audience (people over sixty-five years of age) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

E.87. The content criterion is met because the activity calls for specific action by the recipient (being screened for ABC disease) that will help accomplish the entity's mission (to reduce the incidence of ABC disease), and it explains the need for and benefits of the action (to prevent ABC disease).

Illustration 17

Facts

E.88. Entity Q's mission is to provide cultural and educational television programming to residents in its area. Entity Q owns a public television station and holds a membership drive in which it solicits new members. The drive is conducted by station employees and consists of solicitations that are shown during long breaks between the station's regularly scheduled programs. Entity Q's internal management memoranda state that these drives are designed to raise contributions. Entity Q evaluates the effectiveness of the activity based on the amount of contributions received. Entity Q shows the programs on a

similar scale, without the request for contributions. The audience is members of the general public who watch the programs shown during the drive. Station member benefits are given to those who contribute and consist of tokens of appreciation with a nominal value.

Conclusion

E.89. The purpose, audience, and content criteria are met, and the joint costs should be allocated. (Note that there would be few, if any, joint costs. Costs associated with the fund-raising activities, such as costs of airtime, would be separately identifiable from costs of the program activities, such as licensing costs for a particular television program. Also, note that because no significant benefits or duties are associated with membership, member dues are contributions. Therefore, the substance of the membership-development activities is, in fact, fund raising.)

E.90. The activity calls for specific action by the recipient (watching the television program) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. The purpose criterion is met because (a) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission, and (b) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (Entity Q shows the television programs on a similar scale, without the request for contributions).

E.91. The audience criterion is met. The rebuttable presumption that the audience criterion is not met because the audience is selected based on its likelihood to contribute is overcome in this illustration because the audience (members of the general public who watch the television programs shown during the drive) is also selected for its reasonable potential for use of the program component (watching the television programs). Although the audience may make contributions, that was an insignificant factor in its selection.

E.92. The content criterion is met because the activity calls for specific action by the recipient (watching the television programs) that will help accomplish the entity's mission (providing cultural and educational television programming to residents in its area), and the need for and benefits of the action are clearly evident (watching the programs is a positive cultural and educational experience).

Appendix F

Illustrations of Allocation Methods

F.1. Some commonly used cost allocation methods follow.

Physical Units Method

F.2. Joint costs are allocated to materials and activities in proportion to the number of units of output that can be attributed to each of the materials and activities. Examples of units of output are lines, square inches, and physical content measures. This method assumes that the benefits received by the fund-raising, program, or management and general component of the materials or activity from the joint costs incurred are directly proportional to the lines, square inches, or other physical output measures attributed to each component of the activity. This method may result in an unreasonable allocation of joint costs if the units of output, for example, line counts, do not reflect the degree to which costs are incurred for the joint activity. Use of the physical units method may also result in an unreasonable allocation if the physical units cannot be clearly ascribed to fund raising, program, or management and general. For example, direct mail and telephone solicitations sometimes include content that is not identifiable with fund raising, program, or management and general; or the physical units of such content are inseparable.

Illustration

F.3. Assume a direct mail campaign is used to conduct programs of the entity and to solicit contributions to support the entity and its programs. Further, assume that the appeal meets the criteria for allocation of joint costs to more than one function.

F.4. The letter and reply card include a total of one hundred lines. Forty-five lines pertain to program because they include a call for action by the recipient that will help accomplish the entity's mission, while fifty-five lines pertain to the fund-raising appeal. Accordingly, 45 percent of the costs are allocated to program and 55 percent to fund-raising.

Relative Direct Cost Method

F.5. Joint costs are allocated to each of the components on the basis of their respective direct costs. Direct costs are those costs that are incurred in connection with the multipurpose materials or activity and that are specifically identifiable with a function (program, fund raising, or management and general). This method may result in an unreasonable allocation of joint costs if the joint costs of the materials and activity are not incurred in approximately the same proportion and for the same reasons as the direct costs of the materials and activity. For example, if a relatively costly booklet informing the reader about the entity's mission (including a call for action by the recipient that will help accomplish the entity's mission) is included with a relatively inexpensive fund-raising letter, the allocation of joint costs based on the cost of these pieces may be unreasonable, particularly if the booklet and letter weigh approximately the same and therefore contribute equally to the postage costs.

Illustration

F.6. The costs of a direct mail campaign that can be specifically identified with program services are the costs of separate program materials and a postcard which calls for specific action by the recipient that will help accomplish the entity's mission. They total \$20,000. The direct costs of the fund-raising component of the direct mail campaign consist of the costs to develop and produce the fund-raising letter. They total \$80,000. Joint costs associated with the direct mail campaign total \$40,000 and would be allocated as follows under the relative direct cost method:

Program	$\$20,000/\$100,000 \times \$40,000 = \$8,000$
Fund raising	$\$80,000/\$100,000 \times \$40,000 = \$32,000$

Stand-Alone Joint-Cost-Allocation Method

F.7. Joint costs are allocated to each component of the activity based on a ratio that uses estimates of costs of items included in joint costs that would have been incurred had the components been conducted independently. The numerator of the ratio is the cost (of items included in joint costs) of conducting a single component independently; the denominator is the cost (of items included in joint costs) of conducting all components independently. This method assumes that efforts for each component in the stand-alone situation are proportionate to the efforts actually undertaken in the joint cost situation. This method may result in an unreasonable allocation because it ignores the effect of each function, which is performed jointly with other functions, on other such functions. For example, the programmatic impact of a direct mail campaign or a telemarketing phone message may be significantly lessened when performed in conjunction with a fund-raising appeal.

Illustration

F.8. Assume that the joint costs associated with a direct mail campaign including both program and fund-raising components are the costs of stationery, postage, and envelopes at a total of \$100,000. The costs of stationery, postage, and envelopes to produce and distribute each component separately would have been \$90,000 for the program component and \$70,000 for the fund-raising component. Under the stand-alone joint-cost-allocation method, the \$100,000 in joint costs would be allocated as follows: $\$90,000/\$160,000 \times \$100,000 = \$56,250$ to program services and $\$70,000/\$160,000 \times \$100,000 = \$43,750$ to fund raising.

Appendix G

Illustrations of Disclosures

G.1. The disclosures discussed in paragraphs .18 and .19 are illustrated below. Alternative 1 reports the required and encouraged information in narrative format. Alternative 2 reports that information in tabular format, as well as information concerning joint costs incurred for each kind of activity by functional classification, which is neither required nor encouraged, but which is not prohibited.

Alternative 1

Note X. Allocation of Joint Costs

In 19XX, the organization conducted activities that included requests for contributions, as well as program and management and general components. Those activities included direct mail campaigns, special events, and a telethon. The costs of conducting those activities included a total of \$310,000 of joint costs, which are not specifically attributable to particular components of the activities (joint costs). [**Note to reader:** *The following sentence is encouraged but not required.*] Joint costs for each kind of activity were \$50,000, \$150,000, and \$110,000 respectively. These joint costs were allocated as follows:

Fund raising	\$180,000
Program A	80,000
Program B	40,000
Management and general	10,000
Total	<u>\$310,000</u>

Alternative 2

Note X. Allocation of Joint Costs

In 19XX, the organization conducted activities that included appeals for contributions and incurred joint costs of \$310,000. These activities included direct mail campaigns, special events, and a telethon. Joint costs were allocated as follows:

	<u>Direct Mail</u>	<u>Special Events</u>	<u>Telethon</u>	<u>Total</u>
Fund raising	\$40,000	\$50,000	\$90,000	\$180,000
Program A	10,000	65,000	5,000	80,000
Program B		25,000	15,000	40,000
Management and general		10,000		10,000
Total	<u>\$50,000</u>	<u>\$150,000</u>	<u>\$110,000</u>	<u>\$310,000</u>

[**Note to reader:** *Shading is used to highlight information that is neither required nor encouraged, but which is not prohibited. However, entities may prefer to disclose it. Disclosing the total joint costs for each kind of activity (\$50,000, \$150,000, and \$110,000) is encouraged but not required.*]

Appendix H

Contrast of Guidance in This SOP With the Guidance in SOP 87-2^{14,**}

This SOP

Applies to all entities that solicit contributions, including state and local governments.

Covers *all* costs of joint activities. (Costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, except for costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event [for example, a meal], should be charged to fund raising unless the criteria in the SOP are met.)

Criteria of purpose, audience, and content should all be met in order to charge costs of the activity to program or management and general.

SOP 87-2

Applied to entities that follow the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* or SOP 78-10. (SOP 87-2 was not applicable to entities that are within the scope of Governmental Accounting Standards Board Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*.)

Covers only joint costs of joint activities.

Unclear concerning whether all criteria should be met in order to charge costs of the activity to program or management and general.

(continued)

¹⁴ In August 1996, the AICPA issued the Audit and Accounting Guide *Not-for-Profit Organizations*, which superseded SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, because the guidance in SOP 87-2 is incorporated into paragraphs 13.36 to 13.45 of the Guide. Also, *Not-for-Profit Organizations* superseded the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* and SOP 78-10. *Not-for-Profit Organizations* applies to all nongovernmental not-for-profit organizations other than those required to follow the Audit and Accounting Guide *Health Care Organizations*. Therefore, incorporating the guidance in SOP 87-2 into *Not-for-Profit Organizations* broadened the scope of the guidance previously included in SOP 87-2 to all not-for-profit organizations other than those required to follow *Health Care Organizations*. The discussion in this SOP of SOP 87-2 refers to both SOP 87-2 and the guidance included in paragraphs 13.36 to 13.45 of *Not-for-Profit Organizations*, except that the guidance in *Not-for-Profit Organizations* applies to all not-for-profit organizations other than those required to follow *Health Care Organizations*.

** See footnotes ‡ and †† in paragraphs D.3 and D.4, respectively. [Footnote revised, June 2004, to reflect conforming changes necessary due to the issuance of GASB Statements No. 34 and No. 35.]

This SOP

Neither prescribes nor prohibits any allocation methods. Includes a discussion to help users determine whether an allocation is reasonable, and provides some illustrations.

Requires note disclosures about the types of activities for which joint costs have been incurred, amounts allocated during the period, and amounts allocated to each functional expense or expenditure category.

SOP 87-2

Neither prescribes nor prohibits any allocation methods. No illustrations are provided.

Requires less extensive note disclosures: total amount allocated during the period and amounts allocated to each functional expense category.

Appendix I

Effects on Other Guidance

I.1. For nongovernmental organizations, this Statement of Position (SOP) amends the AICPA Audit and Accounting Guide *Health Care Organizations* and paragraphs 13.35 to 13.44 of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*. [Revised, June 2004, to reflect conforming changes necessary due to conforming changes made to the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*.]

I.2. Also, this SOP amends the AICPA Audit and Accounting Guide *Not-for-Profit Organizations* to clarify that costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund-raising. In particular, paragraphs 13.21, 13.23, and 13.24 of *Not-for-Profit Organizations* are amended as follows:

13.21 Some organizations conduct joint activities⁹ that are special events, including special social and educational events (such as symposia, dinners, dances, and theater parties) in which the attendee receives a direct benefit (for example, a meal or theater ticket). FASB Statement No. 117 requires the reporting of the gross amounts of revenues and expenses from special events and other fund-raising activities that are ongoing major or central activities, but permits (but does not require) reporting net amounts if the receipts and related costs result from special events that are peripheral or incidental activities.

⁹ See footnote 1.

13.23 For example, assume that an organization has a special event that is an ongoing and major activity with a ticket price of \$100. Assume that the activity does not meet the audience criterion in SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*, and, therefore, all costs of the activity, other than the direct donor benefits, should be reported as fund raising. The event includes a dinner that costs the organization \$25 and that has a fair value of \$30. (Chapter 5, “Contributions Received and Agency Transactions,” of this Guide, discusses the appropriate reporting if the meal or other items of value are donated to the organization for resale.) In addition, the organization incurs other direct costs of the event in connection with promoting and conducting the event, including incremental direct costs incurred in transactions with independent third parties and the payroll and payroll-related costs for the activities of employees who are directly associated with, and devote time to, the event. Those other direct costs, which include (a) \$5 that otherwise might be considered management and general costs if they had been incurred in a different activity, and (b) fund-raising costs of \$10, are unrelated to the direct benefits to donors and, accordingly, should not be included as costs of benefits to donors. In addition, the organization has the following transactions, which are unrelated to the special event: unrestricted contributions of \$200, program expenses of \$60, management and general expenses of \$20, and fund-raising expenses of \$20.

13.24 Some ways in which the organization could display the results of the special event as part of its statement of activities are illustrated as follows:

Statements of Position

Illustration 1

Changes in unrestricted net assets:		
Contributions		\$200
Special event revenue	100	
Less: Costs of direct benefits to donors	<u>(25)</u>	
Net revenues from special events		<u>75</u>
Contributions and net revenues from special events		275
Other expenses:		
Program		60
Management and general		20
Fund raising		<u>35</u>
Total other expenses		<u>115</u>
Increase in unrestricted net assets		<u>\$160</u>

Illustration 2

Changes in unrestricted net assets:		
Revenues:		
Contributions		\$200
Special event revenue		<u>100</u>
Total revenues		300
Expenses:		
Program		60
Costs of direct benefits to donors		25
Management and general		20
Fund raising		<u>35</u>
Total expenses		<u>140</u>
Increase in unrestricted net assets		<u>\$160</u>

Illustration 3

Changes in unrestricted net asset:		
Contributions		\$270
Dinner sales		30
Less: Costs of direct benefits to donors		<u>(25)</u>
Gross profit on special events		<u>5</u>
Contributions and net revenues from special events		275
Other expenses:		
Program		60
Management and general		20
Fund raising		<u>35</u>
Total other expenses		<u>115</u>
Increase in unrestricted net assets		<u>\$160</u>

[Revised, June 2004, to reflect conforming changes necessary due to conforming changes made to the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*.]

I.3. For governmental entities that have applied the accounting and financial reporting principles in SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*, or the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* (modified by all applicable Financial Accounting Standards Board [FASB] pronouncements issued through November 30, 1989, and by most applicable Governmental Accounting Standards Board [GASB] pronouncements) in conformity with GASB Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*, this SOP amends the principles—based on SOP 78-10 and *Audits of Voluntary Health and Welfare Organizations*, as modified—that those entities apply. For governmental entities that have applied the accounting and financial reporting principles in the 1973 AICPA Industry Audit Guide *Audits of Colleges and Universities*, as amended by SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*, and as modified by applicable FASB pronouncements issued through November 30, 1989, and all applicable GASB pronouncements in conformity with GASB Statement No. 15, *Governmental College and University Accounting and Financial Reporting Models*, this SOP amends the principles—based on *Audits of Colleges and Universities*, as amended and modified—that those entities apply. For other governmental organizations, this SOP amends the Audit and Accounting Guide *Audits of State and Local Governmental Units*.^{††}

^{††} See footnotes ‡ and || in paragraphs D.3 and D.4, respectively. Also, the AICPA Audit and Accounting Guide *State and Local Governments* supersedes the 1994 AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* and subsequent editions of that Guide with conforming changes made by the AICPA staff. The AICPA Audit and Accounting Guide *State and Local Governments* provides guidance on the application of this SOP to state and local governments. [Footnote added, June 2004, to reflect conforming changes necessary due to the issuance of GASB Statements No. 34, No. 35, and the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*.]

Glossary

Activities. Activities are efforts to accomplish specific objectives. Some activities include producing and distributing materials. For example, if an entity undertakes a mass mailing that includes a letter and a pamphlet, producing and distributing the letter and pamphlet are part of the activity. Other activities may include no materials, such as an annual dinner or a radio commercial.

Compensation or fees. Reciprocal transfers of cash or other assets in exchange for services performed.

Contributions. Contributions are unconditional transfers of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner.

Costs of joint activities. Costs of joint activities are costs incurred for a joint activity. Costs of joint activities may include joint costs and costs other than joint costs. Costs other than joint costs are costs that are identifiable with a particular function, such as fund raising, program, management and general, and cost of sales. For example, some costs incurred for printing, paper, professional fees, and salaries to produce donor cards are not joint costs, although they may be incurred in connection with conducting joint activities.

Fund-raising activities. Fund-raising activities are activities undertaken to induce potential donors to contribute money, securities, services, materials, facilities, other assets, or time. They include publicizing and conducting fund-raising campaigns; maintaining donor mailing lists; conducting special fund-raising events; preparing and distributing fund-raising manuals, instructions, and other materials; and conducting other activities involved with soliciting contributions from individuals, foundations, governments, and others.

Help accomplish the entity's mission. Actions that help accomplish the entity's mission are actions that either benefit the recipient (such as by improving the recipient's physical, mental, emotional, or spiritual health and well-being) or benefit society (by addressing societal problems).

Joint activity. A joint activity is an activity that is part of the fund-raising function and has elements of one or more other functions, such as program, management and general, membership development, or any other functional category used by the entity.

Joint costs. Joint costs are the costs of conducting joint activities that are not identifiable with a particular component of the activity. For example, the cost of postage for a letter that includes both fund-raising and program components is a joint cost. Joint costs may include the costs of salaries, contract labor, consultants, professional fees, paper, printing, postage, event advertising, telephones, airtime, and facility rentals.

Management and general activities. Management and general activities are those that are not identifiable with a single program, fund-raising activity, or membership-development activity but that are indispensable to the conduct of those activities and to an organization's existence. They

include oversight, business management, general recordkeeping, budgeting, financing, soliciting revenue from exchange transactions, such as government contracts and related administrative activities, and all management and administration except for direct conduct of program services or fund-raising activities. Disseminating information to inform the public of the organization's "stewardship" of contributed funds, announcements concerning appointments, and the annual report, among other activities, are management and general activities, as are soliciting funds other than contributions, including exchange transactions (whether program-related or not).

Medium. A medium is a means of mass communication, such as direct mail, direct response advertising, or television.

Membership-development activities. Membership-development activities include soliciting for prospective members and membership dues, membership relations, and similar activities. If there are no significant benefits or duties connected with membership, however, the substance of membership-development activities may, in fact, be fund-raising.

Program activities. Program activities are the activities that result in goods or services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the organization exists. Those services are the major purpose for and the major output of the organization and often relate to several major programs. For example, a large university may have programs for student instruction, research, and patient care, among others. Similarly, a health and welfare organization may have programs for health and family services, research, disaster relief, and public education, among others.

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IP Section 13,000

Issues Papers of the Accounting Standards Division

Issues Papers of the AICPA's Accounting Standards Division are developed primarily to identify financial accounting and reporting issues the division believes need to be addressed or clarified by the Financial Accounting Standards Board. Issues Papers present neutral discussions of the issues identified, including reviews of pertinent existing literature, current practice, and relevant research, as well as arguments on alternative solutions. Issues Papers normally include advisory conclusions that represent the views of at least a majority of the Institute's Accounting Standards Executive Committee.

Issues Papers do not establish standards of financial accounting enforceable under Rule 203 of the Institute's Code of Professional Conduct.

<u>Title</u>	<u>Date Issued</u>
Accounting for Termination Indemnities (superseded by FASB Statement No. 88, <i>Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits</i>)	12/12/78
Accounting for Changes in Estimates	12/15/78
Accounting for Involuntary Conversions (superseded by FASB Interpretation No. 30, <i>Accounting for Involuntary Conversions of Nonmonetary Assets to Monetary Assets</i>)	12/20/78
Accounting for Time Paid But Not Worked (superseded by FASB Statement No. 43, <i>Accounting for Compensated Absences</i>)	1/11/79
The Meaning of "In Substance a Repossession or Foreclosure" and Accounting for Partial Refinancing of Troubled Real Estate Loans Under FASB Statement No. 15 (superseded by AICPA Practice Bulletin No. 7, <i>Criteria for Determining Whether Collateral for a Loan Has Been In-Substance Foreclosed</i>)	1/15/79
Personal Financial Statements (superseded by AICPA <i>Personal Financial Statements Guide</i>)	2/26/79
Project Financing Arrangements (superseded by FASB Statement No. 47, <i>Disclosure of Long-Term Obligations</i>)	2/26/79
Real Estate ADC Costs (superseded by FASB Statement No. 66, <i>Accounting for Sales of Real Estate</i>)	4/27/79

<u>Title</u>	<u>Date Issued</u>
Accounting for Allowances for Losses on Certain Real Estate and Loans and Receivables Collateralized by Real Estate	6/21/79
Joint Venture Accounting	7/17/79
Accounting for Repurchase, Reverse Repurchase, Dollar Repurchase, and Dollar Reverse Repurchase Agreements for Savings and Loans (incorporated into the AICPA Audit and Accounting Guide <i>Audits of Savings Institutions</i>)	8/7/79
Accounting by Investors for Distributions Received in Excess of Their Investment in a Joint Venture (An Addendum to the July 17, 1979 Issues Paper on Joint Venture Accounting)	10/8/79
Accounting for Grants Received From Governments (superseded by IASC International Accounting Standard No. 20, <i>Accounting for Government Grants and Disclosure of Government Assistance</i>)	10/16/79
“Push Down” Accounting	10/30/79
Mortgage Guaranty Insurance (superseded by FASB Statement No. 60, <i>Accounting and Reporting by Insurance Enterprises</i>)	1/8/80
Accounting for Vested Pension Benefits Existing or Arising When a Plant is Closed or a Business Segment is Discontinued (superseded by FASB Statement No. 87, <i>Employers’ Accounting for Pensions</i>)	2/5/80
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Accounting for the Inability to Fully Recover the Carrying Amounts of Long Lived Assets (superseded by FASB Statement No. 121, <i>Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of</i>)	7/15/80
Intangibles in the Motor Carrier Industry (superseded by FASB Statement No. 44, <i>Accounting for Intangible Assets of Motor Carriers</i>)	8/13/80
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Sales of Timesharing Interests in Real Estate (superseded by FASB Statement No. 67, <i>Accounting for Costs and Initial Rental Operations of Real Estate Projects</i>)	4/10/81

<u>Title</u>	<u>Date Issued</u>
Accounting for Installment Lending Activities of Finance Companies (incorporated into the AICPA Audit and Accounting Guide <i>Audits of Finance Companies (including Independent and Captive Financing Activities of Other Companies)</i>)	6/25/81
Accounting for Agricultural Producers and Agricultural Cooperatives (superseded by SOP 85-3, <i>Accounting by Agricultural Producers and Agricultural Cooperatives</i> [see section 10,390])	7/13/81
Accounting for Joint Costs of Multipurpose Informational Materials and Activities of Nonprofit Organizations (superseded by AICPA SOP No. 87-2, <i>Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal</i>)	7/16/81
Bulk Purchases of Mortgages (superseded by FASB Statement No. 65, <i>Accounting for Certain Mortgage Banking Activities</i>)	8/3/81
Depreciation of Income Producing Real Estate	11/16/81
Accounting for Medical Malpractice Loss Contingencies (Asserted and Unasserted Claims) and Related Issues of Health Care Providers (superseded by SOP 87-1, <i>Accounting for Asserted and Unasserted Medical Malpractice Claims of Health Care Providers and Related Issues</i> [SOP 87-1 was subsequently superseded by the AICPA Audit and Accounting Guide <i>Audits of Providers of Health Care Services</i>])	8/13/82
The Acceptability of "Simplified LIFO" for Financial Reporting Purposes	10/14/82
Financial Reporting by Health Care Entities of the Proceeds of Tax Exempt Bonds and Funds Limited as to Use (incorporated into the AICPA Audit and Accounting Guide <i>Audits of Providers of Health Care Services</i>)	11/1/82
Accounting for Employee Capital Accumulation Plans	11/4/82
Accounting for Nonrefundable Fees of Originating or Acquiring Loans and Acquisition Costs of Loan and Insurance Activities (superseded by FASB Statement No. 91, <i>Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases</i>)	9/20/83
Accounting for Costs of Software for Sale or Lease (superseded by FASB Statement No. 86, <i>Accounting for Costs of Computer Software to be Sold, Leased, or Otherwise Marketed</i>)	2/17/84
Computation of Premium Deficiencies in Insurance Enterprises	3/26/84

<u>Title</u>	<u>Date Issued</u>
Accounting for Income Taxes of Stock Life Insurance Companies (superseded by FASB Technical Bulletin No. 84-3, <i>Accounting for the Effects of the Tax Reform Act on Deferred Income Taxes of Stock Life Insurance Enterprises</i>)	7/12/84
Accounting for Key Person Life Insurance (superseded by FASB Technical Bulletin No. 85-4, <i>Accounting for Purchases of Life Insurance</i>)	10/31/84
Accounting by Stock Life Insurance Companies for Annuities, Universal Life, and Related Products and Accounting for Nonguaranteed-Premium Products	11/5/84
Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories	11/30/84
Accounting for Loss Portfolio Transfers-Letter	1/16/85
Accounting by Health and Maintenance Organizations and Associated Entities (superseded by AICPA SOP 89-5, <i>Financial Accounting and Reporting by Providers of Prepaid Health Care Services</i>)	6/28/85
Accounting for Estimated Credit Losses on Loan Portfolios (incorporated into the AICPA Audit and Accounting Guide <i>Audits of Finance Companies (including Independent and Captive Financing Activities of Other Companies)</i>)	2/14/86
Accounting for Options	3/6/86
Software Revenue Recognition (superseded by AICPA SOP 91-1, <i>Software Revenue Recognition</i> [AICPA SOP 91-1 was subsequently superseded by AICPA SOP 97-2, <i>Software Revenue Recognition</i> ; see section 10,700])	4/21/87
The Use of Discounting in Financial Reporting for Monetary Items With Uncertain Terms Other Than Those Covered by Existing Authoritative Literature (see the FASB Discussion Memorandum on interest rates discounting)	9/9/87
Quasi Reorganizations	10/28/88

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STATEMENT OF POSITION AUDITING AND ATTESTATION

Introduction

Auditing and Attestation Statements of Position (SOPs) are issued to achieve one or more of several objectives: to revise, clarify, or supplement guidance in previously issued Audit and Accounting Guides; to describe and provide implementation guidance for specific types of audit and attestation engagements; or to provide guidance on specialized areas in audit and attestation engagements.

Auditing SOPs

An auditing SOP is recognized as an interpretive publication as defined in AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*). Interpretive publications are recommendations on the application of generally accepted auditing standards (GAAS) in specific circumstances, including engagements for entities in specialized industries.

An interpretive publication is issued under the authority of the AICPA Auditing Standards Board (ASB) after all ASB members have been provided an opportunity to consider and comment on whether the proposed interpretive publication is consistent with GAAS. The members of the ASB have found this SOP to be consistent with existing GAAS.

Although interpretive publications are not auditing standards, AU-C section 200 requires the auditor to consider applicable interpretive publications in planning and performing the audit because interpretive publications are relevant to the proper application of GAAS in specific circumstances. If the auditor does not apply the auditing guidance in an applicable interpretive publication, the auditor should document how the requirements of GAAS were complied with in the circumstances addressed by such auditing guidance.

Attestation SOPs

An attestation SOP is recognized as an attestation interpretation as defined in AT section 50, *SSAE Hierarchy* (AICPA, *Professional Standards*). Attestation interpretations are recommendations on the application of Statements on Standards for Attestation Engagements (SSAEs) in specific circumstances, including engagements for entities in specialized industries. Attestation interpretations are issued under the authority of the ASB. The members of the ASB have found this SOP to be consistent with existing SSAEs.

A practitioner should be aware of and consider attestation interpretations applicable to his or her attestation engagement. If the practitioner does not apply the guidance included in this SOP, the practitioner should be prepared to explain how he or she complied with the SSAE provisions of this SOP.

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AUD Section 14,000

STATEMENTS OF POSITION AUDITING AND ATTESTATION

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Section 14,250

Statement of Position 92-8 Auditing Property/Casualty Insurance Entities' Statutory Financial Statements—Applying Certain Requirements of the NAIC Annual Statement Instructions

October, 1992

NOTE

This AICPA Statement of Position (SOP) has been developed by the AICPA Insurance Companies Committee to provide guidance regarding the audit of property/casualty insurance entities' statutory financial statements in applying certain requirements of the National Association of Insurance Commissioners' Annual Statement Instructions.

This SOP is recognized as an interpretive publication as defined in AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*). Interpretive publications are recommendations on the application of generally accepted auditing standards (GAAS) in specific circumstances, including engagements for entities in specialized industries.

An interpretive publication is issued under the authority of the AICPA Auditing Standards Board (ASB) after all ASB members have been provided an opportunity to consider and comment on whether the proposed interpretive publication is consistent with GAAS. The members of the ASB have found this SOP to be consistent with existing GAAS.

Although interpretive publications are not auditing standards, AU-C section 200 requires the auditor to consider applicable interpretive publications in planning and performing the audit because interpretive publications are relevant to the proper application of GAAS in specific circumstances. If the auditor does not apply the auditing guidance in an applicable interpretive publication, the auditor should document how the requirements of GAAS were complied with in the circumstances addressed by such auditing guidance.

Applicability

.01 This statement of position (SOP) provides guidance on the impact of certain requirements of the National Association of Insurance Commissioners' (NAIC's) Annual Statement Instructions—Property and Casualty on the auditor's procedures in the audit of statutory financial statements of property/casualty insurance entities.

Introduction

.02 The NAIC's Annual Statement Instructions direct property/casualty insurers to require their independent certified public accountants to subject the current Schedule P-Part 1 (excluding those amounts related to bulk and incurred-but-not-reported [IBNR] reserves and claim counts) to the auditing

procedures applied in the audit of the current statutory financial statements to determine whether Schedule P-Part 1 is fairly stated in all material respects in relation to the basic statutory financial statements taken as a whole. Schedule P-Part 1 includes Part 1-Summary and Part 1A-1R.

.03 Although no separate report on Schedule P-Part 1 is required by the NAIC, the provisions of AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*), and the provisions of this SOP apply when information in Schedule P-Part 1 is subjected to auditing procedures applied in the audit of the basic statutory financial statements. The requirements of this SOP do not preclude an auditor from issuing a report similar to those illustrated in paragraph .A17 of AU-C section 725. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2010, to reflect conforming changes necessary due to the issuance of SAS Nos. 118–120. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

Auditing Procedures

.04 Certain of the information in Schedule P-Part 1 is typically subjected to auditing procedures applied in the audit of the basic statutory financial statements (for example, premiums earned and losses paid). Other information not directly related to the basic statutory financial statements is also presented (for example, lines of business classifications for immaterial lines). Although such information may not have been subjected to auditing procedures applied in the audit of the basic statutory financial statements in all instances, such information may have been derived from accounting records that have been tested by the auditor.

.05 Paragraph .A5 of AU-C section 725 states that although an auditor has no obligation to apply auditing procedures to supplementary information presented outside the basic financial statements, the auditor may choose to modify or redirect certain of the procedures to be applied in the audit of the basic financial statements so that the auditor may express an opinion on the supplementary information in relation to the financial statements as a whole. [Revised, December 2010, to reflect conforming changes necessary due to the issuance of SAS Nos. 118–120. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.06 Chapter 4, “The Loss Reserving and Claims Cycle,” of the AICPA Audit and Accounting Guide *Property and Liability Insurance Entities* (the guide), addresses auditing the claims data base, and is applicable when applying auditing procedures to the information presented in Schedule P-Part 1. Chapter 4 also provides a comprehensive discussion of auditing loss reserves and the claims cycle. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.07 As stated in chapter 4 of the guide, because claim data and characteristics such as dates and types of loss can significantly influence reserve estimation, the auditor should test the completeness, accuracy, and classification of the claim loss data during the audit of the statutory financial statements. In extending those procedures to Schedule P-Part 1, the auditor should determine that

- a. The data presented on Schedule P-Part 1 is properly reconciled to the statistical records of the company.

- b. Changes between the prior-year and current-year Schedule P-Part 1 are properly reconciled to the current-year audited statutory financial statements.
- c. The source of the data for the auditing procedures applied to the claim loss and loss adjustment expense data during the current calendar year (for example, tests of payments on claims for all accident years that were paid during the current calendar year) is the same as (or reconciles to) the statistical records that support the data presented on Schedule P-Part 1.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.08 If, as a result of the procedures performed during the audit of the statutory financial statements, the auditor concludes, on the basis of facts known to the auditor, that Schedule P-Part 1 is materially misstated in relation to the basic financial statements as a whole, the auditor should communicate to the company's management and the opining actuary that Schedule P-Part 1 is not fairly stated and should describe the misstatement. If the company will not agree to revise Schedule P-Part 1, the auditor should issue a report on Schedule P-Part 1 and should include a description of the misstatement in that report. (The auditor should refer to AU-C section 725 when a report will be issued.) The auditor should consider the impact of a misstatement in Schedule P-Part 1 on the auditor's report on the statutory financial statements. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2010, to reflect conforming changes necessary due to the issuance of SAS Nos. 118–120. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

Effective Date

.09 This SOP is effective for audits of statutory-basis financial statements of property/casualty insurance entities for periods ending after December 15, 1992.

Insurance Companies Committee (1991–1992)

JOHN T. BAILY, <i>Chairman</i>	ROBERT W. GRANOW
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Statements of Position

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Section 14,350

Statement of Position 99-1 Guidance to Practitioners in Conducting and Reporting on an Agreed-Upon Procedures Engagement to Assist Management in Evaluating the Effectiveness of Its Corporate Compliance Program

May 21, 1999

NOTE

This AICPA Statement of Position (SOP) has been developed by the AICPA Health Care Pilot Task Force of the AICPA Auditing Standards Board (ASB) to provide guidance regarding the application of Statements on Standards for Attestation Engagements (SSAEs) to agreed-upon procedures attestation engagements performed to assist a health care provider in evaluating the effectiveness of its corporate compliance program consistent with the requirements of a Corporate Integrity Agreement entered into with the Office of Inspector General of the U.S. Department of Health and Human Services.

This SOP is recognized as an attestation interpretation as defined in AT section 50, *SSAE Hierarchy* (AICPA, *Professional Standards*). Attestation interpretations are recommendations on the application of SSAEs in specific circumstances, including engagements for entities in specialized industries. Attestation interpretations are issued under the authority of the ASB. The members of the ASB have found this SOP to be consistent with existing SSAEs.

A practitioner should be aware of and consider attestation interpretations applicable to his or her attestation engagement. If the practitioner does not apply the guidance included in this SOP, the practitioner should be prepared to explain how he or she complied with the SSAE provisions of this SOP.

Summary

This Statement of Position (SOP) provides guidance to practitioners in conducting and reporting on an agreed-upon procedures engagement performed pursuant to the AICPA Statements on Standards for Attestation Engagements (SSAEs) to assist a health care provider in evaluating the effectiveness of its corporate compliance program consistent with the requirements of a Corporate Integrity Agreement (CIA) entered into with the Office of Inspector General (OIG) of the U.S. Department of Health and Human Services. CIAs are specific to the entity involved; consequently, users of this SOP should be familiar with the specific requirements of the entity's CIA.

Introduction and Background

.01 Within the past several years, the health care industry has experienced a significant increase in the number and magnitude of allegations of fraud and abuse involving federal health care programs (for example, Medicare and Medicaid) and private health care insurance. These allegations have

triggered regulatory scrutiny, litigation, significant monetary settlements, and negative publicity related to—among other things—coding and billing practices, patient referrals, cost reporting, quality of care, and clinical practices. Typically, as part of the global resolution of these allegations, the entity enters into a CIA with the OIG of the U.S. Department of Health and Human Services. Such agreements require that management annually report on its compliance with the terms of the CIA and that there be an assessment of the entity's compliance with the CIA. This assessment includes a billing analysis, which may be performed by an independent review organization (such as a practitioner or consultant) or the provider (if permitted by the OIG), and an agreed-upon procedures engagement.

.02 This SOP provides guidance to practitioners in conducting and reporting on an agreed-upon procedures engagement performed pursuant to the AICPA Statements on Standards for Attestation Engagements to assist an entity in evaluating the effectiveness of its corporate compliance program consistent with the requirements of a CIA.¹ The terms of a CIA are unique to the entity; consequently, users of this SOP need to be familiar with the actual CIA and its requirements.

.03 This SOP applies to agreed-upon procedures engagements to assist in evaluating an entity's compliance for a specified period. Such engagements should follow the AICPA attestation standards, including AT section 201, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*), and the applicable sections of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*), and AT section 601, *Compliance Attestation* (AICPA, *Professional Standards*). The engagement should be conducted in accordance with standards established by the AICPA, including the criteria set forth in this SOP. However, this SOP is not intended to provide all the required criteria set forth in individual CIAs, nor all the applicable standards established by the AICPA. Additionally, the SOP contains some guidance that may be applied in evaluating an organization's corporate compliance program, even though the program was not imposed by a CIA.

Overview of a Typical Corporate Integrity Agreement

.04 A CIA is an agreement between a health care provider and the OIG in conjunction with a global settlement of a fraud investigation. Such an agreement typically seeks to establish a compliance program within the health care provider (for example, hospital, clinical lab, physician group) that will promote compliance with the requirements of Medicare, Medicaid, and all other federal health care programs.

.05 CIAs are case-specific. Their terms are tailored to address the organizational and operating deficiencies related to providing and billing for health care services that have been identified by the OIG, the entity, or others. Detailed compliance requirements are imposed as a condition for continued participation in federal health care programs. A sample CIA, provided by the OIG and

¹ The practitioner also might be engaged to assist in other areas beyond an agreed-upon procedures engagement such as providing consulting services in connection with evaluating the company's billing practices, policies, and procedures as required by the CIA or in implementing, assessing, and reporting on voluntarily adopted compliance programs. In addition, the practitioner may assist in preparing an entity's self-disclosure reports to federal health agencies related to billing errors and other compliance matters. Similarly, practitioners may be involved in an entity's preparation of government-required (but not CIA-imposed) compliance reporting (for example, contract requirements for Medicare part C) beyond an agreed-upon procedures engagement.

intended to identify potential requirements, is included in appendix A [paragraph .32], “Sample Corporate Integrity Agreement Between the Office of Inspector General of the Department of Health and Human Services and [Provider].” Typical agreements cover five years and require the entity to address the following areas:

- Appointment of a compliance officer and establishment of a compliance committee
- Establishment of a code of conduct
- Establishment of policies and procedures regarding the compliance program
- Development of an information and education program as to the CIA requirements, compliance program and code of conduct
- Annual assessment of billing policies, procedures, and practices
- Establishment of a confidential disclosure program
- Prohibition of employment of excluded or convicted persons
- Notification to OIG of investigation or legal proceedings
- Reporting of credible evidence of misconduct
- Notifications to OIG of new provider locations
- Provision of implementation and annual reports
- Proper notification and submission of required reports
- Granting of OIG access to documents and individuals to conduct assessments
- Documentation of record retention requirements
- Awareness of disclosure criteria
- Agreement to comply with certain default provisions, penalties, and remedies
- Review of rights as to dispute resolution
- Review of effective and binding agreement clauses

Conditions for Engagement Performance

.06 A practitioner may perform an agreed-upon procedures engagement related to management’s compliance with a CIA if all of the conditions specified in AT sections 201 and 601 are met.

.07 As discussed more fully in the AT sections identified in paragraph .06, management’s assertions as to its compliance must be capable of evaluation against reasonable criteria that either have been established by a recognized body or are stated in or attached to the practitioner’s report in a sufficiently clear and comprehensive manner. Generally, to avoid confusion, management’s assertions, which are based on the specific terms of its CIA, should be attached to the practitioner’s report. If the entity is not required to have a CIA, management may develop its assertions using the model CIA. A sample based on the model CIA, which is not meant to be all-inclusive, is included as appendix B (paragraph .33), “Sample Statement of Management’s Assertions.” [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Establishing an Understanding With the Client

.08 The practitioner should document the understanding in the working papers, preferably through a written communication with the client, such as an engagement letter. Appendix C [paragraph .34], “Sample Engagement Letter,” contains a sample engagement letter that may be used for this kind of engagement.

Responsibilities of Specified Parties

.09 AT section 201 identifies the users of an agreed-upon procedures report as specified parties. The specified parties to the agreed upon procedures report described in this SOP typically would be the management of the health care provider and the OIG. Management is responsible for ensuring that the entity complies with the requirements of the CIA. That responsibility encompasses (a) identifying applicable compliance requirements, (b) establishing and maintaining internal control policies and procedures to provide reasonable assurance that the entity complies with those requirements, (c) evaluating and monitoring the entity’s compliance, and (d) preparing reports that satisfy legal, regulatory, or contractual requirements. Management’s evaluation may include documentation such as accounting or statistical data, policy manuals, accounting manuals, narrative memoranda, procedural write-ups, flowcharts, completed questionnaires, internal auditors’ reports, and other special studies or analyses. The form and extent of documentation will vary depending on the nature of the compliance requirements and the size and complexity of the entity. Management may engage the practitioner to gather information to assist it in evaluating the entity’s compliance. Regardless of the procedures performed by the practitioner, management must accept responsibility for its assertions and must not base such assertions solely on the practitioner’s procedures. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.10 The specified parties are responsible for the sufficiency (nature, timing, and extent) of the agreed-upon procedures because they best understand their own needs. The specified parties assume the risk that such procedures might be insufficient for their purposes. In addition, the specified parties assume the risk that they might misunderstand or otherwise inappropriately use findings properly reported by the practitioner. Use of an agreed-upon procedures report is restricted to the specified parties. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Practitioner’s Responsibilities

.11 The objective of the practitioner’s agreed-upon procedures is to present specific findings to assist the specified parties in evaluating an entity’s compliance with the requirements specified in the CIA. (See appendix D [paragraph .35], “Sample Procedures.”) [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.12 The practitioner’s procedures generally may be as limited or extensive as the specified parties desire, as long as the specified parties agree upon the procedures performed or to be performed and take responsibility for the sufficiency of the agreed-upon procedures for their purposes. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.13 To satisfy the requirements that the practitioner and the specified parties agree upon the procedures performed or to be performed and that the specified parties take responsibility for the sufficiency of the agreed-upon procedures for their purposes, ordinarily the practitioner should communicate directly with and obtain affirmative acknowledgment from each of the specified parties. For the purposes of these engagements, an effective way to obtain this agreement ordinarily is to distribute a draft of the report, detailing the procedures, that is expected to be issued to the OIG with a request for any comments it may have. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.14 To avoid possible misunderstandings, the practitioner should circulate the draft with a legend stating that these are the procedures expected to be performed, and unless informed otherwise, the practitioner assumes that there are no additional procedures that he or she is expected to perform. A legend such as the following might be used.

This draft is furnished solely for the purpose of indicating the form of report that we would expect to be able to furnish pursuant to the request by Management of [Provider] for our performance of limited procedures relating to [Provider's] compliance with the Corporate Integrity Agreement with the Office of Inspector General (OIG) of the U.S. Department of Health and Human Services. Based on our discussions with [Provider], it is our understanding that the procedures outlined in this draft report are those we are expected to follow. Unless informed otherwise within ninety (90) days of this transmittal, we shall assume that there are no additional procedures that we are expected to follow. The text of the definitive report will depend, of course, on the results of the procedures.

Involvement of a Specialist²

.15 The practitioner's education and experience enable him or her to be knowledgeable about business matters in general, but he or she is not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation. In certain circumstances, it may be appropriate to involve a specialist to assist the practitioner in the performance of one or more procedures. The following are examples:

- An attorney might provide assistance concerning the application of laws, regulations, or rules to a client's situation.
- A medical specialist might provide assistance in understanding the characteristics of diagnosis codes documented in patient medical records.

.16 The practitioner and the specified parties should agree to the involvement of a specialist in assisting a practitioner in the performance of an agreed-upon procedures engagement. This agreement may be reached when obtaining agreement on the procedures performed or to be performed and acknowledgment of responsibility for the sufficiency of the procedures, as discussed previously. The practitioner's report should describe the nature of the assistance provided by the specialist. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

² A *specialist* is a person (or firm) possessing special skill or knowledge in a particular field other than the attest function. As used herein, a specialist does not include a person employed by the practitioner's firm who participates in the attestation engagement.

.17 A practitioner may agree to apply procedures to the report or work product of a specialist that does not constitute assistance by the specialist to the practitioner in an agreed-upon procedures engagement. For example, the practitioner may make reference to information contained in a report of a specialist in describing an agreed-upon procedure. However, it is inappropriate for the practitioner to agree to merely read the specialist's report solely to describe or repeat the findings, or to take responsibility for all or a portion of any procedures performed by a specialist or the specialist's work product.

Internal Auditors and Other Personnel³

.18 The agreed-upon procedures to be enumerated or referred to in the practitioner's report are to be performed entirely by the practitioner except as discussed in paragraphs .16–.18 of this SOP. However, internal auditors or other personnel may prepare schedules, accumulate data, perform an internal assessment of management's compliance, or provide other information for the practitioner's use in performing the agreed-upon procedures.

.19 A practitioner may agree to perform procedures on information documented in the working papers of internal auditors. For example, the practitioner may agree to

- repeat all or some of the procedures.
- determine whether the internal auditors' working papers contain documentation of procedures performed and whether the findings documented in the working papers are presented in a report by the internal auditors.

.20 However, it is inappropriate for the practitioner to

- agree to merely read the internal auditor's report solely to describe or repeat its findings.
- take responsibility for all or a portion of any procedures performed by internal auditors by reporting those findings as the practitioner's own.
- report in any manner that implies shared responsibility for the procedures with the internal auditors.

Planning the Engagement

.21 Planning an agreed-upon procedures engagement involves working with the specified parties to develop an overall strategy for the expected conduct and scope of the engagement. To develop such a strategy, practitioners should have adequate technical training and proficiency in the attestation standards and have adequate knowledge in health care regulatory matters to enable them to sufficiently understand the events, transactions, and practices that, in their judgment, have a significant effect on the presentation of the assertions. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

³ AU-C section 610, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*), does not apply to agreed-upon procedures engagements. [Footnote revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

Documentation

.22 The practitioner should prepare and maintain attest documentation, the form and content of which should be designed to meet the circumstances of the particular attest engagement. Attest documentation is the principal record of attest procedures applied, information obtained, and conclusions or findings reached by the practitioner in the engagement. The quantity, type, and content of attest documentation are matters of the practitioner's professional judgment and are discussed in paragraphs .100–.103 of AT section 101. Paragraphs .104–.107 of AT section 101 present further requirements and guidance regarding attest documentation. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.23 Concern over access to the practitioner's documentation might cause some clients to inquire about documentation requirements. In situations where the practitioner is requested to not maintain copies of certain client documentation, or to not prepare and maintain documentation similar to client documents, the practitioner may refer to Interpretation No. 1, "The Effect of an Inability to Obtain Audit Evidence Relating to Income Tax Accruals," of AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*, AU-C sec. 9500 par. .01–.22), for guidance. See Interpretation No. 4, "Providing Access to or Copies of Attest Documentation to a Regulator," of AT section 101 (AICPA, *Professional Standards*, AT sec. 9101 par. .43–.46), for guidance related to providing access to or copies of attest documentation to a regulator in connection with work performed on an attestation engagement. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

Management's Representations

.24 The practitioner should obtain written representation from management on various matters including the following:

- a. Acknowledging management's responsibility for complying with the CIA
- b. Acknowledging management's responsibility for establishing and maintaining effective internal control over compliance
- c. Stating that management has performed an evaluation of the entity's compliance with CIA-specified requirements
- d. Stating management's assertions about the entity's compliance with all aspects of the CIA, including the specific issues that gave rise to the CIA^{4,5}

⁴ Footnote 21 in paragraph .100 of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*), indicates that attest documentation may also be referred to as working papers. [Footnote added, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

⁵ Depending on the circumstances, representations in the following areas might be appropriate.

- Violations or possible violations of laws or regulations, such as those related to the Medicare and Medicaid antifraud and abuse statutes
- Compliance of third-party billings with applicable coding guidelines (for example, ICD-9-CM, CPT) and laws and regulations (including medical necessity, proper approvals, and proper rendering of care)
- Proper filing of all required Medicare, Medicaid, and similar reports under the applicable reimbursement rules and regulations (including nature of costs—allowable, patient-related, properly allocated, in accordance with applicable rules and regulations, properly adjusted to

- e. Stating that management has disclosed to the practitioner all known noncompliance with the CIA
- f. Stating that management has made available all documentation relating to compliance with the CIA
- g. Stating management's interpretation of any compliance requirements that have varying interpretations
- h. Stating that management has disclosed any communication from regulatory agencies, internal auditors, legal counsel, and other parties concerning matters regarding the design, implementation, and monitoring of the policies and procedures in place, including communication received between the end of the reporting period and the date of the practitioner's report (the date of signature)
- i. Stating that management has disclosed any known noncompliance occurring subsequent to the end of the reporting period
- j. Describing any related material fraud or abuse, other fraud, abuse or illegal acts that, whether or not material, involve management or other employees who have a significant role in the entity's design, implementation, and monitoring of the policies and procedures in place upon which compliance is based
- k. Stating that management has disclosed to the practitioners, orally or in writing, information about past noncompliance issues covered in the settlement agreement that gave rise to the CIA and the related corrective measures taken to support compliance in those areas

Management's refusal to furnish all appropriate written representations constitutes a limitation on the scope of the engagement sufficient to require withdrawal from the engagement.⁶

Reporting Considerations

.25 A practitioner should present the results of applying agreed-upon procedures to the specific subject matter in the form of findings. The practitioner should not provide negative assurance about whether the assertion is fairly stated in accordance with established or stated criteria. For example, the practitioner should not include a statement that "nothing came to my attention that caused me to believe that the assertion is not fairly stated in accordance with (established or stated) criteria."

.26 The practitioner should report all findings from the application of the agreed-upon procedures. The concept of materiality does not apply to findings to be reported in an agreed-upon procedures engagement unless the definition of materiality is agreed to by the specified parties. Any agreed-upon materiality limits should be described in the practitioner's report. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.27 The practitioner has no obligation to perform procedures beyond the agreed-upon procedures. However, if noncompliance related to management's

(footnote continued)

reflect prior audit adjustments) and adequacy of disclosures (including disputed costs) [Footnote renumbered, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

⁶ See paragraph .62 of AT section 101. [Footnote added, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

assertion comes to the practitioner's attention by other means, such information ordinarily should be included in his or her report.

.28 The practitioner may become aware of noncompliance related to management's assertion that occurs subsequent to the reporting period but before the date of the practitioner's report. The practitioner should consider including information regarding such noncompliance in his or her report. However, the practitioner has no responsibility to perform procedures to detect such noncompliance other than obtaining management's representation about noncompliance in the subsequent period.

.29 The practitioner should follow the reporting guidance in AT section 201. A sample report is included in appendix E (paragraph .36), "Sample Report."

.30 Evaluating compliance with certain requirements may require interpretation of the laws, regulations, rules, contracts, or other agreements that establish those requirements. In such situations, the practitioner should consider whether he or she is provided with the reasonable criteria required to evaluate an assertion under the third general attestation standard. If these interpretations are significant, the practitioner may include a paragraph stating the description and the source of interpretations made by the entity's management. An example of such a paragraph, which should precede the procedures and findings paragraph(s), follows:

We have been informed that, under [*name of entity's*] interpretation of [*identify the compliance requirement*], [*explain the nature and source of the relevant interpretation*].

.31 The date of completion of the agreed-upon procedures should be used as the date of the practitioner's report.

Appendix A — Sample Corporate Integrity Agreement Between the Office of Inspector General of the Department of Health and Human Services and [Provider]

I. Preamble

[Provider] (“[Provider]”) hereby enters into this Corporate Integrity Agreement (“CIA”) with the Office of Inspector General (“OIG”) of the United States Department of Health and Human Services (“HHS”) to ensure compliance by its employees with the requirements of Medicare, Medicaid and all other Federal health care programs (as defined in 42 U.S.C. 1320a-7b(f)) (hereinafter collectively referred to as the “Federal health care programs”). [Provider’s] compliance with the terms and conditions in this CIA shall constitute an element of [Provider’s] present responsibility with regard to participation in the Federal health care programs. Contemporaneously with this CIA, [Provider] is entering into a Settlement Agreement with the United States, and this CIA is incorporated by reference into the Settlement Agreement.

II. Term of the CIA

The period of the compliance obligations assumed by [Provider] under this CIA shall be 5 years from the effective date of this CIA (unless otherwise specified). The effective date of this CIA will be the date on which the final signatory of this CIA executes this CIA (the “effective date”).*

III. Corporate Integrity Obligations

[Provider] shall establish a compliance program that includes the following elements:

A. Compliance Officer

Within ninety (90) days after the effective date of this CIA, [Provider] shall appoint an individual to serve as Compliance Officer, who shall be responsible for developing and implementing policies, procedures, and practices designed to ensure compliance with the requirements set forth in this CIA and with the requirements of the Federal health care programs. The Compliance Officer shall be a member of senior management of [Provider], shall make regular (at least quarterly) reports regarding compliance matters directly to the CEO and/or to the Board of Directors of [Provider] and shall be authorized to report to the Board of Directors at any time. The Compliance Officer shall be responsible for monitoring the day-to-day activities engaged in by [Provider] to further its compliance objectives as well as any reporting obligations created under this CIA. In the event a new Compliance Officer is appointed during the term of this CIA, [Provider] shall notify the OIG, in writing, within fifteen (15) days of such a change.

[Provider] shall also appoint a Compliance Committee within ninety (90) days after the effective date of this CIA. The Compliance Committee shall, at a minimum, include the Compliance Officer and any other appropriate officers as necessary to meet the requirements of

* Source: Office of the Inspector General of the United States Department of Health and Human Services.

this CIA within the provider's corporate structure (e.g., senior executives of each major department, such as billing, clinical, human resources, audit, and operations). The Compliance Officer shall chair the Compliance Committee and the Committee shall support the Compliance Officer in fulfilling his/her responsibilities.

B. Written Standards

1. *Code of Conduct.* Within ninety (90) days of the effective date of this CIA, [Provider] shall establish a Code of Conduct. The Code of Conduct shall be distributed to all employees within ninety (90) days of the effective date of this CIA. [Provider] shall make the promotion of, and adherence to, the Code of Conduct an element in evaluating the performance of managers, supervisors, and all other employees. The Code of Conduct shall, at a minimum, set forth:
 - a. [Provider's] commitment to full compliance with all statutes, regulations, and guidelines applicable to Federal health care programs, including its commitment to prepare and submit accurate billings consistent with Federal health care program regulations and procedures or instructions otherwise communicated by the Health Care Financing Administration ("HCFA") (or other appropriate regulatory agencies) and/or its agents;
 - b. [Provider's] requirement that all of its employees shall be expected to comply with all statutes, regulations, and guidelines applicable to Federal health care programs and with [Provider's] own policies and procedures (including the requirements of this CIA);
 - c. the requirement that all of [Provider's] employees shall be expected to report suspected violations of any statute, regulation, or guideline applicable to Federal health care programs or with [Provider's] own policies and procedures;
 - d. the possible consequences to both [Provider] and to any employee of failure to comply with all statutes, regulations, and guidelines applicable to Federal health care programs and with [Provider's] own policies and procedures or of failure to report such non-compliance; and
 - e. the right of all employees to use the confidential disclosure program, as well as [Provider's] commitment to confidentiality and non-retaliation with respect to disclosures.

Within ninety (90) days of the effective date of the CIA, each employee shall certify, in writing, that he or she has received, read, understands, and will abide by [Provider's] Code of Conduct. New employees shall receive the Code of Conduct and shall complete the required certification within two (2) weeks after the commencement of their employment or within ninety (90) days of the effective date of the CIA, whichever is later.

[Provider] will annually review the Code of Conduct and will make any necessary revisions. These revisions shall be distributed within thirty (30) days of initiating such a change. Employees shall certify on an annual basis that they have received, read, understand and will abide by the Code of Conduct.

2. *Policies and Procedures.* Within ninety (90) days of the effective date of this CIA, [Provider] shall develop and initiate implementation of written Policies and Procedures regarding the operation of [Provider's] compliance program and its compliance with all federal and state health care statutes, regulations, and guidelines, including the requirements of the Federal health care programs. At a minimum, the Policies and Procedures shall specifically address [insert language relevant to allegations in the case]. In addition, the Policies and Procedures shall include disciplinary guidelines and methods for employees to make disclosures or otherwise report on compliance issues to [Provider] management through the Confidential Disclosure Program required by section III.E. [Provider] shall assess and update as necessary the Policies and Procedures at least annually and more frequently, as appropriate. A summary of the Policies and Procedures will be provided to OIG in the Implementation Report. The Policies and Procedures will be available to OIG upon request.

Within ninety (90) days of the effective date of the CIA, the relevant portions of the Policies and Procedures shall be distributed to all appropriate employees. Compliance staff or supervisors should be available to explain any and all policies and procedures.

C. Training and Education

1. *General Training.* Within ninety (90) days of the effective date of this CIA, [Provider] shall provide at least two (2) hours of training to each employee. This general training shall explain [Provider's]:
 - a. Corporate Integrity Agreement requirements;
 - b. Compliance Program (including the Policies and Procedures as they pertain to general compliance issues); and
 - c. Code of Conduct.

These training materials shall be made available to the OIG, upon request.

New employees shall receive the general training described above within thirty (30) days of the beginning of their employment or within ninety (90) days after the effective date of this CIA, whichever is later. Each year, every employee shall receive such general training on an annual basis.

2. *Specific Training.* Within ninety (90) days of the effective date of this CIA, each employee who is involved directly or indirectly in the delivery of patient care and/or in the preparation or submission of claims for reimbursement for such care (including, but not limited to, coding and billing) for any Federal health care programs shall receive at least [insert number of training hours] hours of training in addition to the general training required above. This training shall include a discussion of:
 - a. the submission of accurate bills for services rendered to Medicare and/or Medicaid patients;
 - b. policies, procedures and other requirements applicable to the documentation of medical records;
 - c. the personal obligation of each individual involved in the billing process to ensure that such billings are accurate;

- d. applicable reimbursement rules and statutes;
- e. the legal sanctions for improper billings; and
- f. examples of proper and improper billing practices.

These training materials shall be made available to OIG, upon request. Persons providing the training must be knowledgeable about the subject area.

Affected new employees shall receive this training within thirty (30) days of the beginning of their employment or within ninety (90) days of the effective date of this CIA, whichever is later. If a new employee has any responsibility for the delivery of patient care, the preparation or submission of claims and/or the assignment of procedure codes prior to completing this specific training, a [Provider] employee who has completed the substantive training shall review all of the untrained person's work regarding the assignment of billing codes.

Each year, every employee shall receive such specific training on an annual basis.

3. *Certification.* Each employee shall certify, in writing, that he or she has attended the required training. The certification shall specify the type of training received and the date received. The Compliance Officer shall retain the certifications, along with specific course materials. These shall be made available to OIG upon request.

D. Review Procedures

[Provider] shall retain an entity, such as an accounting, auditing or consulting firm (hereinafter "Independent Review Organization"), to perform review procedures to assist [Provider] in assessing the adequacy of its billing and compliance practices pursuant to this CIA. This shall be an annual requirement and shall cover a twelve (12) month period. The Independent Review Organization must have expertise in the billing, coding, reporting and other requirements of the Federal health care programs from which [Provider] seeks reimbursement. The Independent Review Organization must be retained to conduct the assessment of the first year within ninety (90) days of the effective date of this CIA. For purposes of complying with this review procedures requirement, the OIG at its discretion, may permit the [Provider] to utilize internal auditors to perform the review(s). In such case, the [Provider] will engage the Independent Review Organization to verify the propriety of the internal auditors' methods and accuracy of their results. The [Provider] will request the Independent Review Organization to produce a report on its findings which report shall be included in the Annual Report to the OIG.

The Independent Review Organization (or the [Provider], if permitted by the OIG, as set forth above) will conduct two separate engagements. One will be an analysis of [Provider's] billing to the Federal health care programs to assist the [Provider] and OIG in determining compliance with all applicable statutes, regulations, and directives/guidance ("billing engagement"). The second engagement will assist the [Provider] and OIG in determining whether [Provider] is in compliance with this CIA ("compliance engagement").

1. *Billing Engagement.* The billing engagement shall consist of a review of a statistically valid sample of claims for the relevant

period. The sample size shall be determined through the use of a probe sample.¹ At a minimum, the full sample must be within a ninety (90) percent confidence level and a precision of twenty-five (25) percent. The probe sample must contain at least thirty (30) sample units and cannot be used as part of the full sample. Both the probe sample and the sample must be selected through random numbers. [Provider] shall use OIG's Office of Audit Services Statistical Sampling Software, also known as "RAT-STATS", which is available through the Internet at <https://oig.hhs.gov/compliance/rat-stats/index.asp>.

Each annual billing engagement analysis shall include the following components in its methodology:

- a. **Billing Engagement Objective:** Provide a statement stating clearly the objective intended to be achieved by the billing engagement and the procedure or combination of procedures that will be applied to achieve the objective.
- b. **Billing Engagement Population:** Identify the population, which is the group about which information is needed. Explain the methodology used to develop the population and provide the basis for this determination.
- c. **Sources of Data:** Provide a full description of the source of the information upon which the billing engagement conclusions will be based, including the legal or other standards applied, documents relied upon, payment data, and/or any contractual obligations.
- d. **Sampling Unit:** Define the sampling unit, which is any of the designated elements that comprise the population of interest.
- e. **Sampling Frame:** Identify the sampling frame, which is the totality of the sampling units from which the sample will be selected.

As part of the billing engagement:

- a. Inquire of management as to the procedures and controls affecting the billing process subject to the annual assessment as specified in the CIA. Document that aspect of the billing process (e.g., flow of documents, processing activities), and those controls that will be tested in the sample. The documentation may consist of flow charts, excerpts from policies and procedures manuals, control questionnaires, etc.
 - b. Report the sample results, including the overall error rate and the nature of the errors found (e.g., no documentation, inadequate documentation, assignment of incorrect code).
 - c. Document findings related to [Provider's] procedures to correct inaccurate billings and codings to the Federal health care programs and findings regarding the steps [Provider] is taking to bring its operations into compliance or to correct problems identified by the audit.
2. **Agreed-upon Procedures or Compliance Engagement.** An Independent Review Organization (or the [Provider], if permitted by the OIG) shall also conduct an agreed-upon procedures or compliance

¹ Probe sample is defined as a small, random preliminary sample.

engagement, which shall assist the users in determining whether [Provider's] program, policies, procedures, and operations comply with the terms of this CIA. This engagement shall include a section by section analysis of the requirements of this CIA.

A complete copy of the Independent Review Organization's billing and agreed-upon procedures or compliance engagement shall be included in each of [Provider's] Annual Reports to OIG.

3. *Disclosure of Overpayments and Material Deficiencies.* If, as a result of these engagements, [Provider] or the Independent Review Organization identifies any billing, coding or other policies, procedures and/or practices that result in an overpayment, [Provider] shall notify the payor (e.g., Medicare fiscal intermediary or carrier) within 30 days of discovering the deficiency or overpayment and take remedial steps within 60 days of discovery (or such additional time as may be agreed to by the payor) to correct the problem, including preventing the deficiency from recurring. The notice to the payor shall include:
 - a. a statement that the refund is being made pursuant to this CIA;
 - b. a description of the complete circumstances surrounding the overpayment;
 - c. the methodology by which the overpayment was determined;
 - d. the amount of the overpayment;
 - e. any claim-specific information used to determine the overpayment (e.g., beneficiary health insurance number, claim number, service date, and payment date);
 - f. the cost reporting period; and
 - g. the provider identification number under which the repayment is being made.

If [Provider] determines an overpayment represents a material deficiency, contemporaneous with [Provider's] notification to the payor as provided above, [Provider] shall also notify OIG of:

- a. a complete description of the material deficiency;
- b. amount of overpayment due to the material deficiency;
- c. [Provider's] action(s) to correct and prevent such material deficiency from recurring;
- d. the payor's name, address, and contact person where the overpayment was sent;
- e. the date of the check and identification number (or electronic transaction number) on which the overpayment was repaid.

For purposes of this CIA, an "overpayment" shall mean the amount of money the provider has received in excess of the amount due and payable under the Federal health care programs' statutes, regulations or program directives, including carrier and intermediary instructions.

For purposes of this CIA, a "material deficiency" shall mean anything that involves: (i) a substantial overpayment or improper payment relating to the Medicare and/or Medicaid programs; (ii)

conduct or policies that clearly violate the Medicare and/or Medicaid statute, regulations or directives issued by HCFA and/or its agents; or (iii) serious quality of care implications for federal health care beneficiaries or recipients. A material deficiency may be the result of an isolated event or a series of occurrences.

4. *Verification/Validation.* In the event that the OIG determines that it is necessary to conduct an independent review to determine whether or the extent to which [Provider] is complying with its obligations under this CIA, [Provider] agrees to pay for the reasonable cost of any such review or engagement by the OIG or any of its designated agents.

E. Confidential Disclosure Program

Within ninety (90) days after the effective date of this CIA, [Provider] shall establish a Confidential Disclosure Program, which must include measures (e.g., a toll-free compliance telephone line) to enable employees, contractors, agents or other individuals to disclose, to the Compliance Officer or some other person who is not in the reporting individual's chain of command, any identified issues or questions associated with [Provider's] policies, practices or procedures with respect to the Federal health care program, believed by the individual to be inappropriate. [Provider] shall publicize the existence of the hotline (e.g., e-mail to employees or post hotline number in prominent common areas).

The Confidential Disclosure Program shall emphasize a non-retaliation, non-retaliation policy, and shall include a reporting mechanism for anonymous, confidential communication. Upon receipt of a complaint, the Compliance Officer (or designee) shall gather the information in such a way as to elicit all relevant information from the individual reporting the alleged misconduct. The Compliance Officer (or designee) shall make a preliminary good faith inquiry into the allegations set forth in every disclosure to ensure that he or she has obtained all of the information necessary to determine whether a further review should be conducted. For any disclosure that is sufficiently specific so that it reasonably: (1) permits a determination of the appropriateness of the alleged improper practice, and (2) provides an opportunity for taking corrective action, [Provider] shall conduct an internal review of the allegations set forth in such a disclosure and ensure that proper follow-up is conducted.

The Compliance Officer shall maintain a confidential disclosure log, which shall include a record and summary of each allegation received, the status of the respective investigations, and any corrective action taken in response to the investigation.

F. Ineligible Persons

[Provider] shall not hire or engage as contractors any "Ineligible Person." For purposes of this CIA, an "Ineligible Person" shall be any individual or entity who: (i) is currently excluded, suspended, debarred or otherwise ineligible to participate in the Federal health care programs; or (ii) has been convicted of a criminal offense related to the provision of health care items or services and has not been reinstated in the Federal health care programs after a period of exclusion, suspension, debarment, or ineligibility.

Within ninety (90) days of the effective date of this CIA, [Provider] will review its list of current employees and contractors against the General Services Administration's List of Parties Excluded from Federal Programs (available through the Internet at www.arnet.gov/epl) and the HHS/OIG Cumulative Sanction Report (available through the Internet at www.dhhs.gov/progorg/oig) to ensure that it is not currently employing or contracting with any Ineligible Person. Thereafter, [Provider] will review the list once semi-annually to ensure that no current employees or contractors are or have become Ineligible Persons.

To prevent hiring or contracting with any Ineligible Person, [Provider] shall screen all prospective employees and prospective contractors prior to engaging their services by (i) requiring applicants to disclose whether they are Ineligible Persons, and (ii) reviewing the General Services Administration's List of Parties Excluded from Federal Programs (available through the Internet at www.arnet.gov/epl) and the HHS/OIG Cumulative Sanction Report (available through the Internet at www.dhhs.gov/progorg/oig).

If [Provider] has notice that an employee or agent is charged with a criminal offense related to any Federal health care program, or is suspended or proposed for exclusion during his or her employment or contract with [Provider], within 10 days of receiving such notice [Provider] will remove such employee from responsibility for, or involvement with, [Provider's] business operations related to the Federal health care programs until the resolution of such criminal action, suspension, or proposed exclusion. If [Provider] has notice that an employee or agent has become an Ineligible Person, [Provider] will remove such person from responsibility for, or involvement with, [Provider's] business operations related to the Federal health care programs and shall remove such person from any position for which the person's salary or the items or services rendered, ordered, or prescribed by the person are paid in whole or in part, directly or indirectly, by Federal health care programs or otherwise with Federal funds at least until such time as the person is reinstated into participation in the Federal health care programs.

G. Notification of Proceedings

Within thirty (30) days of discovery, [Provider] shall notify OIG, in writing, of any ongoing investigation or legal proceeding conducted or brought by a governmental entity or its agents involving an allegation that [Provider] has committed a crime or has engaged in fraudulent activities or any other knowing misconduct. This notification shall include a description of the allegation, the identity of the investigating or prosecuting agency, and the status of such investigation or legal proceeding. [Provider] shall also provide written notice to OIG within thirty (30) days of the resolution of the matter, and shall provide OIG with a description of the findings and/or results of the proceedings, if any.

H. Reporting

1. *Credible evidence of misconduct.* If [Provider] discovers credible evidence of misconduct from any source and, after reasonable inquiry, has reason to believe that the misconduct may violate criminal, civil, or administrative law concerning [Provider's] practices relating to the Federal health care programs, then [Provider] shall promptly report the probable violation of law to OIG. Defendants shall make this disclosure as soon as practicable, but, not later than thirty (30) days

after becoming aware of the existence of the probable violation. The [Provider's] report to OIG shall include:

- a. the findings concerning the probable violation, including the nature and extent of the probable violation;
- b. [Provider's] actions to correct such probable violation; and
- c. any further steps it plans to take to address such probable violation and prevent it from recurring.

To the extent the misconduct involves an overpayment, the report shall include the information listed in section III.D.3 regarding material deficiencies.

2. *Inappropriate Billing.* If [Provider] discovers inappropriate or incorrect billing through means other than the Independent Review Organization's engagement, the provider shall follow procedures in section III.D.3 regarding overpayments and material deficiencies.

IV. New Locations

In the event that [Provider] purchases or establishes new business units after the effective date of this CIA, [Provider] shall notify OIG of this fact within thirty (30) days of the date of purchase or establishment. This notification shall include the location of the new operation(s), phone number, fax number, Federal health care program provider number(s) (if any), and the corresponding payor(s) (contractor specific) that has issued each provider number. All employees at such locations shall be subject to the requirements in this CIA that apply to new employees (e.g., completing certifications and undergoing training).

V. Implementation and Annual Reports

A. Implementation Report

Within one hundred and twenty (120) days after the effective date of this CIA, [Provider] shall submit a written report to OIG summarizing the status of its implementation of the requirements of this CIA. This Implementation Report shall include:

1. the name, address, phone number and position description of the Compliance Officer required by section III.A;
2. the names and positions of the members of the Compliance Committee required by section III.A;
3. a copy of [Provider's] Code of Conduct required by section III.B.1;
4. the summary of the Policies and Procedures required by section III.B.2;
5. a description of the training programs required by section III.C including a description of the targeted audiences and a schedule of when the training sessions were held;
6. a certification by the Compliance Officer that:
 - a. the Policies and Procedures required by section III.B have been developed, are being implemented, and have been distributed to all pertinent employees;

- b. all employees have completed the Code of Conduct certification required by section III.B.1; and
 - c. all employees have completed the training and executed the certification required by section III.C;
7. a description of the confidential disclosure program required by section III.E;
 8. the identity of the Independent Review Organization(s) and the proposed start and completion date of the first audit; and
 9. a summary of personnel actions taken pursuant to section III.F.

B. Annual Reports

[*Provider*] shall submit to OIG an Annual Report with respect to the status and findings of [*Provider's*] compliance activities. The Annual Reports shall include:

1. any change in the identity or position description of the Compliance Officer and/or members of the Compliance Committee described in section III.A;
2. a certification by the Compliance Officer that:
 - a. all employees have completed the annual Code of Conduct certification required by section III.B.1; and
 - b. all employees have completed the training and executed the certification required by section III.C;
3. notification of any changes or amendments to the Policies and Procedures required by section III.B and the reasons for such changes (e.g., change in contractor policy);
4. a complete copy of the report prepared pursuant to the Independent Review Organization's billing and compliance engagement, including a copy of the methodology used;
5. [*Provider's*] response/corrective action plan to any issues raised by the Independent Review Organization;
6. a summary of material deficiencies reported throughout the course of the previous twelve (12) months pursuant to III.D.3 and III.H;
7. a report of the aggregate overpayments that have been returned to the Federal health care programs that were discovered as a direct or indirect result of implementing this CIA. Overpayment amounts should be broken down into the following categories: Medicare, Medicaid (report each applicable state separately) and other Federal health care programs;
8. a copy of the confidential disclosure log required by section III.E;
9. a description of any personnel action (other than hiring) taken by [*Provider*] as a result of the obligations in section III.F;
10. a summary describing any ongoing investigation or legal proceeding conducted or brought by a government entity involving an allegation that [*Provider*] has committed a crime or has engaged in fraudulent activities, which have been reported pursuant to section III.G. The statement shall include a description of the allegation, the identity of the investigating or prosecuting agency, and the status of such investigation, legal proceeding or requests for information;

11. a corrective action plan to address the probable violations of law identified in section III.H; and
12. a listing of all of the [Provider's] locations (including locations and mailing addresses), the corresponding name under which each location is doing business, the corresponding phone numbers and fax numbers, each location's Federal health care program provider identification number(s) and the payor (specific contractor) that issued each provider identification number.

The first Annual Report shall be received by the OIG no later than one year and thirty (30) days after the effective date of this CIA. Subsequent Annual Reports shall be submitted no later than the anniversary date of the due date of the first Annual Report.

C. *Certifications*

The Implementation Report and Annual Reports shall include a certification by the Compliance Officer under penalty of perjury, that: (1) [Provider] is in compliance with all of the requirements of this CIA, to the best of his or her knowledge; and (2) the Compliance Officer has reviewed the Report and has made reasonable inquiry regarding its content and believes that, upon such inquiry, the information is accurate and truthful.

VI. Notifications and Submission of Reports

Unless otherwise stated in writing subsequent to the effective date of this CIA, all notifications and reports required under this CIA shall be submitted to the entities listed below:

OIG:

Civil Recoveries Branch—Compliance Unit
Office of Counsel to the Inspector General
Office of Inspector General
U.S. Department of Health and Human Services
Cohen Building, Room 5527
330 Independence Avenue, SW
Washington, DC 20201
Phone 202-619-2078; Fax 202-205-0604

[Provider]:

[Address and Telephone number of Provider's Compliance Contact]

VII. OIG Inspection, Audit and Review Rights

In addition to any other rights OIG may have by statute, regulation, or contract, OIG or its duly authorized representative(s), may examine [Provider's] books, records, and other documents and supporting materials for the purpose of verifying and evaluating: (a) [Provider's] compliance with the terms of this CIA; and (b) [Provider's] compliance with the requirements of the Federal health care programs in which it participates. The documentation described above shall be made available by [Provider] to OIG or its duly authorized representative(s) at all reasonable times for inspection, audit or reproduction. Furthermore, for purposes of this provision, OIG or its duly authorized representative(s) may interview any of [Provider's] employees who consent to be interviewed at the employee's place of business during normal business hours or at such other place and time as may be mutually agreed upon between the employee and OIG. [Provider] agrees to assist OIG in contacting and arranging interviews with such employees upon

OIG's request. [Provider's] employees may elect to be interviewed with or without a representative of [Provider] present.

VIII. Document and Record Retention

[Provider] shall maintain for inspection all documents and records relating to reimbursement from the Federal health care programs or to compliance with this CIA one year longer than the term of this CIA (or longer if otherwise required by law).

IX. Disclosures

Subject to HHS's Freedom of Information Act ("FOIA") procedures, set forth in 45 C.F.R. Part 5, the OIG shall make a reasonable effort to notify [Provider] prior to any release by OIG of information submitted by [Provider] pursuant to its obligations under this CIA and identified upon submission by [Provider] as trade secrets, commercial or financial information and privileged and confidential under the FOIA rules. [Provider] shall refrain from identifying any information as trade secrets, commercial or financial information and privileged and confidential that does not meet the criteria for exemption from disclosure under FOIA.

X. Breach and Default Provisions

[Provider] is expected to fully and timely comply with all of the obligations herein throughout the term of this CIA or other time frames herein agreed to.

A. Stipulated Penalties for Failure to Comply with Certain Obligations

As a contractual remedy, [Provider] and OIG hereby agree that failure to comply with certain obligations set forth in this CIA may lead to the imposition of the following monetary penalties (hereinafter referred to as "Stipulated Penalties") in accordance with the following provisions.

1. A Stipulated Penalty of \$2,500 (which shall begin to accrue on the day after the date the obligation became due) for each day, beginning 120 days after the effective date of this CIA and concluding at the end of the term of this CIA, [Provider] fails to have in place any of the following:
 - a. a Compliance Officer;
 - b. a Compliance Committee;
 - c. a written Code of Conduct;
 - d. written Policies and Procedures;
 - e. a training program; and
 - f. a Confidential Disclosure Program;
2. A Stipulated Penalty of \$2,500 (which shall begin to accrue on the day after the date the obligation became due) for each day [Provider] fails to meet any of the deadlines to submit the Implementation Report or the Annual Reports to the OIG.
3. A Stipulated Penalty of \$2,000 (which shall begin to accrue on the date the failure to comply began) for each day [Provider]:
 - a. hires or contracts with an Ineligible Person after that person has been listed by a federal agency as excluded, debarred, suspended or otherwise ineligible for participation in the Medicare, Medicaid or any other Federal health care program

- (as defined in 42 U.S.C. 1320a7b(f)). This Stipulated Penalty shall not be demanded for any time period if [Provider] can demonstrate that it did not discover the person's exclusion or other ineligibility after making a reasonable inquiry (as described in section III.F) as to the status of the person;
- b. employs or contracts with an Ineligible Person and that person: (i) has responsibility for, or involvement with, [Provider's] business operations related to the Federal health care programs or (ii) is in a position for which the person's salary or the items or services rendered, ordered, or prescribed by the person are paid in whole or in part, directly or indirectly, by the Federal health care programs or otherwise with Federal funds (this Stipulated Penalty shall not be demanded for any time period during which [Provider] can demonstrate that it did not discover the person's exclusion or other ineligibility after making a reasonable inquiry (as described in III.F) as to the status of the person);
 - c. employs or contracts with a person who: (i) has been charged with a criminal offense related to any Federal health care program, or (ii) is suspended or proposed for exclusion, and that person has responsibility for, or involvement with, [Provider's] business operations related to the Federal health care programs (this Stipulated Penalty shall not be demanded for any time period before 10 days after [Provider] received notice of the relevant matter or after the resolution of the matter).
4. A Stipulated Penalty of \$1,500 (which shall begin to accrue on the date the [Provider] fails to grant access) for each day [Provider] fails to grant access to the information or documentation as required in section V of this CIA.
 5. A Stipulated Penalty of \$1,000 (which shall begin to accrue ten (10) days after the date that OIG provides notice to [Provider] of the failure to comply) for each day [Provider] fails to comply fully and adequately with any obligation of this CIA. In its notice to [Provider], the OIG shall state the specific grounds for its determination that the [Provider] has failed to comply fully and adequately with the CIA obligation(s) at issue.

B. Payment of Stipulated Penalties

1. *Demand Letter.* Upon a finding that [Provider] has failed to comply with any of the obligations described in section X.A and determining that Stipulated Penalties are appropriate, OIG shall notify [Provider] by personal service or certified mail of (a) [Provider's] failure to comply; and (b) the OIG's exercise of its contractual right to demand payment of the Stipulated Penalties (this notification is hereinafter referred to as the "Demand Letter").

Within fifteen (15) days of the date of the Demand Letter, [Provider] shall either (a) cure the breach to the OIG's satisfaction and pay the applicable stipulated penalties, or (b) request a hearing before an HHS administrative law judge ("ALJ") to dispute the OIG's determination of noncompliance, pursuant to the agreed-upon provisions set forth below in section X.D. In the event [Provider] elects to request an ALJ hearing, the Stipulated Penalties shall continue to accrue until [Provider] cures, to the OIG's satisfaction, the alleged breach in dispute. Failure to respond to

the Demand Letter in one of these two manners within the allowed time period shall be considered a material breach of this CIA and shall be grounds for exclusion under section X.C.

2. *Timely Written Requests for Extensions.* [Provider] may submit a timely written request for an extension of time to perform any act or file any notification or report required by this CIA. Notwithstanding any other provision in this section, if OIG grants the timely written request with respect to an act, notification, or report, Stipulated Penalties for failure to perform the act or file the notification or report shall not begin to accrue until one day after [Provider] fails to meet the revised deadline as agreed to by the OIG-approved extension. Notwithstanding any other provision in this section, if OIG denies such a timely written request, Stipulated Penalties for failure to perform the act or file the notification or report shall not begin to accrue until two (2) business days after [Provider] receives OIG's written denial of such request. A "timely written request" is defined as a request in writing received by OIG at least five (5) business days prior to the date by which any act is due to be performed or any notification or report is due to be filed.
3. *Form of Payment.* Payment of the Stipulated Penalties shall be made by certified or cashier's check, payable to "Secretary of the Department of Health and Human Services," and submitted to OIG at the address set forth in section VI.
4. *Independence from Material Breach Determination.* Except as otherwise noted, these provisions for payment of Stipulated Penalties shall not affect or otherwise set a standard for the OIG's determination that [Provider] has materially breached this CIA, which decision shall be made at the OIG's discretion and governed by the provisions in section X.C, below.

C. Exclusion for Material Breach of this CIA

1. *Notice of Material Breach and Intent to Exclude.* The parties agree that a material breach of this CIA by [Provider] constitutes an independent basis for [Provider's] exclusion from participation in the Federal health care programs (as defined in 42 U.S.C. 1320a7b(f)). Upon a determination by OIG that [Provider] has materially breached this CIA and that exclusion should be imposed, the OIG shall notify [Provider] by certified mail of (a) [Provider's] material breach; and (b) OIG's intent to exercise its contractual right to impose exclusion (this notification is hereinafter referred to as the "Notice of Material Breach and Intent to Exclude").
2. *Opportunity to Cure.* [Provider] shall have thirty-five (35) days from the date of the Notice of Material Breach and Intent to Exclude Letter to demonstrate to the OIG's satisfaction that:
 - a. [Provider] is in full compliance with this CIA;
 - b. the alleged material breach has been cured; or
 - c. the alleged material breach cannot be cured within the 35-day period, but that: (i) [Provider] has begun to take action to cure the material breach, (ii) [Provider] is pursuing such action with due diligence, and (iii) [Provider] has provided to OIG a reasonable timetable for curing the material breach.

3. *Exclusion Letter.* If at the conclusion of the thirty-five (35) day period, [Provider] fails to satisfy the requirements of section X.C.2, OIG may exclude [Provider] from participation in the Federal health care programs. OIG will notify [Provider] in writing of its determination to exclude [Provider] (this letter shall be referred to hereinafter as the “Exclusion Letter”). Subject to the Dispute Resolution provisions in section X.D, below, the exclusion shall go into effect thirty (30) days after the date of the Exclusion Letter. The exclusion shall have national effect and will also apply to all other federal procurement and non-procurement programs. If [Provider] is excluded under the provisions of this CIA, [Provider] may seek reinstatement pursuant to the provisions at 42 C.F.R. §§1001.3001–3004.
4. *Material Breach.* A material breach of this CIA means:
 - a. a failure by [Provider] to report a material deficiency, take corrective action and pay the appropriate refunds, as provided in section III.D;
 - b. repeated or flagrant violations of the obligations under this CIA, including, but not limited to, the obligations addressed in section X.A of this CIA;
 - c. a failure to respond to a Demand Letter concerning the payment of Stipulated Penalties in accordance with section X.B above; or
 - d. a failure to retain and use an Independent Review Organization for review purposes in accordance with section III.D.

D. Dispute Resolution

1. *Review Rights.* Upon the OIG’s delivery to [Provider] of its Demand Letter or of its Exclusion Letter, and as an agreed-upon contractual remedy for the resolution of disputes arising under the obligation of this CIA, [Provider] shall be afforded certain review rights comparable to the ones that are provided in 42 U.S.C. §§1320a7(f) and 42 C.F.R. §1005 as if they applied to the Stipulated Penalties or exclusion sought pursuant to this CIA. Specifically, the OIG’s determination to demand payment of Stipulated Penalties or to seek exclusion shall be subject to review by an ALJ and, in the event of an appeal, the Departmental Appeals Board (“DAB”), in a manner consistent with the provisions in 42 C.F.R. §§1005.2–.21. Notwithstanding the language in 42 C.F.R. §1005.2(c), the request for a hearing involving stipulated penalties shall be made within fifteen (15) days of the date of the Demand Letter and the request for a hearing involving exclusion shall be made within thirty (30) days of the date of the Exclusion Letter.
2. *Stipulated Penalties Review.* Notwithstanding any provision of Title 42 of the United States Code or Chapter 42 of the Code of Federal Regulations, the only issues in a proceeding for stipulated penalties under this CIA shall be (a) whether [Provider] was in full and timely compliance with the obligations of this CIA for which the OIG demands payment; and (b) the period of noncompliance. [Provider] shall have the burden of proving its full and timely compliance and the steps taken to cure the noncompliance, if any. If the ALJ finds for the OIG with regard to a finding of a breach of this CIA and orders [Provider] to pay Stipulated Penalties, such

Stipulated Penalties shall become due and payable twenty (20) days after the ALJ issues such a decision notwithstanding that [Provider] may request review of the ALJ decision by the DAB.

3. *Exclusion Review.* Notwithstanding any provision of Title 42 of the United States Code or Chapter 42 of the Code of Federal Regulations, the only issues in a proceeding for exclusion based on a material breach of this CIA shall be (a) whether [Provider] was in material breach of this CIA; (b) whether such breach was continuing on the date of the Exclusion Letter; and (c) the alleged material breach cannot be cured within the 35-day period, but that (i) [Provider] has begun to take action to cure the material breach, (ii) [Provider] is pursuing such action with due diligence, and (iii) [Provider] has provided to OIG a reasonable timetable for curing the material breach.

For purposes of the exclusion herein, exclusion shall take effect only after an ALJ decision that is favorable to the OIG. [Provider's] election of its contractual right to appeal to the DAB shall not abrogate the OIG's authority to exclude [Provider] upon the issuance of the ALJ's decision. If the ALJ sustains the determination of the OIG and determines that exclusion is authorized, such exclusion shall take effect twenty (20) days after the ALJ issues such a decision, notwithstanding that [Provider] may request review of the ALJ decision by the DAB.

4. *Finality of Decision.* The review by an ALJ or DAB provided for above shall not be considered to be an appeal right arising under any statutes or regulations. Consequently, the parties to this CIA agree that the DAB's decision (or the ALJ's decision if not appealed) shall be considered final for all purposes under this CIA and [Provider] agrees to waive any right it may have to appeal the decision administratively, judicially or otherwise seek review by any court or other adjudicative forum.

XI. Effective and Binding Agreement

Consistent with the provisions in the Settlement Agreement pursuant to which this CIA is entered, and into which this CIA is incorporated, [Provider] and OIG agree as follows:

- a. This CIA shall be binding on the successors, assigns and transferees of [Provider];
- b. This CIA shall become final and binding on the date the final signature is obtained on the CIA;
- c. Any modifications to this CIA shall be made with the prior written consent of the parties to this CIA; and
- d. The undersigned [Provider] signatories represent and warrant that they are authorized to execute this CIA. The undersigned OIG signatory represents that he is signing this CIA in his official capacity and that he is authorized to execute this CIA.

Statements of Position

On Behalf of [Provider]

Date

Date

Date

[Please identify all signatories]

**ON BEHALF OF THE OFFICE OF INSPECTOR GENERAL OF THE
DEPARTMENT OF HEALTH AND HUMAN SERVICES**

Lewis Morris

[Date]

**Assistant Inspector General for Legal Affairs
Office of Inspector General
U.S. Department of Health and Human Services**

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Appendix B

Sample Statement of Management's Assertions

[Date]

In connection with the Corporate Integrity Agreement (CIA) entered into with the Office of the Inspector General of the United States Department of Health and Human Services dated [date], we make the following assertions, which are true to the best of our knowledge and belief.

Governance

Within 90 days of the date of the CIA, we—

1. Established a Compliance Committee, which meets at least monthly and requires a quorum to meet.
2. Appointed to our Compliance Committee members who include at a minimum those individuals specified in the CIA.
3. Delegated to the Compliance Committee the authority to implement and monitor the CIA, as evidenced by the organization chart or the Compliance Committee's charter.
4. Appointed a compliance officer, who reports directly to the individual specified in the CIA.

We appointed a compliance officer who—

1. Has sufficient staff and resources to carry out his or her responsibilities.
2. Actively participates in compliance training.
3. Has authority to conduct full and complete internal investigations without restriction.
4. Periodically revises the compliance program to meet changing circumstances and risks.

Billing Practices, Policies, and Procedures

Although no system of internal controls can provide absolute assurance that all bills comply in all respects with Medicare, Medicaid, and other federal health care program guidelines, we are not aware of any material weaknesses in our billing practices, policies, and procedures. Billings to third-party payors comply in all material respects with applicable coding principles and laws and regulations (including those dealing with Medicare and Medicaid antifraud and abuse) and only reflect charges for goods and services that were medically necessary, properly approved by regulatory bodies (e.g., the Food and Drug Administration), if required and properly rendered. [Insert other assertions as necessary to address matters covered in the CIA.] Any Medicare, Medicaid, and other federal health program billing deficiencies that we identified have been properly reported to the applicable payor within 60 days of discovery of the deficiency.

Corporate Integrity Policy

1. Our policy was developed and implemented within [number] days of execution of the CIA.
2. The policy addresses the Company's commitment to preparation and submission of accurate billings consistent with the standards set forth

in federal health care program statutes, regulations, procedures and guidelines or as otherwise communicated by Health Care Financing Administration (HCFA), its agents or any other agency engaged in the administration of the applicable federal health care program.

3. The policy addressed the specific issues that gave rise to the settlement, as well as other risk areas identified by the OIG in published Fraud Alerts issued through [date].
4. Further details on the development and implementation of our policy were provided to the OIG in our letter dated [date].
5. Our policy was distributed to all employees, physicians and independent contractors involved in submitting or preparing requests for reimbursement.
6. We have prominently displayed a copy of our policy on the Company's premises.

Information and Education Program

As discussed more fully in our letter to the OIG dated [date], we conducted an Information and Education Program within [number] days of the CIA. The Information and Education Program requires that each officer, employee, agent and contractor charged with administering federal health care programs (including, but not limited to billers, coders, nurses, physicians, medical records, hospital administration and other individuals directly involved in billing federal health care programs) receive at least [number] hours of training.

The training provided to employees involved in billing, coding, and/or charge capture consisted of instructions on submitting accurate bills, the personal obligations of each individual to ensure billings are accurate, the nature of company-imposed disciplinary actions on individuals who violate company policies and/or laws and regulations, applicable federal health care program rules, legal sanctions against the company for submission of false or fraudulent information, and how to report potential abuses or fraud. The training material addresses those issues underlying our settlement with the OIG.

The experience of the trainers is consistent with the topics presented.

Confidential Disclosure Program

Our Confidential Disclosure Program—

1. Was established within [number] days of the CIA.
2. Enables any employee to disclose any practices or billing procedures relating to federal health care programs.
3. Provides a toll-free telephone line maintained by the Company, which Company representatives have indicated is maintained twenty-four hours a day, seven days a week, for the purpose of making any disclosures regarding compliance with the Company's Compliance Program, the obligations in the CIA, and Company's overall compliance with federal and state standards.
4. Includes policies requiring the review of any disclosures to permit a determination of the appropriateness of the billing practice alleged to be involved and any corrective action to be taken to ensure that proper follow-up is conducted.
5. A detailed summary of the communications (including the number of disclosures by employees and the dates of such disclosures) concerning billing practices reported as, and found to be, inappropriate under the Confidential Disclosure Program, and the results of any internal

review and the follow-up on such disclosures are summarized in Attachment [title] to our Annual Report.

Excluded Individuals or Entities

Company policy—

1. Prohibits the employment of or contracting with an individual or entity that is listed by a federal agency as convicted of abuse or excluded, suspended or otherwise ineligible for participation in federal health care programs.
2. Includes a process to make an inquiry into the status of any potential employee or independent contractor.
3. Provides for an annual review of the status of all existing employees and contractors to verify whether any individual had been suspended or excluded or charged with a criminal offense relating to the provision of federal health care services.

We are not aware of any individuals employed in contravention of the prohibitions in the CIA.

Record Retention

Our record retention policy is consistent with the requirements of the CIA.

Signed by:

[Chief Executive Officer]

[Chief Financial Officer]

[Corporate Compliance Officer]

Appendix C

Sample Engagement Letter

The following is an illustration of a sample engagement letter that may be used for this kind of engagement.

[CPA Firm Letterhead]

[Client's Name and Address]

Dear _____:

This will confirm our understanding of the arrangements for our performance of certain agreed-upon procedures in connection with management's compliance with the terms of the Corporate Integrity Agreement (CIA) with the Office of Inspector General (OIG) of the U.S. Department of Health and Human Services (HHS) dated [date of CIA] for the period ending [date].

We will perform those procedures enumerated in the attachment to this letter. Our responsibility is to carry out these procedures and report our findings. We will conduct our engagement in accordance with standards established by the American Institute of Certified Public Accountants. Our planned procedures were agreed to by management and will be communicated to the OIG for its review and are based on the terms specified in the CIA. The sufficiency of these procedures is solely the responsibility of the specified parties to the report. Consequently, it is understood that we make no representation regarding the sufficiency of the procedures described in the attachment for the purpose for which this report has been requested or for any other purpose.

Management is responsible for the Company's compliance with all applicable laws, regulations, and contracts and agreements, including the CIA. Management also is responsible for the design, implementation, and monitoring of the policies and procedures upon which compliance is based.

Our engagement to perform agreed-upon procedures is substantially less in scope than an examination, the objective of which is the expression of an opinion on management's compliance with the CIA. Accordingly, we will not express such an opinion or any other form of assurance thereon.¹

Working papers that are prepared in connection with this engagement are the property of the independent accountant. The working papers are prepared for the purpose of providing the principal support for the independent accountant's report. At the completion of our work, we expect to issue an agreed-upon procedures report in the attached form.

¹ The independent accountant may wish to include an understanding with the client about any limitation or other arrangements regarding liability of the practitioner or the client in the engagement letter. For example, the following might be included in the letter:

Our maximum liability relating to services rendered under this letter (regardless of form of action, whether in contract, negligence or otherwise) shall be limited to the charges paid to us for the portion of the services or work products giving rise to liability. We will not be liable for consequential or punitive damages (including lost profits or savings) even if aware of their possible existence.

You will indemnify us against any damage or expense that may result from any third-party claim relating to our services or any use by you of any work product, and you will reimburse us for all expenses (including counsel fees) as incurred by us in connection with any such claim, except to the extent such claim (i) is finally determined to have resulted from our gross negligence or willful misconduct or (ii) is covered by any of the preceding indemnities.

If, however, we are not able to complete all of the specified procedures, we will so advise you. At that time, we will discuss with you the form of communication, if any, that you desire for our findings. We will ask you to confirm your request in writing at that time. If you request that we delay issuance of our report until corrective action is taken that will result in compliance with all aspects of the CIA, we will do so only at your written request. Our working papers will be retained in accordance with our firm's working paper retention policy.

The distribution of the independent accountant's report will be restricted to the governing board and management of the Company and the OIG.

Our fees will be billed as work progresses and are based on the amount of time required at various levels of responsibility plus actual out-of-pocket expenses. Invoices are payable upon presentation. We will notify you immediately of any circumstances we encounter that could significantly affect our initial estimate of total fees.

We agree that to the extent required by law, we will allow the Comptroller General of the United States, HHS, and their duly authorized representatives to have access to this engagement letter and our documents and records to the extent necessary to verify the nature and amount of costs of the services provided to the Company, until the expiration of four years after we have concluded providing services to the Company that are performed pursuant to this Engagement Letter. In the event the Comptroller General, HHS, or their duly authorized representatives request such records, we agree to notify the Company of such request as soon as practicable.

In the event we are requested or authorized by the Company or are required by government regulation, subpoena, or other legal process to produce our documents or our personnel as witnesses with respect to our engagements for the Company, the Company will, so long as we are not a party to the proceeding in which the information is sought, reimburse us for our professional time and expenses, as well as the fees and expenses of our counsel, incurred in responding to such requests.

If this letter correctly expresses your understanding of this engagement, please sign the enclosed copy where indicated and return it to us. We appreciate the opportunity to serve you.

Sincerely, _____

[Partner's Signature]

[Firm Name or Firm Representative]

Accepted and agreed to: _____

[Client Representative's Signature]

[Title] _____

[Date] _____

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Appendix D

Sample Procedures

<i>Procedure</i>	<i>Findings</i>
Governance	
<ol style="list-style-type: none"> 1. We read the Company's corporate minutes and organization chart and ascertained that, within [number] days of the date of the Corporate Integrity Agreement (CIA), the Company— <ol style="list-style-type: none"> a. Established a Compliance Committee, which is to meet meets at least monthly and requires a quorum to meet. b. Appointed to its Compliance Committee members who include, at a minimum, those individuals specified in the CIA. c. Delegated to the Compliance Committee the authority to implement and monitor the CIA, as evidenced by the organization chart or the Compliance Committee's charter. d. Appointed a compliance officer who reports directly to the individual specified in the CIA. 2. We interviewed the compliance officer and were informed that, in his or her opinion, the Compliance Officer— <ol style="list-style-type: none"> a. Has sufficient staff and resources to carry out his or her responsibilities. b. Actively participates in compliance training. c. Has the authority to conduct full and complete internal investigations without restriction. d. Periodically revises the compliance program to meet changing circumstances and risks. 3. We read the OIG notification letter as specified in the CIA and noted that the appropriate official signed the letter, that it was addressed to the OIG, that it covered items (a) through (d) in Step 1, and that it was dated within [number of] days of the execution of the CIA. 	
Billing Practices, Policies, and Procedures	
<p><i>The practitioner might be engaged to provide consulting services in connection with the evaluation of the company's billing practices, policies, and procedures. If so, generally no agreed-upon procedures would be performed relating to this area.</i></p> <p><i>Alternatively, if the procedures relating to the Company's billing practices, policies, and procedures are performed by others such as the Company's internal audit staff, the practitioner performs Steps 4 through 9.</i></p>	
<ol style="list-style-type: none"> 4. We read the compliance work plan and noted the following: 	

Procedure**Findings**

-
- a. The work plan's stated objectives include the determination that billings are accurate and complete, for services rendered that have been deemed by medical specialists as being necessary, and are submitted in accordance with federal program guidelines.
- b. The work plan sampling methodology sets confidence levels consistent with those defined in the CIA.
- c. The work plan identifies risk areas, as defined in the CIA (if applicable), and specifies testing procedures by risk area.
- d. The work plan specifies that samples are taken in risk areas (if applicable) identified by the CIA.
- e. The work plan includes testing procedures, which the practitioner should modify as required by the CIA, for the following risks areas (if applicable) identified in the CIA:
- (1) Clinical documentation, as follows:
 - (i) No documentation of service
 - (ii) Insufficient documentation of service
 - (iii) Improper diagnosis or treatment plan giving rise to the provision of a medically unnecessary service or treatment
 - (iv) Service or treatment does not conform medically with the documented diagnosis or treatment plan
 - (v) Services incorrectly coded
 - (2) Billing and coding, as follows:
 - (i) Noncovered or unallowable service
 - (ii) Duplicate payment
 - (iii) DRG window error
 - (iv) Unbundling
 - (v) Utilization
 - (vi) Medicare credit balances
- [*Note to Practitioner:* Modify the preceding list as required by the CIA.]
5. We selected [*quantity*] probe samples performed by the independent review organization for the following risk areas [*list risk areas tested*]. For the probe samples selected, we noted that the—
- a. Sample patient billing files were randomly selected.
 - b. Sample size reflected confidence levels specified in the CIA.

(continued)

Procedure**Findings**

-
- c. Sample plan describes how missing items (if any) would be treated.
 - d. Patient billing files tested were pulled per the listing of random numbers and all patient billing files were accounted for in the working papers.
 - e. Work plans for the specific sample described the risk areas (if applicable) being tested and the testing approach/procedures.
 - f. Working papers noted the completion of each work plan step.
 - g. Working papers contained a summary of findings for the sample.
6. We reperformed the work plan steps [*list of specific steps performed*] for the sample patient billing files. The reperformance of work plan steps related to the medical review of the sample patient billing files was performed by the following individuals [*note the professional qualifications of individuals without listing names*]. Any exceptions between our findings and the Company's are summarized in the Attachment to this report.
 7. We read the summary findings of all internal compliance reviews that the Company's Internal Audit department indicated it had performed for the Company and noted that all material billing deficiencies [*specify material threshold as defined by the Company*] noted therein were discussed in written communications addressed to the appropriate payor (for example, Medicare Part B carrier) and were dated within 60 days from the time the deficiency occurred.¹
 8. We inquired of [*individual*] as to whether the Company took remedial steps within [*number of*] days (or such additional time as agreed to by the payor) to correct all material billing deficiencies noted in Step 7. We were informed that such remedial steps had been taken.
 9. By reading applicable correspondence, we noted that any material billing deficiencies noted in Step 7 were communicated to the OIG, including specific findings relative to the deficiency, the Company's actions taken to correct the deficiency, and any further steps the Company plans to take to prevent any similar deficiencies from recurring.

Corporate Integrity Policy

10. We read the Company's Corporate Integrity Policy and noted the following.

¹ The CIA provides its own legal definition of a "material deficiency." Determination of whether a billing or other act meets this definition is normally beyond the auditor's professional competence and may have to await final determination by a court of law. Accordingly, to avoid confusion, a working definition different from that provided in the CIA (e.g., a specified dollar threshold) may be necessary.

Procedure**Findings**

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- a. The policy was developed and implemented within *[number of]* days of execution of the CIA.
 - b. The policy addressed the Company's commitment to preparation and submission of accurate billings consistent with the standards set forth in federal health care program statutes, regulations, procedures, and guidelines or as otherwise communicated by HCFA, its agents, or any other agency engaged in the administration of the applicable federal health care program.
 - c. The policy addressed the specific issues that gave rise to the settlement, as well as other risk areas identified by the OIG in published Fraud Alerts issued through *[agency]*.
 - d. Correspondence addressed to the OIG covered the development and implementation of the policy.
 - e. Documentation indicating that the policy was distributed to all employees, physicians, and independent contractors involved in submitting or preparing requests for reimbursement.
 - f. The prominent display of a copy of the policy on the Company's premises.
11. We selected a sample of ten employees (involved in submitting and preparing requests for reimbursement) and examined written confirmation in the employee's personnel file indicating receipt of a copy of the Corporate Integrity Policy.

Information and Education Program

12. We read the Company's Information and Education Program and noted the following.
- a. The Information and Education Program agenda was dated within *[number of]* days of execution of the CIA.
 - b. Correspondence covering the development and implementation of the Information and Education Program was addressed to the OIG.
 - c. The Information and Education Program requires that each officer, employee, agent, and contractor charged with administering federal health care programs (including, but not limited to billers, coders, nurses, physicians, medical records, hospital administration and other individuals directly involved in billing federal health care programs) receive at least *[number of]* hours of training.

(continued)

Procedure**Findings**

-
13. We selected a sample of ten employees involved in billing, coding and/or charge capture and examined sign-in logs of the training classes and noted that each had signed indicating that they had received at least *[number of]* hours of training as specified in the Information and Education Program. We also reviewed tests and surveys completed by each of the ten trained employees noting evidence that they were completed.
 14. We inquired as to the training of individuals not present during the regularly scheduled training programs and were informed that each such individual is trained either individually or in a separate make-up session. We inquired as to the names of individuals not initially present and selected one such individual and examined that individual's post-training test and survey for completion.
 15. We read the course agenda and noted that the training provided to employees involved in billing, coding, and/or charge capture consisted of instructions on submitting accurate bills, the personal obligations of each individual to ensure billings are accurate, the nature of company-imposed disciplinary actions on individuals who violate company policies and/or laws and regulations applicable to federal health care program rules, legal sanctions against the company for submission of false or fraudulent information, and how to report potential abuses or fraud. We also noted that the training material addressed the following issues which gave rise to the settlement *[practitioner list]*.
 16. We inquired of the Corporate Compliance Officer as to the qualifications and experience of the trainers and were informed that, in the Corporate Compliance Officer's opinion, they were consistent with the topics presented.
 17. We noted that the Company's draft Annual Report to the OIG dated *[date]* addresses certification of training.

Confidential Disclosure Program

18. We read documentation of the Company's Confidential Disclosure Program and noted that it—
 - a. Includes the printed effective date that was within *[number of]* days of execution of the CIA.
 - b. Consists of a confidential disclosure program enabling any employee to disclose any practices or billing procedures relating to federal health care programs.

Procedure**Findings**

- c. Provides a toll-free telephone line maintained by the Company, which Company representatives have indicated is maintained twenty-four hours a day, seven days a week, for the purpose of making any disclosures regarding compliance with the Company's Compliance Program, the obligations in the CIA, and Company's overall compliance with federal and state standards.
 - d. Includes policies requiring the review of any disclosures to permit a determination of the appropriateness of the billing practice alleged to be involved and any corrective action to be taken to ensure that proper follow-up is conducted.
- 19. We made five test calls to the toll free telephone line (hotline) and noted the following.
 - a. Each call was captured in the hotline logs and reported with all other incoming calls.
 - b. Anonymity is not discouraged.
- 20. We noted that the Company included in its draft Annual Report addressed to OIG dated [date] a detailed summary of the communications (including the number of disclosures by employees and the dates of such disclosures) concerning billing practices reported as, and found to be, inappropriate under the Confidential Disclosure Program, and the results of any internal review and the follow-up on such disclosures.
- 21. We observed the display of the Company's Confidential Disclosure Program, including notice of the availability of its hotline, on the Company's premises.

Excluded Individuals or Entities

- 22. We read the Company's written policy relating to dealing with excluded or convicted persons or entities and noted that the policy—
 - a. Prohibits the hiring of or contracting with an individual or entity that is listed by a federal agency as convicted of abuse or excluded, suspended, or otherwise ineligible for participation in federal health care programs.
 - b. Includes a process to make an inquiry into the status of any potential employee or independent contractor.
 - c. Provides for a semi-annual review of the status of all existing employees and contractors to verify whether any individual had been suspended or excluded or charged with a criminal offense relating to the provision of federal health care services.

(continued)

Procedure**Findings**

-
23. We selected a sample of ten employees hired over the course of the test period as defined in the CIA and examined support in the employee's personnel file documenting inquiries made into the status of the employee, including documentation of comparison to the *[source specified in the CIA]*.
24. We performed the following procedures related to the Company's semi-annual review of employee status.
- a. Read documentation of the semi-annual review as evidence that a review was performed.
 - b. Selected and reviewed the lesser of ten or all exceptions and determined that such employees were removed from responsibility for or involvement with Provider business operations related to the Federal health care programs.
 - c. Examined a notification letter addressed to the OIG and dated within 30 days of the employee's removal from employment.
 - d. Inquired of *[officer]* as to whether he or she was aware of any individuals employed in contravention of the prohibitions in the CIA. If so, we further noted that *[indicate specific procedures]* to confirm that such situation was cured within 30 days by *[indicate how situation was cured]*.

Annual Report

25. We read the Company's draft Annual Report dated *[date]* and determined that it included the following items, to be modified as appropriate, by the practitioner:
- a. Compliance Program Charter and organization chart
 - b. Amendments to policies
 - c. Detailed descriptions of reviews and audits
 - d. Summary of hotline communications
 - e. Summary of annual review of employees
 - f. Cross-referencing to items noted in the CIA

Record Retention

26. We read the Company's record retention policy and noted that it was consistent with the requirements as outlined in the CIA.

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Appendix E

Sample Report

Independent Accountant's Report

[Date]

[Sample Health Care Provider]

Office of Inspector General of the U.S. Department of Health and Human Services

We have performed the procedures enumerated in the Attachment, which were agreed to by Sample Health Care Provider (Company) and the Office of Inspector General (OIG) of the U.S. Department of Health and Human Services, solely to assist the users in evaluating management's assertion about [name of entity's] compliance with the Corporate Integrity Agreement (CIA) with the OIG dated [date of CIA] for the [period] ending [date], which is included as Attachment A to this report. This agreed-upon procedures engagement was performed in accordance with standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of the specified users of the report. Consequently, we make no representation regarding the sufficiency of the procedures described in Attachment B either for the purpose for which this report has been requested or for any other purpose.

We were not engaged to and did not perform an examination, the objective of which would be the expression of an opinion on management's compliance with the CIA. 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 Compliance Committee and management of the Company and the OIG, and is not intended to be and should not be used by anyone other than those specified parties.

[Include as Attachments the CIA and the summary that enumerates procedures and findings.]

[Signature]

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[The next page is 31,431.]

Section 14,360**Statement of Position 00-1 Auditing Health Care Third-Party Revenues and Related Receivables**

March 10, 2000

NOTE

This AICPA Statement of Position (SOP) has been developed by the AICPA Health Care Third-Party Revenue Recognition Task Force of the AICPA Auditing Standards Board (ASB) to provide guidance regarding auditing financial statement assertions about third-party revenues and related receivables of health care entities. This SOP is recognized as an interpretive publication as defined in AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards (AICPA, Professional Standards)*. Interpretive publications are recommendations on the application of generally accepted auditing standards (GAAS) 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 GAAS. The members of the ASB have found this SOP to be consistent with existing GAAS.

Although interpretive publications are not auditing standards, AU-C section 200 requires the auditor to consider applicable interpretive publications in planning and performing the audit because interpretive publications are relevant to the proper application of GAAS in specific circumstances. If the auditor does not apply the auditing guidance in an applicable interpretive publication, the auditor should document how the requirements of GAAS were complied with in the circumstances addressed by such auditing guidance.

Summary

This Statement of Position (SOP) provides guidance to auditors regarding uncertainties inherent in health care third-party revenue recognition. It discusses auditing matters related to testing third-party revenues and related receivables, and provides guidance regarding the sufficiency and appropriateness of audit evidence and reporting on financial statements, prepared in accordance with generally accepted accounting principles (GAAP), of health care entities exposed to material uncertainties. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

Introduction and Background

.01 Most health care providers participate in payment programs that pay less than full charges for services rendered. For example, some cost-based programs retrospectively determine the final amounts reimbursable for services rendered to their beneficiaries based on allowable costs. With increasing frequency, even non-cost-based programs (such as the Medicare Prospective Payment System)

have become subject to retrospective adjustments (for example, billing denials and coding changes). Often, such adjustments are not known for a considerable period of time after the related services were rendered.

.02 The lengthy period of time between rendering services and reaching final settlement, compounded further by the complexities and ambiguities of reimbursement regulations, makes it difficult to estimate the net patient service revenue associated with these programs. This situation has been compounded due to the frequency of changes in federal program guidelines.

.03 Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 954-605-45-2 states, in part, that “service revenue shall be reported net of contractual and other adjustments in the statement of operations, including patient service revenue.” As a result, patient receivables, including amounts due from third-party payors, are also reported net of expected contractual and other adjustments. However, amounts ultimately realizable will not be known until some future date, which may be several years after the period in which the services were rendered. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.04 This SOP provides guidance to auditors regarding uncertainties inherent in health care third-party revenue recognition. It discusses auditing matters related to testing third-party revenue and related receivables, including the effects of settlements (both cost-based and non-cost-based third-party payment programs), and provides guidance regarding the sufficiency and appropriateness of audit evidence and reporting on financial statements of health care entities exposed to material uncertainties. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Scope and Applicability

.05 This SOP applies to audits of health care entities falling within the scope of the AICPA Audit and Accounting Guide *Health Care Entities* (the guide). Its provisions are effective for audits of periods ending on or after June 30, 2000. Early application of the provisions of this SOP is permitted.

Third-Party Revenues and Related Receivables—Inherent Uncertainties

.06 Health care entities need to estimate amounts that ultimately will be realizable in order for revenues to be fairly stated in accordance with GAAP. The basis for such estimates may range from relatively straightforward calculations using information that is readily available to highly complex judgments based on assumptions about future decisions.

.07 Entities doing business with governmental payors (for example, Medicare and Medicaid) are subject to risks unique to the government-contracting environment that are hard to anticipate and quantify and that may vary from entity to entity. For example

- a health care entity’s revenues may be subject to adjustment as a result of examination by government agencies or contractors. The audit process and the resolution of significant related matters (including disputes based on differing interpretations of the regulations) often are not finalized until several years after the services were rendered.
- different fiscal intermediaries (entities that contract with the federal government to assist in the administration of the Medicare program) may interpret governmental regulations differently.

- differing opinions on a patient's principal medical diagnosis, including the appropriate sequencing of codes used to submit claims for payment, can have a significant effect on the payment amount.¹
- otherwise valid claims may be determined to be nonallowable after the fact due to differing opinions on medical necessity.
- claims for services rendered may be nonallowable if they are later determined to have been based on inappropriate referrals.²
- governmental agencies may make changes in program interpretations, requirements, or "conditions of participation," some of which may have implications for amounts previously estimated.

.08 Such factors often result in retrospective adjustments to interim payments. Reasonable estimates of such adjustments are central to the third-party revenue recognition process in health care, in order to avoid recognizing revenue that the provider will not ultimately realize. The delay between rendering services and reaching final settlement, as well as the complexities and ambiguities of billing and reimbursement regulations, makes it difficult to estimate net realizable third-party revenues.

Management's Responsibilities

.09 Management and, when appropriate, those charged with governance are responsible for the preparation and fair presentation of its financial statements in accordance with GAAP as well as for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error. Despite the inherent uncertainties, management is responsible for estimating the amounts recorded in the financial statements and making the required disclosures in accordance with GAAP, based on management's analysis of existing conditions. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.10 Management's assertions regarding proper valuation of its revenues and receivables are embodied in the financial statements. Management is responsible for recognizing revenues when their realization is reasonably assured. As a result, management makes a reasonable estimate of amounts that ultimately will be realized, considering—among other things—adjustments associated with regulatory reviews, audits, billing reviews, investigations, or other proceedings. Estimates that are significant to management's assertions about revenue include the provision for third-party payor contractual adjustments and allowances. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

¹ Historically, the Health Care Financing Administration contracted with Peer Review Organizations to validate the appropriateness of admissions and the clinical coding from which reimbursement was determined. Such reviews were typically performed within ninety days of the claim submission date. However, the government has modified its policies with respect to such reviews and now analyzes coding errors through other means, including in conjunction with investigations conducted by the Office of the Inspector General of the U. S. Department of Health and Human Services.

² Effective January 1, 1995, the Limitation on Certain Physician Referrals law prohibited physicians from referring Medicare and Medicaid patients to health care entities with which they had a financial relationship for the furnishing of designated health services. Implementing regulations have not yet been adopted as of the date of this publication.

.11 Management also is responsible for preparing and certifying cost reports submitted to federal and state government agencies in support of claims for payment for services rendered to government program beneficiaries.

The Auditor's Responsibilities

.12 The auditor's responsibility is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with an applicable financial reporting framework. Reasonable assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. In developing an opinion, the auditor should conclude whether the auditor has obtained reasonable assurance, which includes considering whether, among other matters,

- sufficient appropriate audit evidence has been obtained.
- uncorrected misstatements are material, individually or in aggregate.
- the financial statements are prepared and fairly presented, in all material respects, in accordance with GAAP.[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.13 Current industry conditions, as well as specific matters affecting the entity,³ provide relevant information when planning the audit. Among a number of procedures, the auditor's procedures may include an analysis of historical results (for example, prior fiscal intermediary audit adjustments and comparisons with industry benchmarks and norms) that enable the auditor to better assess the risk of material misstatements in the current period. When there are heightened risks, the auditor should perform audit procedures that respond to those risks, for example, more extensive tests covering the current period. Exhibit 10-1 of the guide includes examples of procedures auditors may perform. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of the 2012 edition of the Audit and Accounting Guide *Health Care Entities*.]

.14 With respect to auditing third-party revenues, a relevant consideration in addition to the usual revenue recognition considerations, is whether ultimately realizable amounts are known or will be presently known, or whether those amounts are uncertain because they are dependent on some other future, prospective actions or confirming events. For example, under a typical fee-for-service contract with a commercial payor, if the provider has performed a service for a covered individual, the revenue to which the provider is entitled should be determinable at the time the service is rendered. On the other hand, if the service was provided under a cost-based government contract, the revenue ultimately collectible may not be known until certain future events occur (for example, a cost report has been submitted and finalized after desk review or audit). In this case, management estimates the effect of such potential

³ Risk factors, including ones related to legislative and regulatory matters, are discussed annually in the AICPA Audit Risk Alert *Health Care Industry Developments*.

future adjustments. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.15 As stated previously, management is responsible for preparing the estimates contained in the financial statements. The auditor should evaluate the sufficiency and appropriateness of the evidence supporting those estimates, including the facts supporting management's judgments, and the judgments made based on conditions existing at the time of the audit. The fact that net revenues recorded at the time services are rendered differ materially from amounts that ultimately are realized does not necessarily mean the audit was not properly planned or carried out. Similarly, the fact that future events may differ materially from management's assumptions or estimates does not necessarily mean that management's estimates were not valid or the auditor did not follow generally accepted auditing standards as described in this SOP with respect to auditing estimates. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Audit Evidence

.16 The measurement of estimates is inherently uncertain and depends on the outcome of future events. AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (AICPA, *Professional Standards*), and AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report* (AICPA, *Professional Standards*), provide guidance to the auditor when the ultimate outcome of uncertainties cannot be expected to exist at the time of the audit because the outcome and related audit evidence are prospective. In the current health care environment, conclusive evidence concerning amounts ultimately realizable cannot be expected to exist at the time of the financial statement audit because the uncertainty associated with future program audits, administrative reviews, billing reviews, regulatory investigations, or other actions will not be resolved until sometime in the future. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.17 The fact that information related to the effects of future program audits, administrative reviews, regulatory investigations, or other actions does not exist does not lead to a conclusion that the evidence supporting management's assertions is not sufficient to support management's estimates. Rather, the auditor's professional judgment regarding the sufficiency of the audit evidence is based on the audit evidence that is, or should be, available. If, after considering the existing conditions and available evidence, the auditor concludes that sufficient appropriate audit evidence supports management's assertions about the nature of a matter involving an uncertainty (in this example, the valuation of revenues and receivables), and their presentation or disclosure in the financial statements, an unmodified opinion ordinarily is appropriate. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.18 The inability to obtain sufficient appropriate audit evidence that the auditor needs to conclude that the financial statements as a whole are free from material misstatement would require the auditor to express a qualified opinion or to disclaim an opinion because of a scope limitation. For example, if an entity has conducted an internal evaluation (for example, of coding or other billing matters) under attorney-client privilege and management and its legal counsel refuse to respond to the auditor's inquiries and the auditor determines the

information is necessary, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive, the auditor would express a qualified opinion for a scope limitation. If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive, the auditor would disclaim an opinion. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.19 The accuracy of management's assumptions will not be known until future events occur. In evaluating the accuracy of those assumptions, the entity's historical experience in making past estimates and the auditor's experience in the industry are relevant. For certain matters, the best evidence available to the auditor (particularly as it relates to clinical and legal interpretations) may be the representations of management and its legal counsel, as well as information obtained through reviewing correspondence from regulatory agencies. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.20 Pursuant to AU-C section 580, *Written Representations* (AICPA, *Professional Standards*), the auditor should request management to provide written representations that all instances of identified or suspected noncompliance with laws and regulations whose effects should be considered by management when preparing financial statements have been disclosed to the auditor. Examples of specific representations include the following:

- Receivables
 - Adequate consideration has been given to, and appropriate provision made for, estimated adjustments to revenue, such as for denied claims and changes to home health resource group, resource utilization group, ambulatory payment classification, and diagnosis-related group assignments.
 - Recorded valuation allowances are necessary, appropriate, and properly supported.
 - All peer review organizations, fiscal intermediary, and third-party payor reports and information have been made available.
- Cost reports filed with third parties
 - All required Medicare, Medicaid, and similar reports have been properly filed.
 - Management is responsible for the accuracy and propriety of all filed cost reports.
 - All costs reflected on such reports are appropriate and allowable under applicable reimbursement rules and regulations and are patient-related and properly allocated to applicable payors.
 - The employed reimbursement methodologies and principles are in accordance with applicable rules and regulations.
 - Adequate consideration has been given to, and appropriate provision made for, audit adjustments by intermediaries, third-party payors, or other regulatory agencies.

- All items required to be disclosed, including disputed costs that are being claimed to establish a basis for a subsequent appeal, have been fully disclosed in the cost report.
- Recorded third-party settlements include differences between filed (and to be filed) cost reports and calculated settlements, which are necessary based on historical experience or new or ambiguous regulations that may be subject to differing interpretations. Although management believes that the entity is entitled to all amounts claimed on the cost reports, management also believes the amounts of these differences are appropriate.
- Contingencies
 - No violations or possible violations of laws or regulations exist, such as those related to Medicare and Medicaid antifraud and abuse statutes, in any jurisdiction, whose effects are considered for disclosure in the financial statements or as a basis for recording a loss contingency other than those disclosed or accrued in the financial statements. This is including, but not limited to, the anti-kickback statute of the Medicare and Medicaid Patient and Program Protection Act of 1987, limitations on certain physician referrals (the Stark law), and the False Claims Act.
 - Billings to third-party payors comply in all material respects with applicable coding guidelines (for example, ICD-9-CM and CPT-4) and laws and regulations (including those dealing with Medicare and Medicaid antifraud and abuse), and billings reflect only charges for goods and services that were medically necessary; properly approved by regulatory bodies (for example, the Food and Drug Administration), if required; and properly rendered.
 - There have been no internal or external investigations relating to compliance with applicable laws and regulations, including investigations in progress, that would have an effect on the amounts reported in the financial statements or on the disclosure in the notes to the financial statements.
 - There have been no oral or written communications from regulatory agencies, governmental representatives, employees, or others concerning investigations or allegations of noncompliance with laws and regulations in any jurisdiction, including those related to Medicare and Medicaid antifraud and abuse statutes; deficiencies in financial reporting practices; or other matters that could have a material adverse effect on the financial statements.
 - Adequate consideration has been given to, and appropriate provision made for, a continuing care retirement community's obligation to provide future services and the use of facilities to current residents.
 - Adequate consideration has been given to, and appropriate provision made for, a prepaid health care provider's obligation to provide future health services.
 - Guarantees, whether written or oral, under which the health care entity is contingently liable, including guarantee contracts and indemnification agreements pursuant to FASB ASC 460, *Guarantees*, have been properly recorded or disclosed in the (consolidated) financial statements.

The auditor of the health care entity also might obtain specific representations, if applicable, of the following items that are unique or pervasive in the health care industry:

- The health care entity is in compliance with the provisions of Internal Revenue Code (IRC) Section 501(c)(3) and is exempt from federal income tax under IRC Section 501(a), as evidenced by a determination letter, and from state income tax.
- Information returns (Form 990) have been filed on a timely basis.
- Provision has been made, when material, for estimated retroactive adjustments by third-party payors under reimbursement agreements.
- The health care organization is in compliance with bond indentures or other debt instruments.
- For each of its outstanding bond issues, the health care entity is in compliance with postissuance requirements, as specified in the IRC, including, but not limited to, the areas of arbitrage and private business use.
- Pending changes in the organizational structure, financing arrangements, or other matters that could have a material effect on the financial statements of the entity are properly disclosed.
- The health care entity is in compliance with contractual agreements, grants, and donor restrictions.
- The health care entity has maintained an appropriate composition of net assets in amounts needed to comply with all donor restrictions.
- The internal controls over the receipt and recording of received contributions are adequate.
- The allocation of expenses reported in the notes to the financial statements is reasonable based on the health care entity's current operations.
- The health care entity has properly classified equity securities with readily determinable fair values and all debt securities as either trading or other-than-trading securities and reported these investments at fair value.
- The health care entity has reported to its risk management department all known asserted and unasserted claims and incidents. Adequate and reasonable provision has been made for losses related to asserted and unasserted malpractice, health insurance, worker's compensation, and any other claims.
- The health care entity is (or is not) subject to the requirements of Office of Management and Budget Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations*, or Title 45 U.S. Code of Federal Regulations Part 74.26 because it expended (or did not expend) more than \$500,000 in federal awards during the year.
- The health care entity has classified net assets as unrestricted, temporarily restricted, or permanently restricted based on its assessment of the donor's intention, as specified in original donor correspondence, when available. When not available, the entity used other corroborating evidential matter, including minutes of the board, accounting records, and financial statements. To the extent that it was unable to review original donor correspondence to determine the amount of the original gift and donor additions, its determination of such amount was based on its best estimate considering the relevant facts and circumstances. Amounts classified as temporarily restricted are subject to donor-imposed purpose or time restrictions that precluded the health

care entity from expending such amounts or recognizing such amounts as unrestricted as of the balance sheet date. Amounts classified as permanently restricted are subject to donor-imposed or statutory restrictions that require these amounts to be held in perpetuity. In addition, the health care entity has classified appreciation and income related to such donations in accordance with relevant donor or statutory restrictions. Losses on investments of a donor-restricted endowment fund have been classified in accordance with FASB ASC 958-205-45. Reclassifications between net asset classes are proper.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance of the 2012 edition of the Audit and Accounting Guide *Health Care Entities* and SAS Nos. 122–126.]

.21 Management’s refusal to furnish written representations constitutes a limitation on the scope of the audit. Such refusal is often sufficient to preclude an unmodified opinion and may 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. [Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

Potential Departures From GAAP Related to Estimates and Uncertainties

.22 The auditor also is responsible for determining whether financial statement assertions and disclosures related to accounting estimates have been presented in accordance with GAAP. Departures from GAAP related to accounting estimates generally fall into one of the following categories:

- Unreasonable accounting estimates
- Inappropriate accounting principles
- Inadequate disclosure

Therefore, in order to render an opinion, the auditor’s responsibility is to evaluate the reasonableness of management’s estimates based on present circumstances and to determine that estimates are reported in accordance with GAAP and adequately disclosed. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.23 As discussed in AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*), the objective of the auditor is to design and perform audit procedures that enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor’s opinion. As discussed previously, exhibit 10-1 of the guide provides a number of sample procedures that the auditor may perform in auditing an entity’s patient revenues and accounts receivable, including those derived from third-party payors. For example, the guide notes that the auditor might “test the reasonableness of settlement amounts, including specific and unallocated reserves, in light of the involved payors, the nature of the payment mechanism, the risks associated with future audits, and other relevant factors.”⁴ [Revised, September 2008, to reflect conforming changes necessary due to the issuance of SAS No. 105. Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012,

⁴ See paragraphs .25–.28.

to reflect conforming changes necessary due to the issuance of the 2012 edition of the Audit and Accounting Guide *Health Care Entities* and SAS Nos. 122–126.]

Unreasonable Accounting Estimates

.24 The basis for management's assumptions regarding the nature of future adjustments and calculations as to the effects of such adjustments are relevant factors when evaluating the reasonableness of management's estimates.⁵ The auditor cannot determine with certainty whether such estimates are right or wrong, because the accuracy of management's assumptions cannot be confirmed until future events occur. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.25 Paragraph .08c of AU-C section 540 requires the auditor to obtain an understanding of how management makes the accounting estimates, including the assumptions underlying the accounting estimates to provide a basis for the assessment of the risks of material misstatement for accounting estimates. Based on the assessed risks of material misstatement, the auditor should determine, in accordance with paragraph .12 of AU-C section 540,

- a. whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate and
- b. whether the methods for making the accounting estimates are appropriate and have been applied consistently and whether changes from the prior period, if any, in accounting estimates or the method for making them are appropriate in the circumstances.

In responding to the assessed risks of material misstatement, as required by AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), the auditor should undertake one or more of the following, in accordance with paragraph .13 of AU-C section 540, taking into account the nature of the accounting estimate:

- a. Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate.
- b. Test how management made the accounting estimate and the data on which it is based. In doing so, the auditor should evaluate whether
 - i. the method of measurement used is appropriate in the circumstances,
 - ii. the assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework, and
 - iii. the data on which the estimate is based is sufficiently reliable for the auditor's purposes.
- c. Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures.
- d. Develop a point estimate or range to evaluate management's point estimate. For this purpose
 - i. if the auditor uses assumptions or methods that differ from management's, the auditor should obtain an understanding of management's assumptions or methods sufficient to establish that the auditor's point estimate or range takes into account relevant

⁵ The lack of such analyses may call into question the reasonableness of recorded amounts.

variables and to evaluate any significant differences from management's point estimate.

- ii. if the auditor concludes that it is appropriate to use a range, the auditor should narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.26 The auditor should evaluate, based on the audit evidence, whether the accounting estimates in the financial statements are either reasonable in the context of the applicable financial reporting framework or are misstated. Based on the audit evidence obtained, the auditor may conclude that the evidence points to an accounting estimate that differs from management's point estimate. When the audit evidence supports a point estimate, the difference between the auditor's point estimate and management's point estimate constitutes a misstatement. When the auditor has concluded that using the auditor's range provides sufficient appropriate audit evidence, a management point estimate that lies outside the auditor's range would not be supported by audit evidence. In such cases, the misstatement is no less than the difference between management's point estimate and the nearest point of the auditor's range. (Paragraph .A122 of AU-C section 540). When management has changed an accounting estimate, or the method in making it, from the prior period based on a subjective assessment that there has been a change in circumstances, the auditor may conclude, based on the audit evidence, that the accounting estimate is misstated as a result of an arbitrary change by management or may regard it as an indicator of possible management bias (Paragraph .A123 of AU-C section 540). [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.27 Approaches and estimates will vary from entity to entity. Some entities with significant prior experience may attempt to quantify the effects of individual potential intermediary or other governmental (for example, the Office of Inspector General and the Department of Justice) or private payor adjustments, basing their estimates on very detailed calculations and assumptions regarding potential future adjustments. Some may prepare cost report⁶ analyses to estimate the effect of potential adjustments. Others may base their estimates on an analysis of potential adjustments in the aggregate, in light of the payors involved; the nature of the payment mechanism; the risks associated with future audits; and other relevant factors. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.28 One of the key factors in evaluating the estimate is the historical experience of the entity (for example, the aggregate amount of prior cost-report adjustments and previous regulatory settlements) as well as the risk of potential future adjustments. The fact that an entity currently is not subject to

⁶ Medicare cost reimbursement is based on the application of highly complex technical rules, some of which are ambiguous and subject to different interpretations even among Medicare's fiscal intermediaries. It is not uncommon for fiscal intermediaries to reduce claims for reimbursement that were based on management's good faith interpretations of pertinent laws and regulations. Additionally, the Provider Reimbursement Review Board or the courts may be required to resolve controversies regarding the application of certain rules. To avoid recognizing revenues before their realization is reasonably assured, providers estimate the effects of such potential adjustments. This is occasionally done by preparing a cost report based on alternative assumptions to help estimate contractual allowances required by generally accepted accounting principles. The existence of reserves or a reserve cost report does not by itself mean that a cost report was incorrectly or fraudulently filed.

a governmental investigation does not mean that a recorded valuation allowance for potential billing adjustments is not warranted. Nor do these emerging industry trends necessarily indicate that an accrual for a specific entity is warranted. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.29 In evaluating valuation allowances, the auditor may consider the entity's historical experience and potential future adjustments in the aggregate. For example, assume that over the past few years after final cost report audits were completed, a hospital's adjustments averaged 3 percent to 5 percent of total filed reimbursable costs. Additionally, the hospital is subject to potential billing adjustments, including errors (for example, violations of the three-day window, discharge and transfer issues, and coding errors). Even though specific incidents are not known, it may be reasonable for the hospital to estimate and accrue a valuation allowance for such potential future retrospective adjustments, both cost-based and non-cost-based. Based on this and other information obtained, the auditor may conclude that a valuation allowance for the year under audit of 3 percent to 5 percent of reimbursable costs plus additional amounts for potential non-cost-based program billing errors is reasonable.

.30 Amounts that ultimately will be realized by an entity are dependent on a number of factors, many of which may be unknown at the time the estimate is first made. Further, even if two entities had exactly the same clinical and coding experience, amounts that each might realize could vary materially due to factors outside of their control (for example, differing application of payment rules by fiscal intermediaries, legal interpretations of courts, local enforcement initiatives, timeliness of reviews, and quality of documentation). As a result, because estimates are a matter of judgment and their ultimate accuracy depends on the outcome of future events, different entities in seemingly similar circumstances may develop materially different estimates. The auditor may conclude that both estimates are reasonable in light of the differing assumptions.

Inappropriate Accounting Principles

.31 As previously stated, the auditor also is responsible for determining whether financial statement assertions and disclosures related to accounting estimates are presented in accordance with GAAP. When the financial statements are materially affected by a departure from GAAP, the auditor should express a qualified or adverse opinion in accordance with AU-C section 705. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.32 Valuation allowances should be recorded so that revenues are not recognized until the revenues are realizable. Valuation allowances are not established based on the provisions of FASB ASC 450, *Contingencies*. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.33 Indicators of possible measurement bias related to valuation allowances include

- valuation allowances that are not associated with any particular program, issue, or time period (for example, cost-report year or year the service was rendered).
- distorted earnings trends over time (for example, building up specific or unallocated valuation allowances in profitable years and drawing them down in unprofitable years).

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Inadequate Disclosure

.34 If the auditor concludes that a matter involving a risk or an uncertainty is not adequately disclosed in the financial statements in accordance with GAAP, the auditor should express a qualified or adverse opinion in accordance with AU-C section 705. FASB ASC 275-10-50 provides guidance on the information that reporting entities should disclose regarding risks and uncertainties existing as of the date of the financial statements. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.35 In the health care environment, it is almost always at least reasonably possible that estimates regarding third-party payments could change in the near term as a result of one or more future confirming events (for example, regulatory actions reflecting local or national audit or enforcement initiatives). For most entities with significant third-party revenues, the effect of the change could be material to the financial statements. Where material exposure exists, the uncertainty regarding revenue realization should be disclosed in the notes to the financial statements. Because representations from legal counsel are often key audit evidence in evaluating the reasonableness of management's estimates of potential future adjustments, the inability of an attorney to form an opinion on matters about which he or she has been consulted may be indicative of an uncertainty that should be specifically disclosed in the financial statements. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.36 Differences between original estimates and subsequent revisions might arise due to final settlements, ongoing audits and investigations, or passage of time in relation to the statute of limitations. FASB ASC 954-605 requires that these differences be included in the statement of operations in the period in which the revisions are made and disclosed. Such differences are not treated as prior period adjustments unless they meet the criteria for prior period adjustments as set forth in FASB ASC 250-10-45. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.37 Disclosures such as the following may be appropriate:

General Hospital (the Hospital) is a (not-for-profit, for-profit, or governmental hospital or health care system) located in (City, State). The Hospital provides health care services primarily to residents of the region.

Net patient service revenue is reported at estimated net realizable amounts from patients, third-party payors, and others for services rendered and includes estimated retroactive revenue adjustments due to future audits, reviews, and investigations. Retroactive adjustments are considered in the recognition of revenue on an estimated basis in the period the related services are rendered, and such amounts are adjusted in future periods as adjustments become known or as years are no longer subject to such audits, reviews, and investigations.

Revenue from the Medicare and Medicaid programs accounted for approximately 40 percent and 10 percent, respectively, of the Hospital's net patient revenue for the year ended 1999. Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. The 1999 net patient service revenue increased approximately \$10,000,000 due

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to removal of allowances previously estimated that are no longer necessary as a result of final settlements and years that are no longer subject to audits, reviews, and investigations. The 1998 net patient service revenue decreased approximately \$8,000,000 due to prior-year retroactive adjustments in excess of amounts previously estimated.

Appendix — Other Considerations Related to Government Investigations

In recent years, the federal government and many states have aggressively increased enforcement efforts under Medicare and Medicaid anti-fraud and abuse legislation. Broadening regulatory and legal interpretations have significantly increased the risk of penalties for providers; for example, broad interpretations of “false claims” laws are exposing ordinary billing mistakes to scrutiny and penalty consideration. In such circumstances, evaluating the adequacy of accruals for or disclosure of the potential effects of noncompliance with laws and regulations in the financial statements of health care entities is a matter that is likely to require a high level of professional judgment.

As previously discussed in this Statement of Position, the far-reaching nature of alleged fraud and abuse violations creates an uncertainty with respect to the valuation of revenues, because future allegations of noncompliance with laws and regulations could, if proven, result in a subsequent reduction of revenues. In addition, management makes provisions in the financial statements and disclosures for any contingent liabilities associated with fines and penalties due to violations of such laws. Financial Accounting Standards Board *Accounting Standards Codification* 450, *Contingencies*, provides guidance in evaluating contingent liabilities, such as fines and penalties under applicable laws and regulations. Estimates of potential fines and penalties are not accrued unless their payment is probable and reasonably estimable.

The auditor’s expertise is in accounting and auditing matters rather than operational, clinical, or legal matters. Accordingly, the auditor’s procedures focus on areas that normally are subject to internal control relevant to financial reporting. However, the further that suspected noncompliance with laws and regulations is removed from the events and transactions ordinarily reflected in the financial statements, the less likely the auditor is to become aware of the suspected noncompliance, to recognize its possible noncompliance with laws and regulations, and to evaluate the effect on the financial statements. For example, determining whether a service was medically necessary, obtained through a legally appropriate referral, properly performed (including using only approved devices, rendered in a quality manner), adequately supervised, accurately documented and classified, or rendered and billed by nonsanctioned individuals typically is not within the auditor’s professional expertise. As a result, an audit in accordance with generally accepted auditing standards (GAAS) is not designed to detect such matters.

Further, because of the inherent limitations of an audit, an audit conducted in accordance with GAAS provides no assurance that all instances of noncompliance with laws and regulations will be detected.¹

Nor does an audit under GAAS include providing any assurance on an entity’s billings or cost report. In fact, cost reports typically are not prepared and submitted until after the financial statement audit has been completed.

Certain audit procedures, although not specifically designed to detect noncompliance with laws and regulations, may bring possible noncompliance with laws and regulations to an auditor’s attention. When suspected noncompliance is detected, the auditor’s responsibilities are addressed in AU-C section 250, *Consideration of*

¹ Even when auditors undertake a special engagement designed to attest to compliance with certain provisions of laws, regulations, contracts, and grants (for example, an audit in accordance with Office of Management and Budget Circular A-133), the auditor’s procedures do not extend to testing compliance with laws and regulations related to Medicare and Medicaid fraud and abuse.

Laws and Regulations in an Audit of Financial Statements (AICPA, *Professional Standards*). Disclosure of noncompliance with laws and regulations to parties other than the client's senior management and its audit committee or board of directors is not ordinarily part of the auditor's responsibility, and such disclosure would be precluded by the auditor's ethical or legal obligation of confidentiality, unless the matter affects the auditor's opinion on the financial statements.² [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

² Paragraph .A28 of AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* (AICPA, *Professional Standards*), discusses circumstances in which a duty to notify parties outside the entity of identified or suspected noncompliance with laws and regulations may exist. [Footnote revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

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Section 14,370

Statement of Position 01-3 Performing Agreed-Upon Procedures Engagements That Address Internal Control Over Derivative Transactions as Required by the New York State Insurance Law

June 15, 2001

NOTE

This AICPA Statement of Position (SOP) has been developed by the AICPA Reporting on Internal Control Over Derivative Transactions at Insurance Entities Task Force of the AICPA Auditing Standards Board (ASB) to provide guidance regarding the application of Statements on Standards for Attestation Engagements (SSAEs) to agreed-upon procedures engagements performed to comply with the requirements of Section 1410 (b)(5) of the New York State Insurance Law, as amended (the law), which addresses the assessment of internal control over derivative transactions as defined in Section 1401(a) of the law, and Section 178.5 of Regulation No. 163.

This SOP is recognized as an attestation interpretation as defined in AT section 50, *SSAE Hierarchy* (AICPA, *Professional Standards*). Attestation interpretations are recommendations on the application of SSAEs in specific circumstances, including engagements for entities in specialized industries. Attestation interpretations are issued under the authority of the ASB. The members of the ASB have found this SOP to be consistent with existing SSAEs.

A practitioner should be aware of and consider attestation interpretations applicable to his or her attestation engagement. If the practitioner does not apply the guidance included in this SOP, the practitioner should be prepared to explain how he or she complied with the SSAE provisions of this SOP.

Introduction and Background

.01 In 1999 and 2000, the New York State Insurance Department (the department) issued regulations to implement the New York Derivative Law (the law) which amends Article 14 of the State of New York Insurance Law, effective July 1, 1999. The law establishes certain requirements for domestic life insurers, domestic property and casualty insurers, domestic reciprocal insurers, domestic mortgage guaranty insurers, domestic cooperative property and casualty insurance corporations, and domestic financial guaranty insurers. Foreign insurers engaging in derivative transactions and derivative instruments are subject to and required to comply with all of the provisions of the law. However, a foreign insurer may enter into other derivative transactions provided the insurer meets certain conditions of its domestic state law. In this document, an insurer covered by the law is referred to as an *insurance company*.

.02 The requirements of the law include the following:

- Approval by the board of directors, or a similar body, of derivative transactions
- Submission of a derivative use plan (the DUP) to the Department
- Assessment by an independent certified public accountant (CPA) of the insurance company's internal control over derivative transactions

.03 In addition to the law, the Department also established Regulation No. 163, "Derivative Transactions" (11 NYCRR 178) (the Regulation), which provides guidance in implementing the law. Section 178.5 of Regulation No. 163 states the following.

As set forth in section 1410 (b)(5) of the Insurance Law, an insurer engaging in derivative transactions shall be required to include, as part of the evaluation of accounting procedures and internal controls required to be filed pursuant to section 307 of the Insurance Law, a statement describing the assessment by the independent certified public accountant of the internal controls relative to derivative transactions. The purpose of this part of the evaluation is to assess the adequacy of the internal controls relative to the derivative transactions being conducted by the insurer. Such an assessment shall be made whether or not the derivative transactions are material in relation to the insurer's financial statements. The independent certified public accountant shall issue a report regarding internal controls relative to derivative transactions, whether or not deficiencies in internal controls would lead to a "reportable condition," as that term is used in auditing standards adhered to by certified public accountants. An assessment in the form of an "agreed upon procedures engagement" or an "attestation engagement," as those terms are used in auditing standards adhered to by certified public accountants, may be used to meet this requirement. If an "agreed upon procedures engagement" is performed, the procedures used shall be those that management and the independent certified public accountant determine are appropriate to meet the purpose of the assessment as set forth above.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

[.04-.05] [Paragraphs deleted, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.06 An agreed-upon procedures engagement or other attestation engagement may be used to satisfy the requirements of the law. However, this Statement of Position (SOP) only describes an agreed-upon procedures engagement. It does not address any other attestation engagements that might be performed, such as an examination-level attestation engagement. For guidance on performing such other attestation engagements, see AT section 101, *Attest Engagements* (AICPA, *Professional Standards*). [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Applicability

.07 This SOP was developed to provide practitioners with guidance on performing agreed-upon procedures engagements that address an insurance company's internal control over derivative transactions to meet the requirements of the law. The engagement described in this SOP is designed only to satisfy the requirements of the law. The procedures, as set forth in this SOP, are not necessarily appropriate for use in any other engagement. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.08 Although the Department has indicated that an agreed-upon procedures engagement pursuant to this SOP can be used to satisfy the requirements for an assessment of internal control over derivative transactions, the Department has not agreed to the sufficiency of the procedures included in this SOP for their purposes.

The Law

Definition of a Derivative

.09 Article 14 of the law defines a derivative instrument as including caps, collars, floors, forwards, futures, options, swaps, swaptions, and warrants.

.10 The following definitions are included in the law and are applicable when performing the agreed-upon procedures engagement described in this SOP.

Cap—An agreement obligating the seller to make payments to the buyer with each payment based on the amount by which a reference price or level or the performance or value of one or more underlying interests exceeds a predetermined number, sometimes called the strike rate or strike price.

Collar—An agreement to receive payments as the buyer of an option, cap, or floor and to make payments as the seller of a different option, cap, or floor.

Floor—An agreement obligating the seller to make payments to the buyer in which each payment is based on the amount by which a predetermined number, sometimes called the floor rate or price, exceeds a reference price, level, performance, or value of one or more underlying interests.

Forward—An agreement (other than a future) to make or take delivery in the future of one or more underlying interests, or effect a cash settlement, based on the actual or expected price, level, performance, or value of such underlying interests, but shall not mean or include spot transactions effected within customary settlement periods, when-issued purchases, or other similar cash market transactions.

Future—An agreement traded on a futures exchange, to make or take delivery of, or effect a cash settlement based on the actual or expected price, level, performance, or value of one or more underlying interests.

Option—An agreement giving the buyer the right to buy or receive (a *call option*), sell or deliver (a *put option*), enter into, extend or terminate, or effect a cash settlement based on the actual or expected price, spread, level, performance, or value of one or more underlying interests.

Swap—An agreement to exchange or to net payments at one or more times based on the actual or expected price, yield, level, performance, or value of one or more underlying interests.

Swaption—An option to purchase or sell a swap at a given price and time or at a series of prices and times. A swaption does not mean a swap with an embedded option.

Warrant—An instrument that gives the holder the right to purchase or sell the underlying interest at a given price and time or at a series of prices and times outlined in the warrant agreement.

.11 Article 14 of the law permits an insurance company to enter into *replication transactions* provided that certain conditions set forth in the law are met. A replication transaction is defined in the law as follows.

A derivative transaction or combination of derivative transactions effected either separately or in conjunction with cash market investments included in the insurer's investment portfolio in order to replicate the investment characteristic of another authorized transaction, investment or instrument and/or operate as a substitute for cash market transactions. A derivative transaction entered into by the insurer as a hedging transaction or income generation transaction authorized pursuant to this section [of the law] shall not be considered a replication transaction.

Derivative Use Plan

.12 An insurance company entering into derivative transactions must file a DUP with the Department. The DUP generally should include the following items:¹

- A certified copy of the authorization by the insurer's board of directors, or other similar body, to file the DUP, which should include authorization of derivative transactions and an assurance that individuals responsible for derivative transactions, processes, and controls have the necessary experience and knowledge
- A section on management oversight standards including a discussion of the following:
 - Limits on identified risks
 - Controls over the nature and amount of identified risks
 - Processes for identifying such risks
 - Processes for documenting, monitoring, and reporting risk exposure
 - Internal audit and review processes that ensure integrity of the overall risk management process
 - Quarterly reporting to the board of directors
 - The establishment of risk tolerance levels
 - Management's measurement and monitoring against those levels

¹ Reference should be made to the law and the Regulation for specific details and exact requirements.

- A section on internal control and reporting including a discussion of the following:
 - The existence of controls over the valuation and effectiveness of derivative instruments
 - Credit risk management
 - The adequacy of professional personnel
 - Technical expertise and systems
 - Management reporting
 - The review and legal enforceability of derivative contracts between parties
- A section on documentation and reporting requirements which shall for each derivative transaction document the following:
 - The purpose of the transaction
 - The assets or liabilities to which the transaction relates
 - The specific derivative instrument used
 - For over-the-counter (OTC) transactions, the name of the counterparty and counterparty exposure amount
 - For exchange traded transactions, the name of the exchange and the name of the firm handling the trade
- Written guidelines to be followed in engaging in derivative transactions. The guidelines should include or address the following:
 - The type, maturity, and diversification of derivative instruments
 - The limitation on counterparty exposures, including limitations based on credit ratings
 - The limitations on the use of derivatives
 - Asset and liability management practices with respect to derivative transactions
 - The liquidity needs and the insurance company's capital and surplus as it relates to the DUP
 - The policy objectives of management specific enough to outline permissible derivative strategies
 - The relationship of the strategies to the insurer's operations
 - How the strategies relate to the insurer's risk
 - A requirement that management establish and execute management oversight standards as required by the law
 - A requirement that management establish and execute internal control and reporting standards as required by the law
 - A requirement that management establish and execute documentation and reporting standards as required by the law
- Guidelines for the insurer's determination of acceptable levels of basis risk, credit risk, foreign currency risk, interest rate risk, market risk, operational risk, and option risk
- A requirement that the board of directors and senior management comply with risk oversight functions and adhere to laws, rules, regulations, prescribed practices, or ethical standards

Related Professional Standards

AT Section 201, *Agreed-Upon Procedures Engagements*

.13 Agreed-upon procedures engagements performed to meet the requirements of the law are to be performed in accordance with AT section 201, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*). As described in paragraph .03 of AT section 201, an agreed-upon procedures engagement is one in which a practitioner is engaged by a client to issue a report of findings based on specific procedures performed on the subject matter. Not all of the provisions of AT section 201 are discussed herein. Rather, this SOP includes guidance to assist practitioners in the application of selected aspects of AT section 201.

.14 Paragraph .06 of AT section 201 (states, in part, that the practitioner may perform an agreed-upon procedures engagement provided that, “...(c) the practitioner and the specified parties agree upon the procedures performed or to be performed by the practitioner; and (d) the specified parties take responsibility for the sufficiency of the agreed-upon procedures for their purposes.”

.15 As previously stated, Regulation No. 163 states that an agreed-upon procedures engagement may be used to meet the requirement for an independent CPA’s assessment of internal control over derivative transactions. When performing an agreed-upon procedures engagement under this SOP, practitioners should not eliminate any of the procedures presented in appendix B, “Agreed-Upon Procedures for Testing Internal Control Over Derivative Transactions” (paragraph .37), of this SOP or reduce the extent of the tests. The Department or the insurance company may request that additional procedures be performed and the practitioner may agree to perform such procedures. In those circumstances, it would be expected that the additional procedures would be performed in the context of a separate agreed-upon procedures engagement.

.16 As previously noted, the Department has not agreed to the sufficiency of the procedures included in this SOP for their purposes. *Therefore, the Department should not be named as a specified party to the agreed-upon procedures report, and the use of a practitioner’s agreed-upon procedures report, issued in accordance with this SOP, should be restricted to the board of directors and management of the insurance company.* Although the Department is not a specified party, footnote 15 of AT section 101 states the following, in part:

... a regulatory agency as part of its oversight responsibility for an entity may require access to restricted-use reports in which they are not named as a specified party.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

AU-C section 501, *Audit Evidence—Specific Considerations for Selected Items*

.17 AU-C section 501, *Audit Evidence—Specific Considerations for Selected Items* (AICPA, *Professional Standards*), addresses specific considerations by the auditor in obtaining sufficient appropriate audit evidence, in accordance with AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*), and other relevant AU-C sections in AICPA *Professional Standards*, regarding the

valuation of investments in securities and derivative instruments. A practitioner performing the agreed-upon procedures engagement described in this SOP may find it helpful to consider the guidance in paragraphs .01–.10 of AU-C section 501 and the related Audit Guide *Special Considerations in Auditing Financial Instruments*. AU-C section 620, *Using the Work of an Auditor's Specialist* (AICPA, *Professional Standards*), addresses the auditor's responsibilities related to using the work of an individual or organization possessing expertise in a field other than accounting or auditing to assist the auditor in obtaining sufficient appropriate audit evidence. A practitioner should consider the guidance in AU-C section 620 when the practitioner plans to use the work of a specialist in securities and derivative instruments to perform the agreed-upon procedures described in this SOP. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.18 The procedures in this SOP are not designed to meet the requirements of generally accepted auditing standards for an audit of the financial statements of an entity that engages in derivative transactions. In addition, performing the audit procedures described in AU-C section 501 would not meet the requirements of this SOP. [Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.19 In an audit of financial statements, the auditor may determine that he or she will not perform procedures related to derivative transactions because they are not material to the financial statements. There is no requirement to perform the procedures described in this SOP when performing an audit of financial statements. In contrast, the law requires that an assessment of internal control be performed whether or not the derivative transactions are material to the insurer's financial statements. Accordingly, a decision not to perform procedures related to derivative transactions in an audit of financial statements, because of immateriality, would not alleviate the requirement to perform the agreed-upon procedures engagement described herein.

Procedures to Be Performed

.20 The agreed-upon procedures to be performed are directed toward tests of controls over derivative transactions that occurred during the period covered by the practitioner's report. Any projection of the practitioner's findings to the future is subject to the risk that because of change, the controls may no longer be in existence, suitably designed, or operating effectively. Also, the potential effectiveness of controls over derivative transactions is subject to inherent limitations and, accordingly, errors or fraud may occur and not be detected.

.21 The procedures to be performed in the agreed-upon procedures engagement described in this SOP are presented in appendix B (paragraph .37). The procedures have been designed so that the findings resulting from the application of the procedures can be recorded in a tabular format. The three options available to the practitioner for expressing the findings for each procedure are *No Exception*, *Exception*, or *N/A* (not applicable). If a procedure is not applicable to a particular insurance company, the procedure should be marked *N/A* rather than deleted from the report. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.22 Section 1 of appendix B (paragraph .37) of this SOP is applicable to all insurance companies that enter into derivative transactions. Therefore, the

procedures in section 1 are to be performed in all engagements performed in accordance with this SOP. Sections 2–10 of appendix B (paragraph .37) of this SOP each address a specific type of derivative. The procedures in those sections are to be performed only if the insurance company entered into derivative transactions of the type covered by the section. Sections that address types of derivatives not used by the insurance company should not be attached to the agreed-upon procedures report.

.23 If any portion of a procedure results in an exception, the findings for that entire procedure should be recorded as an exception and described in the section “Description of Exceptions If Any,” at the end of each section. The practitioner should provide a brief factual explanation for each exception that will enable the specified parties to understand the nature of the findings resulting in the exception. If management informs the practitioner that the condition giving rise to the exception was corrected by the date of the practitioner’s report, the practitioner’s explanation of the exception may include that information; for example, “Management has advised us that the condition resulting in the exception was corrected on Month X, 20XX. We have performed no procedures with respect to management’s assertion.”

.24 A practitioner may perform significant portions of the agreed-upon procedures engagement before the end of the period covered by the report. If, during that time, the practitioner identifies conditions that result in an exception in one or more agreed-upon procedures, he or she should report the exception in the findings section of the agreed-upon procedures report, even if management corrects the condition prior to the end of the period.

.25 The law requires the insurance company to provide the Department with a statement describing the independent CPA’s assessment of the insurance company’s internal control over derivative transactions. It also requires the insurance company to include a description of any remedial actions taken or proposed to be taken to correct any deficiencies identified by the independent CPA.

.26 Paragraph .40 of AT section 201 states the following.

The practitioner need not perform procedures beyond the agreed-upon procedures. However, in connection with the application of agreed-upon procedures, if matters come to the practitioner’s attention by other means that significantly contradict the subject matter (or written assertion related thereto) referred to in the practitioner’s report, the practitioner should include this matter in his or her report. For example, if during the course of applying agreed-upon procedures regarding an entity’s internal control, the practitioner becomes aware of a material weakness by means other than performance of the agreed-upon procedures, the practitioner should include this matter in his or her report.

.27 A practitioner has no obligation to perform procedures beyond the agreed-upon procedures included in appendix B (paragraph .37) of this SOP. However, if information indicating a weakness in internal control over derivative transactions comes to the practitioner’s attention by other means, such information should be included in the practitioner’s report. This would apply to conditions or events occurring during the subsequent-events period (subsequent to the period covered by the practitioner’s report but prior to the date of the practitioner’s report) that either contradict the findings in the report or that would have resulted in the reporting of an exception by the practitioner if that condition or event had existed during the period covered by the report. However, the practitioner has no responsibility to perform any procedure to detect such conditions or events.

Establishing an Understanding With the Client

.28 In accordance with paragraph .10 of AT section 201, the practitioner should establish an understanding with the client regarding the services to be performed. Such an understanding reduces the risk that the client may misinterpret the objectives and limitations of an agreed-upon procedures engagement performed to meet the regulatory requirements of the law. Such an understanding also reduces the risk that the client will misunderstand its responsibilities and the responsibilities of the practitioner. The practitioner should document the understanding in the working papers, preferably through a written communication with the client (an *engagement letter*). The communication should be addressed to the client. Matters that might be included in such an understanding are the following:

- A statement confirming that an agreed-upon procedures engagement is to be performed to meet the requirements of Section 1410(b)(5) of the law
- A statement identifying the procedures to be performed as those set forth in this SOP
- A statement identifying the client as the specified party to the agreed-upon procedures report
- A statement acknowledging the client's responsibility for the sufficiency of the procedures in the SOP
- A statement acknowledging that the practitioner makes no representation regarding the sufficiency of the procedures in the SOP
- A statement describing the responsibilities of the practitioner, including but not limited to the responsibility to perform the agreed-upon procedures and to provide the client with a report, and the circumstances under which the practitioner may decline to issue a report
- A statement indicating that the engagement will be conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants (AICPA)
- A statement indicating that an agreed-upon procedures engagement does not constitute an examination, the objective of which would be the expression of an opinion on the internal control over derivative transactions, and that if an examination were performed, other matters might come to the practitioner's attention
- A statement indicating that the practitioner will not express an opinion or any other form of assurance
- A statement describing the client's responsibility to comply with the law and the client's responsibility for the design and operation of effective internal control over derivative transactions
- A statement describing the client's responsibility for providing accurate and complete information to the practitioner
- A statement indicating that the practitioner has no responsibility for the completeness or accuracy of the information provided to the practitioner
- A statement restricting the use of the report to the client
- A statement describing any arrangements to involve a specialist

Management Representations

.29 Although AT section 201 does not require a practitioner to obtain a representation letter from management in an agreed-upon procedures engagement, when performing the engagement described in this SOP, it is recommended that the practitioner obtain such a letter signed by the appropriate members of management, including the highest ranking officer responsible for internal control over derivative transactions. Management's refusal to furnish written representations that the practitioner has determined to be appropriate for the engagement constitutes a limitation on the performance of the engagement that requires either modification of the report or withdrawal from the engagement. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.30 The representations that a practitioner deems appropriate will depend on the specific nature of the engagement; however, they generally include the following representations from management:

- A statement acknowledging responsibility for establishing and maintaining effective internal control over derivative transactions
- A statement that there have been no errors or fraud that might indicate a weakness in the internal control over derivative transactions
- A statement that management has disclosed to the practitioner all significant deficiencies in the design or operation of the internal control over derivative transactions
- A statement that management has disclosed to the practitioner any communications from regulatory agencies, internal auditors, and other practitioners or consultants relating to the internal control over derivative transactions
- A statement that management has made available to the practitioner all information they believe is relevant to the internal control over derivative transactions
- A statement that management has responded fully to all inquiries made by the practitioner during the engagement
- A statement that no events have occurred subsequent to the date as of which the procedures were applied that would require adjustment to or modification to responses to the agreed-upon procedures

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.31 An illustrative representation letter is presented in appendix C, "Illustrative Management Representation Letter" (paragraph .38), of this SOP. For additional information regarding management's representations in an agreed-upon procedures engagement, see paragraphs .37–.39 of AT section 201.

Restriction on the Performance of Procedures

.32 As previously stated, a practitioner should not agree to do either of the following.

- a. Eliminate any of the procedures presented in appendix B (paragraph .37) of this SOP, unless a section is not applicable because the insurance company did not enter into derivative transactions addressed by the section.
- b. Reduce the extent of the tests in an applicable section.

.33 If circumstances impose restrictions on the performance of the agreed-upon procedures presented in appendix B (paragraph .37) of this SOP, the practitioner should describe the restriction(s) in his or her report or withdraw from the engagement.

Dating the Report

.34 The date of completion of the agreed-upon procedures should be used as the date of the practitioner's report.

Effective Date

.35 This SOP is effective upon issuance and is applicable only to agreed-upon procedures engagements that address internal control over derivative transactions required by the law.

Appendix A — Illustrative Agreed-Upon Procedures Report

The following is an illustrative agreed-upon procedures report based on the guidance in AT section 201, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*).

Independent Accountant's Report on Applying Agreed-Upon Procedures

To the Management of ABC Insurance Company:

We have performed the applicable procedures enumerated in the American Institute of Certified Public Accountants' Statement of Position (SOP), 01-3, *Performing Agreed-Upon Procedures Engagements That Address Internal Control Over Derivative Transactions as Required by the New York State Insurance Law*, which were agreed to by ABC Insurance Company, solely to assist you in complying with the requirements of Section 1410 (b)(5) of the New York State Insurance Law, as amended (the law), which addresses the assessment of internal control over derivative transactions as defined in Section 1401(a) of the law, and Section 178.5 of Regulation No. 163 during the year ended December 31, 20XX. Management of ABC Insurance Company is responsible for maintaining effective internal control over derivative transactions. 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 ABC Insurance Company. Consequently, we make no representation regarding the sufficiency of the procedures described in the attached appendix either for the purpose for which this report has been requested or for any other purpose.

The procedures performed and the findings are included in the attached appendix.

We were not engaged to and did not conduct an examination, the objective of which would be the expression of an opinion on the internal control over derivative transactions of ABC Insurance Company for the year ended December 31, 20XX. 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 management and Board of Directors of ABC Insurance Company and is not intended to be and should not be used by anyone other than these specified parties.

[Signature]

[Date]

Appendix B — Agreed-Upon Procedures for Testing Internal Control Over Derivative Transactions

The following table lists the types of derivative transactions permitted by the New York Derivative Law (the law). We inquired of management of the insurance company as to whether the insurance company used the type of derivative addressed by each section, and marked the column entitled “Is the Section Applicable?” either *Yes* or *No* based on management’s response to the inquiry. For each type of derivative with a *Yes* response, we performed the procedures in the applicable section and attached the section to the report. For each type of derivative with a *No* response, we did not perform procedures nor did we attach the applicable section to the report. We compared the types of derivative reported by the insurance company in its “Schedule of Derivative Transactions” included in the Annual Statement with the types of derivatives listed in the following table and found that the types of derivatives included in the schedule were marked *Yes* in the table.

Attachments to the Report

<u>No.</u>	<u>Section of the Agreed-Upon Procedures Type of Derivative</u>	<u>Is the Section Applicable? Yes or No</u>
1	All Derivative Types	Yes
2	Cap Contracts	
3	Collar Contracts	
4	Floor Contracts	
5	Forward Contracts	
6	Future Contracts	
7	Option Contracts	
8	Swap Contracts	
9	Swaption Contracts	
10	Warrant Contracts	

Section 1 – All Derivative Types

Findings

Procedures

<u><i>No</i></u>			
<u><i>Exception</i></u>	<u><i>Exception</i></u>		<u><i>N/A</i></u>

The following procedures were performed to test controls applicable to all derivative transactions. The procedures were applied to the internal control over derivative transactions in existence during the year ended December 31, 20XX

Documentation of Controls, Policies, and Procedures

1. Read the insurance company’s derivative use plan (DUP), amendments thereto, and its documentation of controls, policies, and procedures that describe internal control over derivative transactions and found that the DUP and the documentation of controls, policies, and procedures include a description of controls that address the following:
 - a. Systems or processes for the periodic valuation of derivative transactions including mechanisms for compensating for any lack of independence in valuing derivative positions (Valuation)
 - b. Systems or processes for determining whether a derivative instrument used for hedging or replication has been effective (Effectiveness)
 - c. Credit risk management systems or processes for over-the-counter (OTC) derivative transactions that measure credit risk exposure using the counterparty exposure amount and policies for the establishment of collateral arrangements with counterparties (Credit Risk Management)

_____	_____	_____
_____	_____	_____
_____	_____	_____

Findings

<u>Procedures</u>	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
d. Management assessment of the adequacy and technical expertise of personnel associated with derivative transactions and systems to implement and control investment practices involving derivatives (Professional Competence)	_____	_____	_____
e. Systems or processes for regular reports to management, segregation of duties, and internal review procedures (Reporting)	_____	_____	_____
f. Procedures for conducting initial and ongoing legal reviews of derivative transactions including assessments of contract enforceability (Legal Reviews)	_____	_____	_____

Nontransaction-Specific Procedures

2. Read the minutes of meetings of the board of directors and found an indication that the board of directors of the insurance company approved the DUP and any amendments thereto.	_____	_____	_____
3. Inquired of management as to whether the DUP and any amendments thereto were approved by the New York State Insurance Department and was advised that the DUP and any amendments thereto were approved.	_____	_____	_____
4. Read the minutes of meetings of the board of directors and found an indication that the board of directors of the insurance company approved the commitment of financial resources determined by management to be sufficient to accomplish the objectives of the insurance company's DUP.	_____	_____	_____

(continued)

Findings

Procedures

No
Exception Exception N/A

This procedure does not provide an assessment of or assurance about the adequacy of the resources determined by management to be sufficient to accomplish the objectives of the DUP.

In performing the following procedures, the practitioner frequently will find that management has designated and will have in place limits, controls, or procedures that are more restrictive than those approved for use in the DUP

5. For the year ended December 31, 20XX, inquired of management and was advised that—

a. There was monitoring of derivative transactions by a control staff, such as internal audit or other internal review group, that is independent of derivatives trading activities.

b. There were procedures in place for derivative personnel to obtain, prior to exceeding limits prescribed by management, at least oral approval from members of senior management who are independent of derivatives trading activities.

c. There were procedures in place for senior management to address excesses related to management-established limits and divergences from management-approved derivative strategies, and that such management has authority to grant exceptions to derivatives limits.

d. There were procedures in place requiring that management be informed when limits prescribed in the DUP were exceeded and for management to approve corrective action(s) in such circumstances.

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
e. There were procedures in place for the accurate transmittal of derivatives positions to the risk measurement systems when management had implemented risk management systems.	_____	_____	_____
f. There were procedures in place for the performance of appropriate reconciliations to ensure data integrity across the full range of derivatives, including any new or existing derivatives that may be monitored apart from the main processing networks.	_____	_____	_____
g. There were procedures in place for risk managers and senior management to define constraints on derivative activities to ensure compliance with the DUP and to justify excesses with respect to specified management limits.	_____	_____	_____
h. There were procedures in place for senior management, an independent group, or an individual that management designated to perform at least an annual assessment of the identified controls and financial results of the derivative activities to determine that controls were effectively implemented and that the insurance company's business objectives and strategies were achieved.	_____	_____	_____
i. There were procedures in place for a review of limits in the context of changes in strategy, risk tolerance of the insurance company, and market conditions.	_____	_____	_____

(continued)

Findings

Procedures

No
Exception Exception N/A

Reporting to the Board of Directors or Committee Thereof

The law contains provisions regarding management oversight of derivative and replication transactions.

- | | | | | |
|----|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------|-------|-------|
| 6. | Read the minutes of the board of directors meetings or committees thereof and found an indication that the board of directors or committee thereof received, at least quarterly, a report regarding derivative and replication transactions. | _____ | _____ | _____ |
| 7. | Read one quarterly report referred to in procedure 6 and found that the report contained— | | | |
| | a. A list, or appropriate summaries, of the following: | | | |
| | (1) Derivative transactions during the period | _____ | _____ | _____ |
| | (2) Derivative transactions outstanding at the end of the period | _____ | _____ | _____ |
| | (3) Unrealized gains or losses on open derivative positions | _____ | _____ | _____ |
| | (4) Derivative transactions closed during the period | _____ | _____ | _____ |
| | b. A summary of the performance of the derivatives in comparison to the objective of the derivative transactions | _____ | _____ | _____ |
| | c. An evaluation of the risks and benefits of the derivative transactions | _____ | _____ | _____ |
| | d. A summary of the amount, type, and performance of replication transactions | _____ | _____ | _____ |

Findings

Procedures

No
Exception Exception N/A

- 8. If the report referred to in the preceding procedure was received, reviewed, and approved by a committee of the board of directors, read the minutes of the board of directors meeting and found an indication that a report of such committee was reviewed at the next board of directors meeting.

- 9. Read the board of directors minutes and found an indication that the board of directors received a report during the year describing the level of knowledge and experience of individuals conducting, monitoring, controlling, and auditing derivative and replication transactions.

Derivative and Replication Limitations

The law contains limits on hedging and replication transactions. An insurance company may enter into hedging or replication transactions if, as a result of and after giving effect to the transaction, the derivative investments and replication investments do not exceed certain specified percentages of admitted assets. The following procedures were performed using one analysis per quarter prepared by the insurance company to monitor compliance with the limitations.

- 10. Obtained and read the insurance company’s analysis used to test limitations on investments in derivatives and replication transactions and found that the amounts shown in the analysis indicated that—
 - a. The aggregate statement value of options, swaptions, caps, floors, and warrants purchased was not in excess of seven and one-half percent of the insurance company’s admitted assets, per the last annual statement.

(continued)

Findings

<u>Procedures</u>	<u>No</u> <u>Exception</u>	<u>Exception</u>	<u>N/A</u>
b. The aggregate statement value of options, swaptions, caps, and floors written was not in excess of three percent of admitted assets.	_____	_____	_____
c. The aggregate potential exposure of collars, swaps, forwards, and futures entered into and options, swaptions, caps, and floors written was not in excess of six and one-half percent of admitted assets.	_____	_____	_____
d. The aggregate statement value of all assets being replicated did not exceed ten percent of the insurance company's admitted assets.	_____	_____	_____
e. The extent of derivative transactions did not exceed the insurance company's internal limitations or that any excess had been specifically authorized by management.	_____	_____	_____
11. Inquired of the preparer of the analysis read in procedure 10 and was advised that the analysis excluded transactions entered into to hedge the currency risk of investments denominated in a currency other than United States dollars.	_____	_____	_____
12. Obtained and read the insurance company's analysis used to test limitations on counterparty exposure, as defined in section 178.3 (e) of the Regulation, and found that the report indicated that—			
a. The counterparty exposure under one or more derivative transactions for any single counterparty, other than a "qualified counterparty," was not in excess of one percent of the insurance company's admitted assets.	_____	_____	_____

Findings

Procedures

No
Exception Exception N/A

b. The counterparty exposure under one or more derivative transactions for all counterparties, other than qualified counterparties, was not in excess of three percent of the insurance company’s admitted assets.

13. If the insurance company required collateral arrangements with the counterparties, obtained and read the insurance company’s analysis used to monitor the adequacy of the collateral held in accordance with the terms of the arrangement and found that the amount of the collateral held as shown on the analysis was equal to or in excess of the amount to be held.

Description of Exceptions if Any

Procedure Number

Description of Exception

Section 2—Cap Contracts

Findings

Procedures

No
Exception Exception N/A

Performed the following procedures on selected cap contracts to test internal control over cap transactions. Selected five percent of each type of cap transaction (that is, purchases [premium disbursements], sales [premium receipts], and closeouts [closings and settlements of the position]), with the selections distributed throughout the year. If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in less than four items, selected four or fewer items that represented all the transactions of that type.

Reporting

- | | | | |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------|-------|-------|
| <p>1. Read the insurance company’s derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to enter into cap contracts.</p> | _____ | _____ | _____ |
| <p>2. For each cap selected for testing, read management’s documentation describing the intended use of the cap and performed the following procedures, as applicable.</p> | _____ | _____ | _____ |
| <p>For caps used as a hedge—</p> | | | |
| <p>3. Determined that the documentation described the following:</p> | | | |
| <p>a. The risk hedged</p> | _____ | _____ | _____ |
| <p>b. How the hedge was consistent with the overall risk management strategy</p> | _____ | _____ | _____ |
| <p>c. How the cap was expected to be effective in offsetting the exposure</p> | _____ | _____ | _____ |
| <p>d. The approach in assessing the effectiveness of the hedge</p> | _____ | _____ | _____ |

Findings

Procedures

No
Exception Exception N/A

4. Determined that the following items were documented:

a. The purpose(s) of the cap as a hedge

b. The terms of the cap, the name of the counterparty, and the counterparty exposure amount

c. The assets or liabilities (or portion thereof) that the cap hedged

d. Evidence that the cap continued to be an effective hedge

e. Evidence that the cap was consistent with the insurance company's parameters, as specified in the DUP or applicable company policies and procedures, for entering into hedge transactions; for example, the notional amount or underlying

If the cap was an exact offset to an outstanding cap—

5. Read documentation indicating that the cap offset an outstanding cap previously purchased or sold by the insurance company and that the cap was an exact offset of the market risk of the cap being offset.

For caps used in a replication transaction—

6. Determined that the documentation described the following:

a. The investment type and characteristics replicated

b. How the replication was consistent with the overall management investment strategy

(continued)

Findings

Procedures

No
Exception Exception N/A

<p>c. How the cap was expected to be effective in replicating the investment characteristics of the replicated investment</p>	_____	_____	_____
<p>d. The approach for assessing the effectiveness of the replication transaction</p>	_____	_____	_____
<p>7. Determined that the following items were documented:</p>			
<p>a. The instruments used in the replication and the investment type and characteristics replicated</p>	_____	_____	_____
<p>b. The terms of the cap, the name of the counterparty, and the counterparty exposure amount</p>	_____	_____	_____
<p>For all selected caps including those that are a part of a replication transaction—</p>			
<p>8. Obtained a list of individuals, approved by the board of directors or a committee thereof, who had the authority to authorize cap transactions. Compared the name of the individual who authorized the cap transaction with the names on the list and found the name of the individual on the list.</p>	_____	_____	_____
<p>9. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company's policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transaction tested; for example, a transaction in which the notional amount or strike price exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support and found evidence of approval of the transaction tested.</p>	_____	_____	_____

Findings

<u>Procedures</u>	<u>No</u> <u>Exception</u>	<u>Exception</u>	<u>N/A</u>
10. Obtained a list of <i>qualified</i> and <i>nonqualified</i> counterparties, approved by the board of directors or a committee thereof. Compared the name of the counterparty involved in the cap transaction with names on the list and found the name of the counterparty on the respective qualified or nonqualified list.	_____	_____	_____
11. Determined that the counterparty was listed as qualified or nonqualified in the analysis used for monitoring the insurance company's limitations on counterparty exposure consistent with the classification in the listing obtained in procedure 10.	_____	_____	_____
12. Obtained a list of individuals authorized by the board of directors or a committee thereof to trade cap contracts. Compared the name of the individual who executed the purchase, sale, or closeout of the cap with the names on the list and found the name of the individual on the list.	_____	_____	_____
13. Obtained a list of individuals authorized to approve payments relating to caps. Compared the name of the individual who approved any payment relating to the cap with the names on the list and found the name of the individual on the list.	_____	_____	_____
14. Compared the name of the individual who approved any payment relating to the cap with the name of the individual who approved entering into the contract and found that the names were different.	_____	_____	_____
15. Compared the name of the individual who received cash or other consideration in connection with the cap with the name of the individual who entered into the contract and found that the names of the individuals were different.	_____	_____	_____

(continued)

Findings

Procedures

No
Exception Exception N/A

- | | | | |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------|-------|-------|
| 16. Obtained the deal ticket and confirmation for the purchase, sale, or closeout of the cap and found that the purchase, sale, or closeout was confirmed by the counterparty. | _____ | _____ | _____ |
| 17. Compared the name of the individual who received the deal ticket and confirmation with the names on a list of individuals authorized to trade caps and found that the name was not on the list. | _____ | _____ | _____ |
| 18. Compared the terms of the cap contract, as stated on the deal ticket and confirmation, with the terms of the cap contract recorded in the insurance company's accounting records and found them to be in agreement. | _____ | _____ | _____ |
| 19. Obtained documentation for one reporting period (for example, monthly or quarterly), indicating that the insurance company determined that its accounting records for caps tested in procedure 18, agreed with or reconciled to the related control account; for example, the subsidiary ledger to the general ledger. | _____ | _____ | _____ |
| 20. Obtained the accounting record documenting modifications, if any, to the cap agreement. Compared the name of the individual who approved the modification with a list of individuals authorized to approve modifications and found the name of the individual who approved the modification on the list. | _____ | _____ | _____ |
| 21. Compared the terms of the cap agreement recorded in the insurance company's accounting records with the terms shown in the executed copy of the cap agreement and found them to be in agreement. | _____ | _____ | _____ |

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
22. Obtained documentation for one reporting period (for example, monthly or quarterly), indicating that the insurance company physically inventoried the cap agreements.	_____	_____	_____
23. Using the list of authorized traders obtained in procedure 12, compared the name of the individual who had custody or access to the cap agreement with the names of individuals authorized to execute purchases, sales, or closeouts of cap contracts and found that the name of the individual was not on the list.	_____	_____	_____
24. Compared information regarding the cap, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement.	_____	_____	_____
25. If the cap should have been included in the monitoring analysis separately tested in procedure 10 within section 1, "All Derivative Types," compared information regarding the cap, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement.	_____	_____	_____
26. Read accounting documentation indicating that the insurance company monitored periodic cash settlements related to the cap tested, meaning, the insurance company had controls in place to determine that periodic cash settlements, if any, were received.	_____	_____	_____

(continued)

Findings

Procedures

No
Exception Exception N/A

Effectiveness of Caps Used As Hedges and in Replication Transactions

- 27. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the cap as a hedge or replication in accordance with the policies regarding effectiveness.
- 28. If the cap was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the accounting policies and procedures and found that the action taken was consistent with the accounting policy.

Legal Review

- 29. Read documentation indicating that the legal department reviewed the cap agreement to assess contract compliance with the DUP and enforceability.
- 30. Read documentation indicating that the legal department updated its assessment of agreement enforceability at least annually.

Valuation

- 31. Obtained the insurance company's policies and procedures for valuing caps and found that the insurance company determined the fair value of the cap in accordance with the policy described in the insurance company's procedures for the valuation of caps.
- 32. Read documentation supporting the fair value of the cap and found that the fair value was either (a) obtained from an independent source, (b) checked against an independent source, or (c) calculated internally by an authorized person.

Description of Exceptions if Any

Procedure Number

Description of Exception

Section 3—Collar Contracts

Findings

Procedures

No
Exception Exception N/A

Performed the following procedures on selected collar contracts to test internal control over collar transactions. Selected five percent of each type of collar transaction (that is, executions [entering into a collar transaction in which the net position at inception may result in either no cash outlay, cash received, or cash disbursed] and closeouts [closings and settlements of the position]), with the selections distributed throughout the year. If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in less than four items, selected four or fewer items that represented all the transactions of that type.

Reporting

1. Read the insurance company’s derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to enter into collar contracts. _____

2. For each collar selected for testing, read management’s documentation describing the intended use of the collar and performed the following procedures, as applicable. _____

For collars used as a hedge—

3. Determined that the documentation described the following:

a. The risk hedged _____

b. How the hedge was consistent with the overall risk management strategy _____

c. How the collar was expected to be effective in offsetting the exposure _____

Findings

<u>Procedures</u>	<u>No</u> <u>Exception</u>	<u>Exception</u>	<u>N/A</u>
d. The approach in assessing the effectiveness of the hedge	_____	_____	_____
4. Determined that the following items were documented:			
a. The purpose(s) of the collar as a hedge	_____	_____	_____
b. The terms of the collar, the name of the counterparty, and the counterparty exposure amount	_____	_____	_____
c. The assets or liabilities (or portion thereof) that the collar hedged	_____	_____	_____
d. Evidence that the collar continued to be an effective hedge	_____	_____	_____
e. Evidence that the contract was consistent with the insurance company's parameters, as specified in the DUP or applicable company policies and procedures, for entering into hedge transactions; for example, the notional amount or underlying	_____	_____	_____
If the collar was an exact offset of an outstanding collar—			
5. Read documentation indicating that the collar offset an outstanding collar previously purchased or sold by the insurance company and that the collar was an exact offset of the market risk of the collar being offset.	_____	_____	_____
For collars used in a replication transaction—			
6. Determined that the documentation described the following:			
a. The investment type and characteristics replicated	_____	_____	_____
b. How the replication was consistent with the overall management investment strategy	_____	_____	_____

(continued)

Findings

<u>Procedures</u>	<u>No</u>	<u>Exception</u>	<u>Exception</u>	<u>N/A</u>
c. How the collar was expected to be effective in replicating the investment characteristics of the replicated investment	_____	_____	_____	_____
d. The approach in assessing the effectiveness of the replication transaction	_____	_____	_____	_____
7. Determined that the following items were documented:				
a. The instruments used in the replication and the investment type and characteristics replicated	_____	_____	_____	_____
b. The terms of the collar, the name of the counterparty, and the counterparty exposure amount	_____	_____	_____	_____
For all selected collars including those that are a part of a replication transaction—				
8. Obtained a list of individuals, approved by the board of directors or a committee thereof, who had the authority to authorize collar transactions. Compared the name of the individual who authorized the collar transaction with the names on the list and found the name of the individual on the list.	_____	_____	_____	_____
9. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company’s policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transaction tested; for example, a transaction in which the notional amount or strike price exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support and found evidence of approval of the transaction tested.	_____	_____	_____	_____

Findings

<u>Procedures</u>	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
10. Obtained a list of <i>qualified</i> and <i>nonqualified</i> counterparties approved by the board of directors or a committee thereof. Compared the name of the counterparty involved in the collar transaction with names on the list and found the name of the counterparty on the respective qualified or nonqualified list.	_____	_____	_____
11. Determined that the counterparty was listed as qualified or nonqualified in the analysis used for monitoring the insurance company's limitations on counterparty exposure consistent with the classification in the listing obtained in procedure 10.	_____	_____	_____
12. Obtained a list of individuals authorized by the board of directors or a committee thereof to trade collar contracts. Compared the name of the individual who executed the execution or closeout of the collar contract with the names on the list and found the name of the individual on the list.	_____	_____	_____
13. Obtained a list of individuals authorized to approve payments relating to collars. Compared the name of the individual who approved any payment relating to the collar with the names on the list and found the name of the individual on the list.	_____	_____	_____
14. Compared the name of the individual who approved any payment relating to the collar with the name of the individual who approved entering into the contract and found that the names were different.	_____	_____	_____
15. Compared the name of the individual who received cash or other consideration in connection with the collar with the name of the individual who entered into the contract and found that the names of the individuals were different.	_____	_____	_____

(continued)

Findings

Procedures

No
Exception Exception N/A

- | | | | |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------|-------|-------|
| 16. Obtained the deal ticket and confirmation for the execution or closeout of the collar and found that the execution or closeout was confirmed by the counterparty. | _____ | _____ | _____ |
| 17. Compared the name of the individual who received the deal ticket and confirmation with the names on a list of individuals authorized to trade collars and found that the name was not on the list. | _____ | _____ | _____ |
| 18. Compared the terms of the collar contract, as stated on the deal ticket and confirmation, with the terms of the collar contract recorded in the insurance company's accounting records and found them to be in agreement. | _____ | _____ | _____ |
| 19. Obtained documentation for one reporting period (for example, monthly or quarterly) indicating that the insurance company determined that its accounting records for collars, tested in procedure 18, agreed with or reconciled to the related control account; for example, the subsidiary ledger to the general ledger. | _____ | _____ | _____ |
| 20. Obtained the accounting record documenting modifications, if any, to the collar agreement. Compared the name of the individual who approved the modification with a list of individuals authorized to approve modifications and found the name of the individual who approved the modification on the list. | _____ | _____ | _____ |
| 21. Compared the terms of the collar agreement recorded in the insurance company's accounting records with the terms shown in the executed copy of the collar agreement and found them to be in agreement. | _____ | _____ | _____ |

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
22. Obtained documentation for one reporting period (for example, monthly or quarterly), indicating that the insurance company physically inventoried the collar agreement.	_____	_____	_____
23. Using the list of authorized traders obtained in procedure 12, compared the name of the individual who had custody or access to the collar contracts with the names of individuals authorized to enter into trades, executions, or closeouts of collar contracts and found that the name of the individual was not on the list.	_____	_____	_____
24. Compared information regarding the collar, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement.	_____	_____	_____
25. If the collar should have been included in the monitoring analysis separately tested in procedure 10 within section 1, "All Derivative Types," compared information regarding the collar, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement.	_____	_____	_____
26. Read accounting documentation indicating that the insurance company monitored periodic cash settlements related to the collar tested, meaning, the insurance company had controls in place to determine that periodic cash settlements, if any, were received.	_____	_____	_____

(continued)

Findings

Procedures

No
Exception Exception N/A

Effectiveness of Collars Used As Hedges and in Replication Transactions

- 27. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the collar as a hedge or replication in accordance with the policies regarding effectiveness. _____
- 28. If the collar was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the accounting policies and procedures and found that the action taken was consistent with the accounting policy. _____

Legal Review

- 29. Read documentation indicating that the legal department reviewed the collar agreement to assess contract compliance with the DUP and enforceability. _____
- 30. Read documentation indicating that the legal department updated its assessment of agreement enforceability at least annually. _____

Valuation

- 31. Obtained the insurance company's policies and procedures for valuing collars and found that the insurance company determined the fair value of the collar in accordance with the policy described in the insurance company's procedures for the valuation of collars. _____
- 32. Read documentation supporting the fair value of the collar and found that the fair value was either (a) obtained from an independent source, (b) checked against an independent source, or (c) calculated internally by an authorized individual. _____

Description of Exceptions if Any

Procedure Number

Description of Exception

Section 4—Floor Contracts

Findings

Procedures

No
Exception Exception N/A

Performed the following procedures on selected floor contracts to test internal control over floor transactions. Selected five percent of each type of floor transaction (that is, purchases [premium disbursements], sales [premium receipts], and closeouts [closings and settlements of the position]), with the selections distributed throughout the year. If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in less than four items, selected four or fewer items that represented all the transactions of that type.

Reporting

- | | | | |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------|--------------|--------------|
| <p>1. Read the insurance company's derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to enter into floor contracts.</p> | <p>_____</p> | <p>_____</p> | <p>_____</p> |
| <p>2. For each floor selected for testing, read management's documentation describing the intended use of the floor and performed the following procedures, as applicable.</p> | <p>_____</p> | <p>_____</p> | <p>_____</p> |
| <p>For floors used as a hedge—</p> | | | |
| <p>3. Determined that the documentation described the following:</p> | | | |
| <p> a. The risk hedged</p> | <p>_____</p> | <p>_____</p> | <p>_____</p> |
| <p> b. How the hedge was consistent with the overall risk management strategy</p> | <p>_____</p> | <p>_____</p> | <p>_____</p> |
| <p> c. How the floor was expected to be effective in offsetting the exposure</p> | <p>_____</p> | <p>_____</p> | <p>_____</p> |
| <p> d. The approach in assessing the effectiveness of the hedge</p> | <p>_____</p> | <p>_____</p> | <p>_____</p> |

Findings

Procedures

No
Exception Exception N/A

4. Determined that the following items were documented:

a. The purpose(s) of the floor as a hedge

b. The terms of the floor, the name of the counterparty, and the counterparty exposure amount

c. The assets or liabilities (or portion thereof) that the floor hedged

d. Evidence that the floor continued to be an effective hedge

e. Evidence that the floor was consistent with the insurance company's parameters, as specified in the DUP or applicable company policies and procedures for entering into hedge transactions; for example, the notional amount or underlying

If the floor was an exact offset of an outstanding floor—

5. Read documentation indicating that the floor offset an outstanding floor previously purchased or sold by the insurance company and that the floor was an exact offset of the market risk of the floor being offset.

For floors used in a replication transaction—

6. Determined that the documentation described the following:

a. The investment type and characteristics replicated

b. How the replication was consistent with the overall management investment strategy

(continued)

Findings

<u>Procedures</u>	<u>No</u>	<u>Exception</u>	<u>Exception</u>	<u>N/A</u>
c. How the floor was expected to be effective in replicating the investment characteristics of the replicated investment	_____	_____	_____	_____
d. The approach in assessing the effectiveness of the replication transaction	_____	_____	_____	_____
7. Determined that the following items were documented:				
a. The instruments used in the replication and the investment type and characteristics replicated	_____	_____	_____	_____
b. The terms of the floor, the name of the counterparty, and the counterparty exposure amount	_____	_____	_____	_____
For all selected floors including those that are a part of a replication transaction—				
8. Obtained a list of individuals approved by the board of directors or a committee thereof who had the authority to authorize floor transactions. Compared the name of the individual who authorized the floor transaction with the names on the list and found the name of the individual on the list.	_____	_____	_____	_____
9. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company's policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transaction tested; for example, a transaction in which the notional amount or strike price exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support and found evidence of approval of the transaction tested.	_____	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No</u> <u>Exception</u>	<u>Exception</u>	<u>N/A</u>
10. Obtained a list of <i>qualified</i> and <i>nonqualified</i> counterparties, approved by the board of directors or a committee thereof. Compared the name of the counterparty involved in the floor transaction with names on the list and found the name of the counterparty on the respective qualified or nonqualified list.	_____	_____	_____
11. Determined that the counterparty was listed as qualified or nonqualified in the analysis used for monitoring the insurance company's limitations on counterparty exposure consistent with the classification in the listing obtained in procedure 10.	_____	_____	_____
12. Obtained a list of individuals authorized by the board of directors or a committee thereof to trade floor contracts. Compared the name of the individual who executed the purchase, sale, or closeout of the floor with the names on the list and found the name of the individual on the list.	_____	_____	_____
13. Obtained a list of individuals authorized to approve payments relating to floors. Compared the name of the individual who approved any payment relating to the floor with the names on the list and found the name of the individual on the list.	_____	_____	_____
14. Compared the name of the individual who approved any payment relating to the floor with the name of the individual who approved entering into the contract and found that the names were different.	_____	_____	_____
15. Compared the name of the individual who received cash or other consideration in connection with the floor with the name of the individual who entered into the contract and found that the names of the individuals were different.	_____	_____	_____

(continued)

Findings

Procedures

No
Exception Exception N/A

- | | | | |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------|-------|-------|
| 16. Obtained the deal ticket and confirmation for the purchase, sale, or closeout of the floor and found that the purchase, sale, or closeout was confirmed by the counterparty. | _____ | _____ | _____ |
| 17. Compared the name of the individual who received the deal ticket and confirmation with the names on a list of individuals authorized to trade floors and found that the name was not on the list. | _____ | _____ | _____ |
| 18. Compared the terms of the floor contract, as stated on the deal ticket and confirmation, with the terms of the floor contract recorded in the insurance company's accounting records and found them to be in agreement. | _____ | _____ | _____ |
| 19. Obtained documentation for one reporting period (for example, monthly or quarterly), that the insurance company determined that its accounting records for floors, tested in procedure 18, agreed with or reconciled to the related control account; for example, the subsidiary ledger to the general ledger. | _____ | _____ | _____ |
| 20. Obtained the accounting record documenting modifications, if any, to the floor agreement. Compared the name of the individual who approved the modification with a list of individuals authorized to approve modifications and found the name of the individual who approved the modification on the list. | _____ | _____ | _____ |
| 21. Compared the terms of the floor agreement recorded in the insurance company's accounting records with the terms shown in the executed copy of the floor agreement and found them to be in agreement. | _____ | _____ | _____ |

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
22. Obtained documentation for one reporting period (for example, monthly or quarterly), indicating that the insurance company physically inventoried the floor agreements.	_____	_____	_____
23. Using the list of authorized traders obtained in procedure 12, compared the name of the individual who had custody or access to the floor agreement with the names of individuals authorized to execute purchases, sales, or closeouts of floor contracts and found that the name was not on the list.	_____	_____	_____
24. Compared information regarding the floor, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement.	_____	_____	_____
25. If the floor should have been included in the monitoring analysis separately tested in procedure 10 within section 1, "All Derivative Types," compared information regarding the floor, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement.	_____	_____	_____
26. Read accounting documentation indicating that the insurance company monitored periodic cash settlements related to the floor tested, meaning, the insurance company had controls in place to determine that periodic cash settlements, if any, were received.	_____	_____	_____

(continued)

Findings

Procedures

No
Exception Exception N/A

Effectiveness of Floors Used As Hedges and in Replication Transactions

- 27. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the floor as a hedge or replication in accordance with the policies regarding effectiveness. _____
- 28. If the floor was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the accounting policies and procedures and found that the action taken was consistent with the accounting policy. _____

Legal Review

- 29. Read documentation indicating that the legal department reviewed the floor agreement to assess contract compliance with the DUP and enforceability. _____
- 30. Read documentation indicating that the legal department updated its assessment of agreement enforceability at least annually. _____

Valuation

- 31. Obtained the insurance company's policies and procedures for valuing floors and found that the insurance company determined the fair value of the floor in accordance with the policy described in the insurance company's procedures for the valuation of floors. _____
- 32. Read documentation supporting the fair value of the floor and found that the fair value was either (a) obtained from an independent source, (b) checked against an independent source, or (c) calculated internally by an authorized individual. _____

Findings

Procedures

No
Exception Exception N/A

Description of Exceptions if Any

Procedure Number

Description of Exception

Section 5—Forward Contracts

Findings

Procedures

No
Exception Exception N/A

Performed the following procedures on selected forward contracts to test internal control over forward transactions. Selected five percent of each type of forward transaction, with the selections distributed throughout the year. These are, (1) forward contracts entered into to make delivery, (2) forward contracts entered into to take delivery, (3) forward contracts settled by making delivery, (4) forward contracts settled by taking delivery, (5) forward contracts settled by cash. If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in less than four items, selected four or fewer items that represented all of the transactions of that type.

Reporting

1. Read the insurance company’s derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to enter into forward contracts.

2. For each forward selected for testing, read management’s documentation describing the intended use of the forward and performed the following procedures, as applicable.

For forward contracts used as a hedge—

3. Determined that the documentation describes the following:

a. The risk hedged

b. How the hedge was consistent with the overall risk management strategy

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
c. How the forward was expected to be effective in offsetting the exposure	_____	_____	_____
d. The approach in assessing the effectiveness of the hedge	_____	_____	_____
4. Determined that the following items were documented:			
a. The purpose(s) of the forward as a hedge	_____	_____	_____
b. The terms of the forward, the name of the counterparty, and the counterparty exposure amount	_____	_____	_____
c. The assets or liabilities (or portion thereof) that the forward hedged	_____	_____	_____
d. The specific forward contract used in the hedge	_____	_____	_____
e. Evidence that the forward continued to be an effective hedge	_____	_____	_____
f. Evidence that the forward was consistent with the insurance company's parameters, as specified in the DUP or applicable company policies and procedures, for entering into hedge transactions; for example, the notional amount or underlying	_____	_____	_____
If the forward was an exact offset of an outstanding forward—			
5. Read documentation indicating that the forward offset an outstanding forward previously purchased or sold by the insurance company and that the forward was an exact offset of the market risk of the forward being offset.	_____	_____	_____

(continued)

Findings

Procedures

No
Exception Exception N/A

For forwards used in a replication transaction—

- 6. Determined that the documentation described the following:
 - a. The investment type and characteristics replicated _____
 - b. How the replication was consistent with the overall management investment strategy _____
 - c. How the forward was expected to be effective in replicating the investment characteristic of the replicated investment _____
 - d. The approach for assessing the effectiveness of the replication transaction _____
- 7. Determined that the following items were documented:
 - a. The instruments used in the replication and the investment type and characteristics replicated _____
 - b. The terms of the forward contract, the name of the counterparty, and the counterparty exposure amount _____

For all selected forwards, including those that are a part of the replication transaction—

- 8. Obtained a list of individuals, approved by the board of directors or a committee thereof who had the authority to authorize forward transactions. Compared the name of the individual who authorized the forward transaction with the names on the list and found the name of the individual on the list. _____

FindingsProcedures

No
Exception Exception N/A

9. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company's policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transaction tested; for example, a transaction in which the notional amount exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support and found evidence of approval of the transaction tested.
10. Obtained a list of *qualified* and *nonqualified* counterparties, approved by the board of directors or a committee thereof. Compared the name of the counterparty involved in the forward transaction with names on the list and found the name of the counterparty on the respective qualified or nonqualified list.
11. Determined that the counterparty was listed as qualified or nonqualified in the analysis used for monitoring the insurance company's limitations on counterparty exposure consistent with the classification in the listing obtained in procedure 10.
12. Obtained a list of individuals authorized by the board of directors or committee thereof to trade forward contracts. Compared the name of the individual who executed the purchase or sale of the forward with the names on the list and found the name of the individual on the list.

(continued)

Findings

Procedures

No
Exception Exception N/A

<p>13. Obtained a list of individuals authorized to approve settlements or payments related to forward contracts. For the purchase and any transaction subsequent to purchase, compared the name of the individual who approved any payment or settlement of funds in connection with the forward contract with the names on the list and found the name of the individual on the list.</p>	<p>_____</p>	<p>_____</p>	<p>_____</p>
<p>14. Compared the name of the individual who approved any settlement or payment relating to the forward with the name of the individual who approved entering into the contract and found that the names were different.</p>	<p>_____</p>	<p>_____</p>	<p>_____</p>
<p>15. Compared the name of the individual who received cash or other consideration in connection with the forward with the name of the individual who entered into the contract and found that the names of the individuals were different.</p>	<p>_____</p>	<p>_____</p>	<p>_____</p>
<p>16. Obtained the deal ticket and confirmation for the purchase or sale of the forward contract and found that the purchase or sale was confirmed by the counterparty.</p>	<p>_____</p>	<p>_____</p>	<p>_____</p>
<p>17. Compared the name of the individual who received the deal ticket and confirmation with the names on a list of individuals authorized to trade forwards and found that the name was not on the list.</p>	<p>_____</p>	<p>_____</p>	<p>_____</p>
<p>18. Compared the terms of the forward contract, as stated on the deal ticket and confirmation, with the terms of the forward contract recorded in the insurance company's accounting records and found them to be in agreement.</p>	<p>_____</p>	<p>_____</p>	<p>_____</p>

Findings

<u>Procedures</u>	<u>No</u> <u>Exception</u>	<u>Exception</u>	<u>N/A</u>
19. Obtained documentation for one reporting period, (for example, monthly or quarterly), that the insurance company determined that its accounting records for forwards, tested in procedure 18, agreed with or reconciled to the related control account, (for example, the subsidiary ledger to the general ledger).	_____	_____	_____
20. Obtained the accounting record documenting modifications, if any, to the forward contract. Compared the name of the individual who approved the modification with a list of individuals authorized to approve modifications and found the name of the individual who approved the modification on the list.	_____	_____	_____
21. For one reporting period, (for example, monthly or quarterly), obtained the insurance company's documentation of the existence of the forward contract and found that the insurance company either (a) obtained a statement from the custodian confirming the existence of the forward contract, (b) physically inventoried the forward contract, or (c) obtained a statement from the counterparty acknowledging the existence of the forward contract.	_____	_____	_____
22. Using the list of authorized traders obtained in procedure 12, compared the name of the individual who had custody or access to the forward with the names of individuals authorized to execute purchases and sales of forwards and found that the name was not on the list.	_____	_____	_____
23. Compared information regarding the forward, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement.	_____	_____	_____

(continued)

Findings

Procedures

No
Exception Exception N/A

24. If the forward should have been included in the monitoring analysis separately tested in step 10 within section 1, "All Derivative Types," compared information regarding the forward, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement.

Effectiveness of Forward Contracts Used As Hedges and in Replication Transactions

25. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the forward as a hedge or replication in accordance with the policies regarding effectiveness.

26. If the forward was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the accounting policies and procedures and found that the action taken was consistent with the accounting policy.

Legal Review

27. Read documentation indicating that the legal department reviewed the forward contract to assess contract compliance with the DUP and enforceability.

28. Read documentation indicating that the legal department updated its assessment of contract enforceability at least annually.

Findings

Procedures

No
Exception Exception N/A

Valuation

29. Obtained the insurance company’s policies and procedures for valuing forwards and found that the insurance company determined the fair value of the forward in accordance with the policy described in the insurance company’s procedures for valuation of forwards.

30. Read documentation supporting the fair value of the forward contract and found that the fair value was either (a) obtained from an independent source, (b) checked against an independent source, or (c) calculated internally by an authorized individual.

Description of Exceptions if Any

Procedure Number

Description of Exception

Section 6—Futures Contracts

Findings

<u>Procedures</u>	<u>No</u>	<u>Exception</u>	<u>Exception</u>	<u>N/A</u>
<p>Performed the following procedures on selected futures contracts to test internal control over futures transactions. Selected five percent of each type of futures transaction, with the selections distributed throughout the year. These are purchases, sales, and cash settlements (closeouts of a position). If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in less than four items, selected four or fewer items that represented all of the transactions of that type.</p>				
Reporting				
<p>1. Read the insurance company’s derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to trade futures.</p>	_____	_____	_____	_____
<p>2. For each futures transaction selected for testing, read management’s documentation describing the intended use of the futures and performed the following procedures, as applicable.</p>	_____	_____	_____	_____
For futures used as a hedge—				
<p>3. Determined that the documentation describes the following:</p>				
<p>a. The risk hedged</p>	_____	_____	_____	_____
<p>b. How the hedge was consistent with the overall risk management strategy</p>	_____	_____	_____	_____
<p>c. How the futures position was expected to be effective in offsetting the exposure</p>	_____	_____	_____	_____
<p>d. The approach in assessing the effectiveness of the hedge</p>	_____	_____	_____	_____

Findings

Procedures

No
Exception Exception N/A

4. Determined that the following items were documented:

a. The purpose(s) of the futures as a hedge

b. The terms of the futures transaction and the name of the exchange and firm(s) handling the trade

c. The assets or liabilities (or portion thereof) that the futures transaction hedged

d. Evidence that the futures contract continued to be an effective hedge

e. Evidence that the futures position was consistent with the insurance company's parameters, as specified in the DUP or applicable company policies and procedures for futures transactions; for example, the notional amount or underlying

For futures transactions that were an exact offset of an outstanding futures transaction—

5. Read documentation indicating that the futures transaction offset an outstanding futures position previously purchased or sold by the insurer and that the futures transaction was an exact offset of the market risk of the futures position being offset.

For futures used in a replication transaction—

6. Determined that the documentation described the following:

a. The investment type and characteristics replicated

b. How the replication was consistent with the overall management investment strategy

(continued)

Findings

<u>Procedures</u>	<u>No</u>	<u>Exception</u>	<u>Exception</u>	<u>N/A</u>
c. How the futures position was expected to be effective in replicating the investment characteristics of the replicated investment	_____	_____	_____	_____
d. The approach in assessing the effectiveness of the replication transaction	_____	_____	_____	_____
7. Determined that the following items were documented:				
a. The instruments used in the replication and the investment type and characteristics replicated	_____	_____	_____	_____
b. The terms of the futures transaction and the name of the exchange and the firm(s) handling the trade	_____	_____	_____	_____
c. The specific futures contract used in the replication	_____	_____	_____	_____
For all selected futures including those that are a part of the replication transaction—				
8. Obtained a list of individuals, approved by the board of directors or a committee thereof, who had the authority to authorize futures trades. Compared the name of the individual who authorized the futures transaction with the names on the list and found the name of the individual on the list.	_____	_____	_____	_____

FindingsProcedures

No
Exception Exception N/A

9. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company's policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transaction tested; for example, a transaction in which the notional amount exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support and found evidence of approval of the transaction tested.
10. Obtained a list of individuals authorized by the board of directors or committee thereof to trade futures contracts. Compared the name of the individual who executed the purchase or sale of the futures contract with the names on the list and found the name of the individual on the list.
11. Obtained a list of individuals authorized to approve settlements or disbursements related to futures transactions. For purchases and transactions subsequent to purchase or sale of the futures contract, compared the name of the individual who approved any settlement of funds relating to the futures with the names on the list and found the name of the individual on the list.
12. Compared the name of the individual who approved any payment relating to the futures with the name of the individual who approved entering into the contract and found that the names were different.

(continued)

Findings

Procedures

No
Exception Exception N/A

- | | | | |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------|--------------|--------------|
| <p>13. Compared the name of the individual who received cash or other consideration in connection with the futures with the name of the individual who entered into the contract and found that the names of the individuals were different.</p> | <p>_____</p> | <p>_____</p> | <p>_____</p> |
| <p>14. Obtained the deal ticket and confirmation for the purchase, expiration, or sale of the futures contracts and found that the purchase, sale, or expiration of the futures contract was confirmed by the deal ticket and confirmation.</p> | <p>_____</p> | <p>_____</p> | <p>_____</p> |
| <p>15. Compared the terms of the futures transaction, as stated on the deal ticket and confirmation, with the terms of the transaction recorded in the insurance company's accounting records and found them to be in agreement.</p> | <p>_____</p> | <p>_____</p> | <p>_____</p> |
| <p>16. Obtained documentation for one reporting period, (for example, monthly or quarterly), that the insurance company determined that its accounting records for futures, tested in procedure 15, agreed with or reconciled to the related control account, (for example, the subsidiary ledger to the general ledger).</p> | <p>_____</p> | <p>_____</p> | <p>_____</p> |
| <p>17. For one reporting period, (for example, monthly or quarterly), obtained the insurance company's documentation of the existence of the futures contracts and found that the insurance company obtained statements from the futures counterparty(ies) or broker(s) confirming the futures transactions and positions.</p> | <p>_____</p> | <p>_____</p> | <p>_____</p> |

FindingsProcedures

	<u>No</u>	<u>Exception</u>	<u>Exception</u>	<u>N/A</u>
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18. Compared information regarding the futures contract, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement.

_____	_____	_____	_____	_____
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19. If the futures position should have been included in the monitoring analysis separately tested in procedure 10 within section 1, "All Derivative Types," compared information regarding the futures contract, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement.

_____	_____	_____	_____	_____
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Effectiveness of Futures Used As Hedges and in Replication Transactions

20. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the futures position as a hedge or replication in accordance with the policies regarding effectiveness.

_____	_____	_____	_____	_____
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21. If the futures position was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the company policies and procedures and found that the action taken was consistent with the accounting policy.

_____	_____	_____	_____	_____
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(continued)

Findings

Procedures

No
Exception Exception N/A

Valuation

22. Obtained the insurance company's policies and procedures for valuing positions and found that the insurance company determined the valuation of the futures contract in accordance with the policy described in the insurance company's procedures for valuation of futures.

23. Read documentation supporting the market price of the futures contract and found that the market price was obtained from an independent source.

Description of Exceptions if Any

Procedure Number

Description of Exception

Section 7—Option Contracts

<u>Procedures</u>	<u>Findings</u>		
	<u>No</u> <u>Exception</u>	<u>Exception</u>	<u>N/A</u>
<p>Performed the following procedures on selected option contracts to test internal control over option transactions. Selected five percent of each type of option transaction (that is, purchases, sales, expirations, and exercises), with the selections distributed throughout the year. If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in less than four items, selected four or fewer items that represented all of the transactions of that type.</p> <p>Reporting</p> <p>1. Read the insurance company's derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to trade or enter into option contracts.</p> <p>2. For each option selected for testing, read management's documentation describing the intended use of the option and performed the following procedures, as applicable.</p> <p>For options used as a hedge—</p> <p>3. Determined that the documentation described the following:</p> <p>a. The risk hedged</p> <p>b. How the hedge was consistent with the overall risk management strategy</p> <p>c. How the option was expected to be effective in offsetting the exposure</p> <p>d. The approach in assessing the effectiveness of the hedge</p>	_____	_____	_____

(continued)

Findings

Procedures

No
Exception Exception N/A

- | | | | |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------|-------|-------|
| 4. Determined that the following items were documented: | | | |
| a. The purpose(s) of the option as a hedge | _____ | _____ | _____ |
| b. For over-the-counter (OTC) options, the terms of the option, the name of the counterparty, and the counterparty exposure amount | _____ | _____ | _____ |
| c. For exchange-traded options, the term of the option, the name of the exchange, and the name of the firm(s) handling the trade | _____ | _____ | _____ |
| d. The assets or liabilities (or portion thereof) that the option hedged | _____ | _____ | _____ |
| e. For OTC and exchange-traded options, the specific option used in the hedge | _____ | _____ | _____ |
| f. Evidence that the option continued to be an effective hedge | _____ | _____ | _____ |
| g. Evidence that the option was consistent with the insurance company's parameters, as specified in the DUP or applicable company policies and procedures, for entering into hedge transactions; for example, the notional amount, or underlying | _____ | _____ | _____ |

If the option transaction was (a) for income generation and was for the sale of a call option on securities or (b) an exact offset to an outstanding option—

- | | | | |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------|-------|-------|
| 5. Read the documentation supporting the transaction which indicated that the insurance company was holding or could immediately acquire through the exercise of options, warrants, or conversion rights already owned, the underlying securities during the entire period the option was outstanding. | _____ | _____ | _____ |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------|-------|-------|

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
6. Read documentation indicating that the option offset an outstanding option previously purchased or sold by the insurance company and that the option was an exact offset to the market risk of the option being offset.	_____	_____	_____
For options used in a replication transaction—			
7. Determined that the documentation described the following:			
a. The investment type and characteristics replicated	_____	_____	_____
b. How the replication was consistent with the overall management investment strategy	_____	_____	_____
c. How the option was expected to be effective in replicating the investment characteristics of the replicated investment	_____	_____	_____
d. The approach in assessing the effectiveness of the replication transaction	_____	_____	_____
8. Determined that the following items were documented:			
a. The instruments used in the replication and the investment type and characteristics replicated	_____	_____	_____
b. The specific option used in the replication	_____	_____	_____
c. For OTC options, the terms of the option, the name of the counterparty, and the counterparty exposure amount	_____	_____	_____
d. For exchange-traded options, the name of the exchange and the firm(s) handling the trade	_____	_____	_____

(continued)

Findings

Procedures

No
Exception Exception N/A

For all selected options, including those that are a part of a replication transaction—

9. Obtained a list of individuals, approved by the board of directors or a committee thereof, who had the authority to authorize option transactions. Compared the name of the individual who authorized the option transaction with the names on the list and found the name of the individual on the list.

10. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company's policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transaction tested; for example, a transaction in which the notional amount exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support and found evidence of approval of the transaction tested.

11. Obtained a list of *qualified* and *nonqualified* counterparties, approved by the board of directors or a committee thereof. Compared the name of the counterparty involved in the option transaction with names on the list and found the name of the counterparty on the respective qualified or nonqualified list.

12. For OTC options, determined that the counterparty was listed as qualified or nonqualified in the analysis used for monitoring the insurance company's limitations on counterparty exposure consistent with the classification in the listing obtained in procedure 11.

Findings

<u>Procedures</u>	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
13. Obtained a list of individuals authorized by the board of directors or committee thereof to trade option contracts. Compared the name of the individual who executed the purchase, sale, or exercise of the option with the names on the list and found the name of the individual on the list.	_____	_____	_____
14. Obtained a list of individuals authorized to approve payments relating to options contracts. Compared the name of the individual who approved any payment relating to the option with the names on the list and found the name of the individual on the list.	_____	_____	_____
15. Compared the name of the individual who approved any payment relating to the option with the name of the individual who approved entering into the contract and found that the names were different.	_____	_____	_____
16. Compared the name of the individual who received cash or other consideration in connection with the option with the name of the individual who entered into the contract and found that the names of the individuals were different.	_____	_____	_____
17. Obtained the deal ticket and confirmation for the purchase, sale, or exercise of the option and found that the purchase, sale, or exercise of the option was confirmed by the counterparty or firm handling the transaction.	_____	_____	_____
18. Compared the name of the individual who received the deal ticket and confirmation with the names on a list of individuals authorized to trade options and found that the name was not on the list.	_____	_____	_____

(continued)

Findings

Procedures

No
Exception Exception N/A

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|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------|-------|-------|
| 19. Compared the terms of the option contract, as stated on the deal ticket and confirmation, with the terms of the option contract recorded in the insurance company's accounting records and found them to be in agreement. | _____ | _____ | _____ |
| 20. Obtained documentation for one reporting period, (for example, monthly or quarterly), indicating that the insurance company determined whether its accounting records for options, tested in procedure 19, agreed with or reconciled to the related control account, (for example, the subsidiary ledger to the general ledger). | _____ | _____ | _____ |
| 21. Obtained the accounting record documenting modifications, if any, to the option transaction. Compared the name of the individual who approved the modification with a list of individuals authorized to approve modifications and found the name of the individual who approved the modification on the list. | _____ | _____ | _____ |
| 22. Obtained documentation for one reporting period, (for example, monthly or quarterly), indicating that the insurance company obtained a statement from the counterparty confirming the existence of the option position. | _____ | _____ | _____ |
| 23. Using the list of authorized traders obtained in procedure 13, compared the name of the individual who had custody of or access to the option documentation with the names of individuals authorized to purchase, sell, or exercise the option and found that the name was not on the list. | _____ | _____ | _____ |

FindingsProcedures

	<u>No</u>	<u>Exception</u>	<u>Exception</u>	<u>N/A</u>
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24. Compared information regarding the option, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement.

_____	_____	_____	_____	_____
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25. If the option should have been included in the monitoring analysis separately tested in procedure 10 within section 1, "All Derivative Types," compared information regarding the option, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement.

_____	_____	_____	_____	_____
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Effectiveness of Options Used As Hedges and in Replication Transactions

26. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the option as a hedge or replication in accordance with the policies regarding effectiveness.

_____	_____	_____	_____	_____
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27. If the option was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the accounting policies and procedures and found that the action taken was consistent with the accounting policy.

_____	_____	_____	_____	_____
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Legal Review

28. Read documentation indicating that the legal department reviewed the option agreement to assess contract compliance with the DUP and enforceability.

_____	_____	_____	_____	_____
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(continued)

Findings

Procedures

No
Exception Exception N/A

29. Read documentation indicating that the legal department updated its assessment of legal enforceability of the OTC option agreement at least annually.

Valuation

30. Obtained the insurance company's policies and procedures for valuing options and found that the insurance company determined the fair value of OTC options and the market price of exchange-traded options, in accordance with the policy described in the insurance company's procedures for the valuation of options.

31. Read documentation supporting the fair value for OTC options and the market price of exchange-traded options and found that the fair value or market value was either (a) obtained from an independent source, (b) checked against an independent source, or (c) calculated internally by an authorized individual.

Description of Exceptions if Any

Procedure Number

Description of Exception

Section 8—Swap Contracts

<u>Procedures</u>	<u>Findings</u>		
	<u>No</u> <u>Exception</u>	<u>Exception</u>	<u>N/A</u>
<p>Performed the following procedures on selected swap contracts to test internal control over swap transactions. Selected five percent of each type of swap transaction (that is, executions [purchases] and closeouts [sales]), with the selections distributed throughout the year. If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in fewer than four items, selected four or fewer items that represented all the transactions of that type.</p>			
Reporting			
<p>1. Read the insurance company’s derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to enter into swap agreements.</p>	_____	_____	_____
<p>2. For each swap agreement selected for testing, read management’s documentation describing the intended use of the swap agreement and performed the following procedures, as applicable.</p>	_____	_____	_____
For swaps used as a hedge—			
<p>3. Determined that the documentation describes the following:</p>			
<p>a. The risk hedged</p>	_____	_____	_____
<p>b. How the hedge was consistent with the overall risk management strategy</p>	_____	_____	_____
<p>c. How the swap was expected to be effective in offsetting the exposure</p>	_____	_____	_____
<p>d. The approach in assessing the effectiveness of the hedge</p>	_____	_____	_____

(continued)

Findings

Procedures

No
Exception Exception N/A

4. Determined that the following items were documented:

- a. The purpose(s) of the swap as a hedge _____
- b. The terms of the swap, the name of the counterparty, and the counterparty exposure amount _____
- c. The assets or liabilities (or portion thereof) that the swap hedged _____
- d. Evidence that the swap continued to be an effective hedge _____
- e. Evidence that the swap was consistent with the insurance company's parameters, as specified in the DUP or applicable policies and procedures, for entering into swap agreements; for example, the notional amount or underlying _____

For swaps that were an exact offset of an outstanding swap—

5. Read documentation that indicated that the swap offset a swap previously purchased or sold, and that the swap was an exact offset to the market risk of the swap being offset. _____

For swaps used in a replication transaction—

6. Determined that the documentation described the following:
- a. The investment type and characteristics replicated _____
 - b. How the replication was consistent with the overall management investment strategy _____
 - c. How the swap was expected to be effective in replicating the investment characteristic of the replicated investment _____

Findings

Procedures

No
Exception Exception N/A

<p>d. The approach in assessing the effectiveness of the replication transaction</p>	_____	_____	_____
<p>7. Determined that the following items were documented:</p> <p>a. The instruments used in the replication and the investment type and characteristics replicated</p> <p>b. The terms of the swap, the name of the counterparty, and the counterparty exposure amount</p>	_____	_____	_____
<p>For all selected swaps including those that are a part of a replication transaction—</p>			
<p>8. Obtained a list of individuals, approved by the board of directors or a committee thereof who had the authority to authorize swap transactions. Compared the name of the individual who authorized the swap transaction with the names on the list and found the name of the individual on the list.</p>	_____	_____	_____
<p>9. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company's policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transactions tested; for example, a transaction in which the notional amount exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support and found evidence of approval of the transaction tested.</p>	_____	_____	_____

(continued)

Findings

Procedures

No
Exception Exception N/A

- | | | | |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------|--------------|--------------|
| <p>10. Obtained a list of <i>qualified</i> and <i>nonqualified</i> counterparties, approved by the board of directors or a committee thereof. Compared the name of the counterparty involved in the swap agreement with names on the list and found the name of the counterparty on the respective qualified or nonqualified list.</p> | <p>_____</p> | <p>_____</p> | <p>_____</p> |
| <p>11. Determined that the counterparty was listed as qualified or nonqualified in the analysis used for monitoring the insurance company's limitations on counterparty exposure consistent with the classification in the listing obtained in procedure 10.</p> | <p>_____</p> | <p>_____</p> | <p>_____</p> |
| <p>12. Obtained a list of individuals authorized by the board of directors or committee thereof to trade swap contracts. Compared the name of the individual who executed the swap with the names on the list and found the name of the individual on the list.</p> | <p>_____</p> | <p>_____</p> | <p>_____</p> |
| <p>13. Obtained a list of individuals authorized to approve settlements or disbursements related to swaps. For purchases and any interim settlements or closeouts of the swap subsequent to purchase, compared the name of the individual who approved any settlement of funds relating to the swap with the names on the list and found the name of the individual on the list.</p> | <p>_____</p> | <p>_____</p> | <p>_____</p> |
| <p>14. Compared the name of the individual who approved any payment relating to the swap with the name of the individual who approved entering into the contract and found that the names were different.</p> | <p>_____</p> | <p>_____</p> | <p>_____</p> |

Findings

<u>Procedures</u>	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
15. Compared the name of the individual who received cash or other consideration in connection with the swap with the name of the individual who entered into the contract and found that the names of the individuals were different.	_____	_____	_____
16. Obtained the deal ticket and confirmation for the purchase, execution, or closeout of the swap and found that the purchase, execution, or closeout of the swap was confirmed by the counterparty.	_____	_____	_____
17. Compared the name of the individual who received the deal ticket and confirmation with the names on a list of individuals authorized to trade swaps and found that the name was not on the list.	_____	_____	_____
18. Compared the terms of the swap contract, as stated on the deal ticket and confirmation, with the terms of the swap contract recorded in the insurance company's accounting records and found them to be in agreement.	_____	_____	_____
19. Obtained documentation for one reporting period (for example, monthly, or quarterly), that the insurance company determined whether its accounting records for swaps, tested in procedure 18, agreed with or reconciled to the related control account, (for example, the subsidiary ledger to the general ledger).	_____	_____	_____
20. Obtained the accounting record documenting modifications, if any, to the swap agreement. Compared the name of the individual who approved the modification with a list of individuals authorized to approve modifications and found the name of the individual who approved the modification on the list.	_____	_____	_____

(continued)

Findings

Procedures

No
Exception Exception N/A

- | | | | |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------|-------|-------|
| 21. Compared the terms of the swap agreement recorded in the insurance company's accounting records with the terms shown in the executed copy of the swap agreement and found them to be in agreement. | _____ | _____ | _____ |
| 22. Using the list of authorized traders obtained in procedure 12, compared the name of the individual who had custody or access to the swap agreement with the names of individuals authorized to execute swap agreements and found that the name was not on the list. | _____ | _____ | _____ |
| 23. Compared information regarding the swap, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement. | _____ | _____ | _____ |
| 24. If the swap should have been included in the monitoring analysis separately tested in procedure 10 within section 1, "All Derivative Types," compared information regarding the swap, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement. | _____ | _____ | _____ |
| 25. Read accounting documentation indicating that the insurance company monitored periodic cash settlements related to swap transactions, meaning, the insurance company had controls in place to determine that periodic cash settlements, if any, were received. | _____ | _____ | _____ |

Findings

Procedures

No
Exception Exception N/A

Effectiveness of Swaps Used As Hedges and in Replication Transactions

26. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the swap as a hedge or replication in accordance with the policies regarding effectiveness.

27. If the swap was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the accounting policies and procedures and found that the action taken was consistent with the accounting policy.

Legal Review

28. Read documentation indicating that the legal department reviewed the swap agreement to assess contract compliance with the DUP and enforceability.

29. Read documentation indicating that the legal department updated its assessment of the enforceability of the swap agreement at least annually.

Valuation

30. Obtained the insurance company's policies and procedures for valuing swaps and found that the insurance company determined the fair value of the swap in accordance with the policy described in the insurance company's procedures for valuation of swaps.

31. Read documentation supporting the fair value of the swap and found that the fair value was either (a) obtained from an independent source, (b) checked against an independent source, or (c) calculated internally by an authorized individual.

(continued)

Findings

Procedures

No
Exception Exception N/A

Description of Exceptions if Any

Procedure Number

Description of Exception

Section 9—Swaption Contracts

<u>Procedures</u>	<u>Findings</u>		
	<u>No</u>	<u>Exception</u>	<u>Exception</u>
	<u>Exception</u>	<u>Exception</u>	<u>N/A</u>
<p>Performed the following procedures on selected swaption contracts to test internal control over swaption transactions. Selected five percent of each type of swaption transaction with the selections distributed throughout the year. These are executions (purchases) and closeouts (sales). If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in less than four items, selected four or fewer items that represented all the transactions of that type.</p>			
Reporting			
1. Read the insurance company’s derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to buy or sell swaptions.	_____	_____	_____
2. For each swaption contract selected for testing, read management’s documentation describing the intended use of the swaption and performed the following procedures, as applicable.	_____	_____	_____
For swaptions used as a hedge—			
3. Determined that the documentation describes the following:			
a. The risk hedged	_____	_____	_____
b. How the hedge was consistent with the overall risk management strategy	_____	_____	_____
c. How the swaption was expected to be effective in offsetting the exposure	_____	_____	_____
d. The approach in assessing the effectiveness of the hedge	_____	_____	_____

(continued)

Findings

Procedures

No
Exception Exception N/A

4. Determined that the following items were documented:

- a. The purpose(s) of the swaption as a hedge _____
- b. The terms of the swaption, the name of the counterparty, and the counterparty exposure amount _____
- c. The assets or liabilities (or portion thereof) that the swaption hedged _____
- d. Evidence that the swaption continued to be an effective hedge _____
- e. Evidence that the swaption was consistent with the insurance company's parameters, as specified in the DUP or applicable policies and procedures, for entering into swaption agreements; for example, the notional amount or underlying _____

For swaptions that were an exact offset of an outstanding swaption—

5. Read documentation indicating that the swaption offset an outstanding swaption and that the swaption was an exact offset of the market risk of the swaption being offset. _____

For swaptions used in a replication transaction—

6. Determined that the documentation described the following:
- a. The investment type and characteristics replicated _____
 - b. How the replication was consistent with the overall management investment strategy _____
 - c. How the swaption was expected to be effective in replicating the investment characteristic of the replicated investment _____

Findings

Procedures

No
Exception Exception N/A

<p>d. The approach in assessing the effectiveness of the replication transaction</p>	_____	_____	_____
<p>7. Determined that the following items were documented:</p> <p>a. The instruments used in the replication and the investment type and characteristics replicated</p>	_____	_____	_____
<p>b. The terms of the swaption, the name of the counterparty, and the counterparty exposure amount</p>	_____	_____	_____
<p>For all selected swaptions including those that are a part of a replication transaction—</p>			
<p>8. Obtained a list of individuals, approved by the board of directors or a committee thereof, who had the authority to authorize swaptions. Compared the name of the individual who authorized the swaption transaction with the names on the list and found the name of the individual on the list.</p>	_____	_____	_____
<p>9. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company’s policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transactions tested; for example, a transaction in which the notional amount exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support and found evidence of approval of the transaction tested.</p>	_____	_____	_____

(continued)

Findings

Procedures

No
Exception Exception N/A

- | | | | |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------|--------------|--------------|
| <p>10. Obtained a list of <i>qualified</i> and <i>nonqualified</i> counterparties, approved by the board of directors or a committee thereof. Compared the name of the counterparty involved in the swaption transaction with names on the list and found the name of the counterparty on the respective qualified or nonqualified list.</p> | <p>_____</p> | <p>_____</p> | <p>_____</p> |
| <p>11. Determined that the counterparty was listed as qualified or nonqualified in the analysis used for monitoring the insurance company's limitations on counterparty exposure consistent with the classification in the listing obtained in procedure 10.</p> | <p>_____</p> | <p>_____</p> | <p>_____</p> |
| <p>12. Obtained a list of individuals authorized by the board of directors or committee thereof to trade swaption contracts. Compared the name of the individual who executed the swaption with the names on the list and found the name of the individual on the list.</p> | <p>_____</p> | <p>_____</p> | <p>_____</p> |
| <p>13. Obtained a list of individuals authorized to approve settlements or disbursements related to swaption agreements. Compared the name of the individual who approved settlements and disbursements relating to the swaption with the names on the list and found the name on the list.</p> | <p>_____</p> | <p>_____</p> | <p>_____</p> |
| <p>14. Compared the name of the individual who approved any payment relating to the swaption with the name of the individual who approved entering into the contract and found that the names were different.</p> | <p>_____</p> | <p>_____</p> | <p>_____</p> |
| <p>15. Compared the name of the individual who received cash or other consideration in connection with the swaption with the name of the individual who entered into the contract and found that the names of the individuals were different.</p> | <p>_____</p> | <p>_____</p> | <p>_____</p> |

Findings

<u>Procedures</u>	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
16. Obtained the deal ticket and confirmation for the purchase, sale, modification, or closeout of the swaption and found that the purchase, sale, modification, or closeout was confirmed by the counterparty.	_____	_____	_____
17. Compared the name of the individual who received the deal ticket and confirmation with the names on a list of individuals authorized to trade swaptions and found that the name was not on the list.	_____	_____	_____
18. Compared the terms of the swaption contract, as stated on the deal ticket and confirmation, with the terms of the swaption contract recorded in the insurance company's accounting records and found them to be in agreement.	_____	_____	_____
19. Obtained documentation for one reporting period (for example, monthly or quarterly), that the insurance company determined whether its accounting records for swaptions, tested in procedure 18, agreed with or reconciled to the related control account, (for example, the subsidiary ledger to the general ledger).	_____	_____	_____
20. Obtained the accounting record documenting modifications, if any, to the swaption agreement. Compared the name of the individual who approved the modification with a list of individuals authorized to approve modifications and found the name of the individual who approved the modification on the list.	_____	_____	_____
21. Compared the terms of the swaption agreement recorded in the insurance company's accounting records with the terms shown in the executed copy of the swaption agreement and found them to be in agreement.	_____	_____	_____

(continued)

Findings

Procedures

No
Exception Exception N/A

22. Using the list of authorized traders obtained in procedure 12, compared the name of the individual who had custody or access to the swaption agreement with the names of individuals authorized to execute swaption agreements and found that the name was not on the list.

23. Compared information regarding the swaption, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement.

24. If the swaption should have been included in the monitoring analysis separately tested in procedure 10 within section 1, "All Derivative Types," compared information regarding the swaption, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement.

Effectiveness of Swaptions Used As Hedges and in Replication Transactions

25. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the swaption as a hedge or replication in accordance with the policies regarding effectiveness.

26. If the swaption was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the accounting policies and procedures and found that the action taken was consistent with the accounting policy.

Findings

Procedures

No
Exception Exception N/A

Legal Review

27. Read documentation indicating that the legal department reviewed the swaption agreement to assess contract compliance with the DUP and enforceability.

28. Read documentation indicating that the legal department updated its assessment of the enforceability of the swaption agreement at least annually.

Valuation

29. Obtained the insurance company's policies and procedures for valuing swaptions and found that the insurance company determined the fair value of the swaption in accordance with the policy described in the insurance company's procedures for valuation of swaptions.

30. Read documentation supporting the fair value of the swaption and found that the fair value was either (a) obtained from an independent source, (b) checked against an independent source, or (c) calculated internally by an authorized individual.

Description of Exceptions if Any

Procedure Number

Description of Exception

Section 10—Warrant Contracts

Findings

<u>Procedures</u>	<u>No</u>	<u>Exception</u>	<u>Exception</u>	<u>N/A</u>
<p>Performed the following procedures on selected warrant contracts to test internal control over warrant transactions. Selected five percent of each type of warrant transaction (that is, purchases, sales, expirations, and exercises), with the selections distributed throughout the year. If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in less than four items, selected four or fewer items that represented all of the transactions of that type.</p>				
Reporting				
<p>1. Read the insurance company’s derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to trade or enter into warrant contracts.</p>	_____	_____	_____	_____
<p>2. For each warrant selected for testing, read management’s documentation describing the intended use of the warrant and performed the following procedures, as applicable.</p>	_____	_____	_____	_____
For warrants used as a hedge—				
<p>3. Determined that the documentation described the following:</p>				
<p>a. The risk hedged</p>	_____	_____	_____	_____
<p>b. How the hedge was consistent with the overall risk management strategy</p>	_____	_____	_____	_____
<p>c. How the warrant was expected to be effective in offsetting the exposure</p>	_____	_____	_____	_____
<p>d. The approach in assessing the effectiveness of the hedge</p>	_____	_____	_____	_____

Findings

Procedures

No
Exception Exception N/A

4. Determined that the following items were documented:
 - a. The purpose(s) of the warrant as a hedge
 - b. For exchange-traded warrants, the term of the warrant, the name of the exchange, and the name of the firm(s) handling the trade
 - c. For over-the-counter (OTC) warrants, the terms of the warrant, the name of the counterparty, and the counterparty exposure amount
 - d. The assets or liabilities (or portion thereof) that the warrant hedged
 - e. Evidence that the warrant continued to be an effective hedge
 - f. Evidence that the warrant was consistent with the insurance company's parameters, as specified in the DUP or applicable company policies and procedures for entering into hedge transactions; for example, the notional amount or underlying

_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____

If the warrant transaction was an exact offset of an outstanding warrant—

5. Read documentation indicating that the warrant transaction offset an outstanding warrant previously purchased or sold by the insurance company and that the warrant was an exact offset of the market risk of the warrant being offset

_____	_____	_____
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(continued)

Findings

Procedures

No
Exception Exception N/A

For warrants used in a replication transaction—

6. Determined that the documentation described the following:

- a. The investment type and characteristics replicated _____
- b. How the replication was consistent with the overall management investment strategy _____
- c. How the warrant was expected to be effective in replicating the investment characteristics of the replicated investment _____
- d. The approach in assessing the effectiveness of the replication transaction _____

7. Determined that the following items were documented:

- a. The instruments used in the replication and the investment type and characteristics replicated _____
- b. The specific warrant used in the replication _____
- c. For exchange-traded warrants, the name of the exchange and the firm(s) handling the trade _____
- d. For OTC warrants, the terms of the warrant, the name of the counterparty, and the counterparty exposure amount _____

FindingsProcedures

<u>No</u>	<u>Exception</u>	<u>Exception</u>	<u>N/A</u>
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For all selected warrants including those that are part of a replication transaction—

8. Obtained a list of individuals, approved by the board of directors or a committee thereof who had the authority to authorize warrant transactions. Compared the name of the individual who authorized the warrant transaction with the names on the list and found the name of the individual on the list.

9. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company's policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transaction tested; for example, a transaction in which the notional amount exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support, and found evidence of approval of the transaction tested.

10. Obtained a list of *qualified* and *nonqualified* counterparties, approved by the board of directors or a committee thereof. Compared the name of the counterparty involved in the warrant transaction with names on the list, and found the name of the counterparty on the respective qualified or nonqualified list.

_____	_____	_____
_____	_____	_____
_____	_____	_____

(continued)

Findings

Procedures

No
Exception Exception N/A

- | | | | |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------|--------------|--------------|
| <p>11. For OTC warrants, determined that the counterparty was listed as qualified or nonqualified in the analysis used for monitoring the insurance company's limitations on counterparty exposure, consistent with the classification in the listing obtained in procedure 10.</p> | <p>_____</p> | <p>_____</p> | <p>_____</p> |
| <p>12. Obtained a list of individuals authorized by the board of directors or committee thereof to trade warrant contracts. Compared the name of the individual who executed the purchase, sale, or exercise of the warrant with the names on the list and found the name of the individual on the list.</p> | <p>_____</p> | <p>_____</p> | <p>_____</p> |
| <p>13. Obtained a list of individuals authorized to approve payments related to warrant contracts. Compared the name of the individual who approved any payment relating to the warrant with the names on the list, and found the name of the individual on the list.</p> | <p>_____</p> | <p>_____</p> | <p>_____</p> |
| <p>14. Compared the name of the individual who approved any payment relating to the warrant with the name of the individual who approved entering into the contract and found that the names were different.</p> | <p>_____</p> | <p>_____</p> | <p>_____</p> |
| <p>15. Compared the name of the individual who received cash or other consideration in connection with the warrant with the name of the individual who entered into the contract and found that the names of the individuals were different.</p> | <p>_____</p> | <p>_____</p> | <p>_____</p> |
| <p>16. Obtained the deal ticket and confirmation for the purchase, sale, or exercise of an exchange-traded warrant and found that the purchase, sale, or exercise was confirmed by the firm handling the transaction.</p> | <p>_____</p> | <p>_____</p> | <p>_____</p> |

Findings

<u>Procedures</u>	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
17. Compared the name of the individual who received the deal ticket and confirmation with the names on a list of individuals authorized to trade warrants and found that the name was not on the list.	_____	_____	_____
18. Compared the terms of the warrant contract, as stated on the deal ticket and confirmation, with the terms of the warrant contract recorded in the insurance company's accounting records and found them to be in agreement.	_____	_____	_____
19. Obtained documentation for one reporting period, (for example, monthly or quarterly), that the insurance company determined whether its accounting records for warrants, tested in procedure 18, agreed with or reconciled to the related control account, (for example, the subsidiary ledger to the general ledger).	_____	_____	_____
20. Obtained the accounting record documenting modifications, if any, to the warrant transaction. Compared the name of the individual who approved the modification with a list of individuals authorized to approve modifications and found the name of the individual who approved the modification on the list.	_____	_____	_____
21. For one reporting period, (for example, monthly or quarterly), obtained the insurance company's documentation of the existence of the warrant contract and found that the insurance company either (a) obtained statements from the custodian confirming the existence of the warrant contracts or (b) physically inventoried the warrant contracts.	_____	_____	_____

(continued)

Findings

Procedures

No
Exception Exception N/A

- 22. Using the list of authorized traders obtained in procedure 12, compared the name of the individual who had custody of or access to the warrant contracts with the names of individuals authorized to execute purchases, sales, or exercises of warrants and found that the name was not on the list. _____

- 23. Compared information regarding the warrant, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement. _____

- 24. If the warrant position should have been included in the monitoring analysis separately tested in procedure 10 of section 1, "All Derivative Types," compared information regarding the warrant, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement. _____

Effectiveness of Warrants Used As Hedges and in Replication Transactions

- 25. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the warrant as a hedge or replication in accordance with the policies regarding effectiveness. _____

- 26. If the warrant was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the accounting policies and procedures and found that the action taken was consistent with the accounting policy. _____

Findings

Procedures

No
Exception Exception N/A

Legal Review

27. Read documentation indicating that the legal department reviewed a nonexchange traded warrant agreement to assess contract compliance with the DUP and enforceability.

28. Read documentation indicating that the legal department updated its assessment of enforceability of the nonexchange traded warrant agreement at least annually.

Valuation

29. Obtained the insurance company's policies and procedures for valuing warrants and found that the insurance company determined the fair value of the warrant in accordance with the policy described in the insurance company's procedures for the valuation of warrants

30. Read documentation supporting the fair value of warrants and found that the fair value was either (a) obtained from an independent source, (b) checked against an independent source, or (c) calculated internally by an authorized individual.

Description of Exceptions if Any

Procedure Number

Description of Exception

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Appendix C — Illustrative Management Representation Letter

[Responsible Party's Letterhead]

[Date]

[CPA Firm's Name and Address]

In connection with your engagement to apply the agreed-upon procedures enumerated in the American Institute of Certified Public Accountants' Statement of Position 01-03, *Performing Agreed-Upon Procedures Engagements that Address Internal Control Over Derivative Transactions as Required by the New York State Insurance Law*, which were agreed to by management of ABC Insurance Company, solely to assist us in complying with the requirements of Section 1410 (b)(5) of the New York State Insurance Law, as amended (the law), which addresses the assessment of internal control over derivative transactions as defined in Section 1401 (a) of the law and Section 178.5 of Regulation No. 163 during the year ended December 31, 20XX, we confirm, to the best of our knowledge and belief, the following representations made to you during your engagement:

1. We are responsible for establishing and maintaining effective internal control over derivative transactions in accordance with the law.
2. During the year ended December 31, 20XX, the internal control over derivative transactions was functioning in accordance with the policies and procedures set forth in the Company's derivative use plan (DUP) and related accounting policies and procedures. There have been no errors or fraud that would indicate a weakness in the internal control over derivative transactions.
3. We have disclosed to you all significant deficiencies in the design or operation of the internal control over derivative transactions that would adversely affect the Company's ability to function in accordance with the Company's DUP.
4. There have been no communications from regulatory agencies, internal auditors, or other practitioners or consultants relating to the internal control over derivative transactions, including communications received between December 31, 20XX and the date of this letter.
5. We have made available to you all information that we believe is relevant to the internal control over derivative transactions.
6. We have responded fully to all inquiries made to us by you during the engagement.

To the best of our knowledge and belief, no events have occurred subsequent to December 31, 20XX and through the date of this letter that would require adjustment to or modification of the findings of the agreed-upon procedures.

[Signature]

[Title]

[Signature]

[Title]

**Reporting on Controls Over Derivative
Transactions at Insurance Entities Task Force**ALBERT J. REZNICEK, *Chair*

DAVID A. NACHMAN

EDWARD F. BADER

PAULA C. PANIK

DARRYL BRILEY

ROBERT M. SOLITRO

BEN B. KORBLY

MARY TODD STOCKER

EDWARD J. METZGER

DEBORAH H. WHITMORE

The AICPA is grateful to Jean Connolly, James S. Gerson, Laurel A. Hammer, Jay Matalon, and James M. Yanosy for their technical assistance with this document and also to Michael Moriarty of the New York State Department of Insurance for reviewing this document and providing recommendations.

AICPA Staff

CHARLES E. LANDES

JUDITH M. SHERINSKY

*Director**Technical Manager**Audit and Attest Standards**Audit and Attest Standards*

[The next page is 31,621.]

Section 14,390

Statement of Position 02-1 Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code

May 23, 2002

NOTE

This AICPA Statement of Position (SOP) has been developed by the AICPA New Jersey Annual Claims Prompt Payment Reports Task Force of the AICPA Auditing Standards Board (ASB) to provide guidance regarding the application of Statements on Standards for Attestation Engagements (SSAEs) to agreed-upon procedures engagements performed to comply with the requirements of New Jersey Administrative Code, Title 11, Chapter 22, Subchapter 1 (NJAC 11:22-1 or the Code), which establishes Department of Banking and Insurance (department) standards for the payment of claims relating to health benefits plans and dental plans and contains requirements for carriers to file certain reports with the department relating to the timeliness of claims payments and the reasons for denial and late payment of claims in a format prescribed by the department. The department has approved the use of the agreed-upon procedures outlined in this SOP to comply with the reporting requirements of the Code.

This SOP is recognized as an attestation interpretation as defined in AT section 50, *SSAE Hierarchy* (AICPA, *Professional Standards*). Attestation interpretations are recommendations on the application of SSAEs in specific circumstances, including engagements for entities in specialized industries. Attestation interpretations are issued under the authority of the ASB. The members of the ASB have found this SOP to be consistent with existing SSAEs.

A practitioner should be aware of and consider attestation interpretations applicable to his or her attestation engagement. If the practitioner does not apply the guidance included in this SOP, the practitioner should be prepared to explain how he or she complied with the SSAE provisions of this SOP.

Introduction and Background

.01 New Jersey Administrative Code, Title 11, Chapter 22, Subchapter 1 (NJAC 11:22-1 or the Code), establishes Department of Banking and Insurance (department) standards for the payment of claims relating to health benefits plans and dental plans and contains requirements for carriers to file certain reports with the department relating to the timeliness of claims payments and the reasons for denial and late payment of claims in a format prescribed by the department.

.02 NJAC 11:22-1 applies to any insurance company, health service corporation, medical service corporation, hospital service corporation, health

maintenance organization, dental service corporation, and dental plan organization that issues health benefits plans or dental plans in the state of New Jersey and to any agent, employee, or other representative of such entity that processes claims for such entity.

.03 Among other things, the Code requires carriers to report:

- Quarterly to the department on the timeliness of claims payments in the format set forth in Appendix A (claims payment exhibit report) of NJAC 11:22-1, and
- Quarterly and annually on late payments of claims and the reasons for any denials (claims prompt payment report) in the format set forth in Appendix B of NJAC 11:22-1.

.04 Furthermore, the Code requires that the annual claims prompt payment report, which is due to be filed with the department on or before March 31, pursuant to NJAC 11:22-1.9(a), be accompanied by the report of a private auditing firm, which may be a Certified Public Accountant (CPA) or a firm of CPAs. However, for calendar year 2001, the report of the private auditing firm may be filed with the department on or before July 1, 2002. The department has specified, in Bulletin No. 02-07, that the work shall be conducted, and the report shall be prepared, in accordance with agreed-upon procedures acceptable to the department.

Applicability

.05 This Statement of Position (SOP) was developed to provide practitioners with guidance on performing agreed-upon procedures engagements that address annual claims prompt payment reports as required by the New Jersey Administrative Code. The engagement described in this SOP is designed only to satisfy the requirements of the Code. The procedures, as set forth in this SOP, are not necessarily appropriate for use in any other engagement. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

The Code

Definitions

.06 The following definitions are reprinted from the Code and are applicable when performing the agreed-upon procedures engagement described in this SOP.

Agent—Any entity, including a subsidiary of a carrier, or an organized delivery system as defined by N.J.S.A. 17:48H-1, with which a carrier has contracted to perform claims processing or claims payment services.

Carrier—An insurance company, health service corporation, hospital service corporation, medical service corporation or health maintenance organization authorized to issue health benefits plans in this State and a dental service corporation or dental plan organization authorized to issue dental plans in this State.

Claim—A request by a covered person, a participating health care provider, or a nonparticipating health care provider who has received an assignment of benefits from the covered person, for payment relating to health care services or supplies or dental services or supplies covered under a health benefits plan or dental plan issued by a carrier.

Clean claim—

1. The claim is for a service or supply covered by the health benefits plan or dental plan;
2. The claim is submitted with all the information requested by the carrier on the claim form or in other instructions distributed to the provider or covered person;
3. The person to whom the service or supply was provided was covered by the carrier's health benefits or dental plan on the date of service;
4. The carrier does not reasonably believe that the claim has been submitted fraudulently; and
5. The claim does not require special treatment. For the purposes of this subchapter, special treatment means that unusual claim processing is required to determine whether a service or supply is covered, such as claims involving experimental treatments or newly approved medications. The circumstances requiring special treatment should be documented in the claim file.

*Covered person—*A person on whose behalf a carrier offering the plan is obligated to pay benefits or provide services pursuant to the health benefits or dental plan.

*Covered service or supply—*A service or supply provided to a covered person under a health benefits or dental plan for which the carrier is obligated to pay benefits or provides services or supplies.

*Dental plan—*A benefits plan which pays dental expense benefits or provides dental services and supplies and is delivered or issued for delivery in this State by or through any carrier in this State.

*Department—*The Department of Banking and Insurance.

*Health benefits plan—*A benefits plan that pays hospital and medical expense benefits or provides hospital and medical services, and is delivered or issued for delivery in this State by or through a carrier. Health benefits plan includes, but is not limited to, Medicare supplement coverage and risk contracts to the extent not otherwise prohibited by Federal law. For the purposes of this chapter, health benefits plan shall not include the following plans, policies or contracts: accident only, credit, disability, long-term care, CHAMPUS supplement coverage, coverage arising out of a workers' compensation or similar law, automobile medical payment insurance, personal injury protection insurance issued pursuant to P.L. 1972, c.70 (N.J.S.A. 39:6A-1 et seq.) or hospital confinement indemnity coverage.

*Health care provider or provider—*An individual or entity which, acting within the scope of its license or certification, provides a covered service or supply as defined by the health benefits or dental plan. Health care provider includes, but is not limited to, a physician, dentist and other health care professional licensed pursuant to Title 45 of the Revised Statutes and a hospital and other health care facilities licensed pursuant to Title 26 of the Revised Statutes.

Reporting Requirements

.07 The Code requires a carrier and its agent to remit payment of clean claims pursuant to specified time frames. The Code further requires that if a carrier or its agent denies or disputes a claim, in full or in part, the carrier or

its agent must, within a specified time frame, notify both the covered person when he or she will have increased responsibility for payment, and the provider, of the basis for its decision to deny or dispute the claim.

.08 The Code requires a carrier to report to the department quarterly on the timeliness of claims payments in the format prescribed in NJAC 11:22-1, Appendix A, "New Jersey Claims Payment Exhibit." This quarterly report is not required to be subjected to an agreed-upon procedures engagement, nor is an annual claims payment exhibit report required to be filed with the department.

.09 The Code also requires a carrier to report to the department on a quarterly and annual basis on the late payment of claims and the reasons for denial of claims in the format prescribed in NJAC 11:22-1, Appendix B, "Quarterly (Annual) Claims Prompt Payment Report." The Code requires that the annual claims prompt payment report be accompanied by a report of a private auditing firm, which may be a CPA or a firm of CPAs.

.10 The department has indicated, in Bulletin No. 02-07, that an agreed-upon procedures engagement pursuant to this SOP may be used to satisfy the requirement that an annual claims prompt payment report be accompanied by the report of a private auditing firm. Furthermore, in Bulletin No. 02-12, issued in May 2002, the department has indicated that it agrees to the sufficiency of the procedures included in this SOP for its purposes.

Related Professional Standards

AT Section 201, *Agreed-Upon Procedures Engagements*

.11 Agreed-upon procedures engagements performed to meet the requirements of the Code are to be performed in accordance with AT section 201, *Agreed-Upon Procedures Engagements (AICPA, Professional Standards)*. As described in paragraph .03 of AT section 201, an agreed-upon procedures engagement is one in which a practitioner is engaged by a client to issue a report of findings based on specific procedures performed on the subject matter. Not all of the provisions of AT section 201 are discussed herein. Rather, this SOP includes guidance to assist practitioners in the application of selected aspects of AT section 201.

.12 Paragraph .06 of AT section 201 states, in part, that the practitioner may perform an agreed-upon procedures engagement provided that, "...*(c)* the practitioner and the specified parties agree upon the procedures performed or to be performed by the practitioner; and *(d)* the specified parties take responsibility for the sufficiency of the agreed-upon procedures for their purposes."

.13 As previously stated, Bulletin No. 02-07 from the department states that an agreed-upon procedures engagement may be used to meet the requirement for an independent private auditing firm to report on the annual claims prompt payment reports as required by the New Jersey Administrative Code. Furthermore, the department has approved the use of the agreed-upon procedures outlined in this SOP to comply with the reporting requirements of the Code. Accordingly, practitioners should not eliminate any of the procedures presented in appendix B (paragraph .28), "Agreed-Upon Procedures That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code," of this SOP or reduce the extent of the tests. The department or the carrier may request that additional procedures be performed

and the practitioner may agree to perform such procedures. In those circumstances, it would be expected that the additional procedures would be performed in the context of a separate agreed-upon procedures engagement.

Procedures to Be Performed

.14 The agreed-upon procedures to be performed are applied to the carrier's annual claims prompt payment report, which reports on the late payment of claims and reasons for denial of claims in the format prescribed in NJAC 11:22-1, Appendix B.

.15 The procedures to be performed in the agreed-upon procedures engagement described in this SOP are presented in appendix B (paragraph .28) of this SOP. The procedures have been designed so that the findings resulting from the application of the procedures can be recorded in a tabular format. The three options available to the practitioner for expressing the findings for each procedure are *No Exception*, *Exception*, or *N/A* (not applicable). If a procedure is not applicable to a particular carrier, the procedure should be marked *N/A* rather than deleted from the report. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.16 If any portion of a procedure results in an exception, the findings for that entire procedure should be recorded as an exception and described in the section "Description of Exceptions If Any." The practitioner should provide a brief factual explanation for each exception that will enable the specified parties to understand the nature of the findings resulting in the exception. If management informs the practitioner that the condition giving rise to the exception was corrected by the date of the practitioner's report, the practitioner's explanation of the exception may include that information; for example, "Management has advised us that the condition resulting in the exception was corrected on Month X, 20XX. We have performed no procedures with respect to management's assertion."

.17 A practitioner may perform significant portions of the agreed-upon procedures engagement before the end of the period covered by the report. If, during that time, the practitioner identifies conditions that result in an exception in one or more agreed-upon procedures, he or she should report the exception in the findings section of the agreed-upon procedures report, even if management corrects the condition prior to the end of the period.

.18 Paragraph .40 of AT section 201 states the following:

The practitioner need not perform procedures beyond the agreed-upon procedures. However, in connection with the application of agreed-upon procedures, if matters come to the practitioner's attention by other means that significantly contradict the subject matter (or written assertion related thereto) referred to in the practitioner's report, the practitioner should include this matter in his or her report. For example, if, during the course of applying agreed-upon procedures regarding an entity's internal control, the practitioner becomes aware of a material weakness by means other than performance of the agreed-upon procedure, the practitioner should include this matter in his or her report.

.19 A practitioner has no obligation to perform procedures beyond the agreed-upon procedures included in appendix B (paragraph .28) of this SOP. However, if information that contradicts the information in the carrier's annual claims prompt payment report comes to the practitioner's attention by other means, such information should be included in the practitioner's report. This

also would apply to conditions or events occurring during the subsequent-events period (subsequent to the period covered by the practitioner's report but prior to the date of the practitioner's report) that either contradict the findings in the report or that would have resulted in the reporting of an exception by the practitioner if that condition or event had existed during the period covered by the report. However, the practitioner has no responsibility to perform any procedure to detect such conditions or events.

Establishing an Understanding With the Client

.20 In accordance with paragraph .10 of AT section 201, the practitioner should establish an understanding with the client regarding the services to be performed. Such an understanding reduces the risk that the client may misinterpret the objectives and limitations of an agreed-upon procedures engagement performed to meet the regulatory requirements of the Code. Such an understanding also reduces the risk that the client will misunderstand its responsibilities and the responsibilities of the practitioner. The practitioner should document the understanding in the working papers, preferably through a written communication with the client (an engagement letter). The communication should be addressed to the client. Matters that might be included in such an understanding are the following:

- A statement confirming that an agreed-upon procedures engagement is to be performed to meet the requirements of NJAC 11:22-1
- A statement identifying the procedures to be performed as those set forth in SOP 02-1, *Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code*
- A statement identifying the client and the department as the specified parties to the agreed-upon procedures report
- A statement acknowledging the client's responsibility for the sufficiency of the procedures in the SOP and referring to Bulletin No. 02-12, which acknowledges the department's responsibility for the sufficiency of the procedures in the SOP
- A statement acknowledging that the practitioner makes no representation regarding the sufficiency of the procedures in the SOP
- A statement describing the responsibilities of the practitioner, including but not limited to the responsibility to perform the agreed-upon procedures and to provide the client with a report, and the circumstances under which the practitioner may decline to issue a report
- A statement indicating that the engagement will be conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants (AICPA)
- A statement indicating that an agreed-upon procedures engagement does not constitute an examination, the objective of which would be the expression of an opinion on the carrier's compliance with the requirements of NJAC 11:22-1, and that if an examination were performed, other matters might come to the practitioner's attention
- A statement indicating that the practitioner will not express an opinion or any other form of assurance

- A statement describing the client's responsibility to comply with the requirements of NJAC 11:22-1 and the client's responsibility for the information in the carrier's annual claims prompt payment report
- A statement describing the client's responsibility for providing accurate and complete information to the practitioner
- A statement indicating that the practitioner has no responsibility for the completeness or accuracy of the information provided to the practitioner
- A statement restricting the use of the report to the client and the department
- A statement describing any arrangements to involve a specialist

Management Representations

.21 Although AT section 201 does not require a practitioner to obtain a representation letter from management in an agreed-upon procedures engagement, when performing the engagement described in this SOP, it is recommended that the practitioner obtain such a letter, and that it generally be signed by the appropriate members of management including the highest-ranking officer responsible for the carrier's compliance with the requirements of NJAC 11:22-1. Management's refusal to furnish written representations that the practitioner has determined to be appropriate for the engagement constitutes a limitation on the performance of the engagement that requires either modification of the report or withdrawal from the engagement. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.22 The representations that a practitioner deems appropriate will depend on the specific nature of the engagement; however, they ordinarily include the following representations from management:

- A statement acknowledging responsibility for compliance with the requirements of NJAC 11:22-1 and responsibility for the information in the carrier's annual claims prompt payment report
- A statement that there have been no errors or fraud that might indicate that the carrier is not in compliance with the requirements of NJAC 11:22-1 and that there are no known matters (or that management has disclosed to the practitioner all known matters) that contradict the information in the carrier's annual claims prompt payment report
- A statement that management has disclosed to the practitioner any communications from regulatory agencies relating to the carrier's annual claims prompt payment report
- A statement that management has made available to the practitioner all information it believes is relevant to the carrier's annual claims prompt payment report
- A statement that management has responded fully to all inquiries made by the practitioner during the engagement
- A statement that no events have occurred subsequent to the date as of which the procedures were applied that would require modification of the findings of the agreed-upon procedures

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.23 An illustrative representation letter is presented in appendix C (paragraph .29), “Illustrative Management Representation Letter,” of this SOP. For additional information regarding management’s written representations in an agreed-upon procedures engagement, see paragraphs .37–.39 of AT section 201.

Restriction on the Performance of Procedures

.24 As previously stated, a practitioner should not agree to eliminate any of the procedures presented in appendix B (paragraph .28) of this SOP. If circumstances impose restrictions on the performance of the agreed-upon procedures, the practitioner should attempt to obtain agreement from the specified users for modification of the agreed-upon procedures presented in appendix B (paragraph .28) of this SOP. When such agreement cannot be obtained, the practitioner should describe the restriction(s) on the performance of procedures in his or her report or withdraw from the engagement.

Dating the Report

.25 The date of completion of the agreed-upon procedures should be used as the date of the practitioner’s report.

Effective Date

.26 This SOP is effective upon issuance and is applicable only to agreed-upon procedures engagements that report on annual claims prompt payment reports as required by the NJAC.

Appendix A — Illustrative Agreed-Upon Procedures Report

The following is an illustrative agreed-upon procedures report based on the guidance in AT section 201, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*).

Independent Accountant's Report on Applying Agreed-Upon Procedures

To the Management of ABC Carrier:

We have performed the applicable procedures enumerated in the American Institute of Certified Public Accountants' Statement of Position (SOP) 02-1, *Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code*, which were agreed to by ABC Carrier and the New Jersey Department of Banking and Insurance (the department), solely to assist you in complying with the reporting requirements of New Jersey Administrative Code, Title 11, Chapter 22, Subchapter 1.9 (NJAC 11:22-1.9) for Appendix B 20XX Annual Report (Exhibit I) for the year ended December 31, 20XX. Management of ABC Carrier is responsible for compliance with the requirements of NJAC 11:22-1. 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 ABC Carrier and the department. Consequently, we make no representation regarding the sufficiency of the procedures described in the attached Appendix either for the purpose for which this report has been requested or for any other purpose.

The procedures performed and the findings are included in the attached Appendix.

We were not engaged to and did not conduct an examination, the objective of which would be the expression of an opinion on ABC Carrier's compliance with the requirements of NJAC 11:22-1 for the year ended December 31, 20XX. 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 management of ABC Carrier and the State of New Jersey Department of Banking and Insurance, and is not intended to be and should not be used by anyone other than these specified parties.

[Signature]

[Date]

Appendix B — Agreed-Upon Procedures That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
<p>The following procedures were applied to the ABC Carrier's 20XX Appendix B annual claims prompt payment report.</p> <p>We obtained supporting documentation used by management to prepare the Annual New Jersey Prompt Payment Report, and for each of the five categories (physician, dental, other health care professional, hospital, or other health care facilities), where applicable, compared the number of claims and the amount of claims for each quarter and the annual period from the supporting documentation used by management to prepare the Annual New Jersey Prompt Payment Report to the following columns of the report:</p>			
• Total claims	_____	_____	_____
• Denied ineligible	_____	_____	_____
• Denied document	_____	_____	_____
• Denied coding/enrollment	_____	_____	_____
• Denied for amount	_____	_____	_____
• Time limit special	_____	_____	_____
• Time limit other	_____	_____	_____
• Denied referred fraud	_____	_____	_____
• Interest paid	_____	_____	_____
• Interest amount paid	_____	_____	_____
• Total paid	_____	_____	_____

<u>Procedures</u>	<i>Findings</i>		
	<i>No Exception</i>	<i>Exception</i>	<i>N/A</i>
<p>We selected 10 percent of the claims from ABC Carrier’s supporting documentation used by management to prepare the Annual New Jersey Prompt Payment Report, with the selections distributed throughout the year. If 10 percent of the claims exceeded 50, then the number of items selected was limited to 50. If 10 percent of the claims resulted in less than 10 claims, then the number of items selected was 10, and for each item selected we:</p>			
<p>1. Compared the following information to ABC Carrier’s claim payment system:</p> <ul style="list-style-type: none"> ● Paid amount ● Claim finalization or payment date ● Claim received date ● Denial code ● Claim category (physician, dental, other health care professional, hospital, or other health care facilities) 	<p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p>	<p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p>	<p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p>
<p>2. Compared the following information to the original claim information submissions:</p> <ul style="list-style-type: none"> ● Date received ● Amount billed ● Category (physician, dental, other health care professional, hospital, or other health care facilities) 	<p>_____</p> <p>_____</p> <p>_____</p>	<p>_____</p> <p>_____</p> <p>_____</p>	<p>_____</p> <p>_____</p> <p>_____</p>
<p>3. Noted whether, per ABC Carrier’s member records, original claim information submission, or both, the claim related to a policy issued in the state of New Jersey</p>	<p>_____</p>	<p>_____</p>	<p>_____</p>
<p>4. If a selected claim was denied, compared denial reason indicated in ABC Carrier’s claims system records to supporting documentation used by management to prepare the Annual New Jersey Prompt Payment Report</p>	<p>_____</p>	<p>_____</p>	<p>_____</p>

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
5. If a selected claim is a "clean claim," as defined in NJAC 11:22-1.2, and as determined by ABC Carrier, recalculated the amount of interest paid on the selected claim in accordance with the requirements of NJAC 11:22-1.5	_____	_____	_____
We selected 10 claims from ABC Carrier's primary claims system, with the selections distributed throughout the year, and for each item selected, traced the selected claims covered under New Jersey contracts to the supporting documentation used by management to prepare the Annual New Jersey Prompt Payment Report.	_____	_____	_____
We proved the arithmetic accuracy of ABC Carrier's 20XX Appendix B annual claims prompt payment report.	_____	_____	_____

Description of Exceptions if Any

Appendix C — Illustrative Management Representation Letter

[ABC Carrier's Letterhead]

[Date]

[CPA Firm's Name and Address]

In connection with your engagement to apply the agreed-upon procedures enumerated in the American Institute of Certified Public Accountants' Statement of Position (SOP) 02-1, *Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code*, which were agreed to by ABC Carrier and the New Jersey Department of Banking and Insurance, solely to assist us in complying with the requirements of New Jersey Administrative Code, Title 11, Chapter 22, Subchapter 1 (NJAC 11:22-1.9), for Appendix B 20XX Annual Report (Exhibit I) for the period from January 1, 20XX through December 31, 20XX, we confirm, to the best of our knowledge and belief, the following representations made to you during your engagement:

1. We are responsible for compliance with the requirements of NJAC 11:22-1 and for the information in ABC Carrier's annual claims prompt payment report.
2. During the year ended December 31, 20XX, there have been no errors or fraud that would indicate that ABC Carrier is not in compliance with the requirements of NJAC 11:22-1.
3. We have disclosed to you all known matters contradicting the information in ABC Carrier's annual claims prompt payment report.
4. There have been no communications from regulatory agencies relating to ABC Carrier's annual claims prompt payment report, including communications received between December 31, 20XX, and the date of this letter.
5. We have made available to you all information that we believe is relevant to ABC Carrier's annual claims prompt payment report.
6. We have responded fully to all inquiries made to us by you during the engagement.

To the best of our knowledge and belief, no events have occurred subsequent to December 31, 20XX, and through the date of this letter that would require adjustment to or modification of the findings of the agreed-upon procedures.

[Signature]

[Title]

[Signature]

[Title]

**New Jersey Annual Claims
Prompt Payment Reports Task Force**

JEFF MUZIO, *Chair*

NANCY LOFREDO

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Senior Technical Manager

Audit and Attest Standards

Audit and Attest Standards

The AICPA is grateful to Jean Connolly, James S. Gerson, and Kim Hekker for their technical assistance with this document.

[The next page is 31,701.]

Section 14,410

Statement of Position 04-1 Auditing the Statement of Social Insurance

November 22, 2004

NOTICE TO READERS

This AICPA Statement of Position (SOP) is currently undergoing significant revision by a task force of the Auditing Standards Board to

- reflect the provisions of Statement of Federal Financial Accounting Standards (SFFAS) 36, *Reporting Comprehensive Long-Term Fiscal Projections for the U.S. Government*, which requires that a financial projection be presented as required supplemental information in the consolidated financial report of the U.S. Government for years 2010, 2011, and 2012, after which time the financial projection becomes a basic financial statement;
- reflect the requirements and guidance in AT section 301, *Financial Forecasts and Projections* (AICPA, *Professional Standards*); and
- expand the scope of the SOP to include the projection required by SFFAS 36 and perhaps other long-term projections.

As part of this revision, the task force is also reflecting the conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 122–126. The revisions to this SOP will be reflected in a subsequent update of *AICPA Technical Practice Aids*.

NOTE

This AICPA Statement of Position (SOP) has been developed by the AICPA Social Insurance Task Force to provide guidance regarding the audits of statements of social insurance prepared in accordance with the standards of the Federal Accounting Standards Advisory Board (FASAB). Audits of federal government agencies are also governed by *Government Auditing Standards* (the Yellow Book) and applicable Office of Management and Budget (OMB) guidance.

This SOP is recognized as an interpretive publication as defined in AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*). Interpretive publications are recommendations on the application of generally accepted auditing standards (GAAS) in specific circumstances, including engagements for entities in specialized industries.

An interpretive publication is issued under the authority of the AICPA Auditing Standards Board (ASB) after all ASB members have been provided an opportunity to consider and comment on whether the proposed interpretive publication is consistent with GAAS. The members of the ASB have found this SOP to be consistent with existing GAAS.

Although interpretive publications are not auditing standards, AU-C section 200 requires the auditor to consider applicable interpretive publications in planning and performing the audit because interpretive publications are relevant to the proper application of GAAS in specific circumstances. If the auditor does not apply the auditing guidance in an applicable interpretive publication, the auditor should document how the requirements of GAAS were complied with in the circumstances addressed by such auditing guidance.

Introduction

.01 The Federal Accounting Standards Advisory Board (FASAB) establishes accounting standards for reporting information about the following social insurance programs:

- a. Old-Age Survivors and Disability Insurance (OASDI or Social Security)
- b. Medicare ([Hospital Insurance [HI] and Medicare Supplementary Medical Insurance [SMI])
- c. Railroad Retirement benefits
- d. Black Lung benefits
- e. Unemployment Insurance

.02 FASAB standards require the financial statements of the federal agencies responsible for the Social Security, Medicare, Railroad Retirement, and Black Lung programs and the financial statements of the federal government-wide entity to present a statement of social insurance as a basic financial statement. FASAB standards require these agencies and the government-wide entity to report:

- a. The estimated present value of the income to be received from or on behalf of the following groups during a projection¹ period sufficient to illustrate the long-term sustainability of the social insurance programs:
 - (1) Current participants who have not yet attained retirement age
 - (2) Current participants who have attained retirement age
 - (3) Individuals expected to become participants
- b. The estimated present value of the benefit payments to be made during that same period to or on behalf of the groups listed in item *a*
- c. The estimated net present value of the cash flows during the projection period (the income described in item *a* over the expenditures described in item *b*, or the expenditures described in item *b* over the income described in item *a*)
- d. In notes to the statement of social insurance:
 - (1) The accumulated excess of all past cash receipts, including interest on investments, over all past cash disbursements within the social insurance program represented by the fund balance at the valuation date
 - (2) An explanation of how the net present value referred to in item *c* is calculated for the closed group² (Paragraph 27(3)(i) of Statement

¹ The AICPA Guide *Prospective Financial Information* (guide) defines the term *projection* and differentiates it from the term *forecast*. In this Statement of Position (SOP), the term *projection* is used in its generic sense, as it is used in standards issued by the Financial Accounting Standards Advisory Board (FASAB) and the federal agencies that administer social insurance programs. The use of the term *projection* in this SOP is not intended to suggest that information presented in the statement of social insurance is a projection as defined in the guide or that the provisions of the guide would apply to the audit of the statement of social insurance.

² The *closed group* is defined as those persons who, as of a valuation date, are participants in a social insurance program as beneficiaries, covered workers, or payers of earmarked taxes or premiums.

of Federal Financial Accounting Standards [SFFAS] No. 17, *Accounting for Social Insurance*, identifies the information to be included in this explanation.)

- (3) Comparative financial information for items *a*, *b*, *c*, and *d(1)* for the current year and for each of the four preceding years
- (4) The significant assumptions used in preparing the estimates

.03 The income, expenditures, and net present value of cash flows recognized in the statement of social insurance differ from traditional concepts of income and expenditures for retirement and health benefit programs. Financial reporting for social insurance programs includes estimates of income and expenditures not only for current program participants but also for individuals expected to become participants in social insurance programs in the future. In paragraphs 26–28 of the basis for conclusions section of SFFAS No. 25, *Reclassification of Stewardship Responsibilities and Eliminating the Current Services Assessment*, FASAB acknowledges this difference and explains why the recognition of such amounts is essential to the fair presentation of federal financial statements:

26. The Board believes that the SOSI [statement of social insurance] should be treated as a basic financial statement because it is essential to fair presentation and is important to achieve the objectives of federal financial reporting. The related stewardship objectives include helping users to assess the impact on the country of the Government’s activities, determine whether the Government’s financial position improved or deteriorated over the period, and predict whether future budgetary resources will likely be sufficient to sustain public services and meet obligations as they come due. In that regard, the multi-trillion dollar obligations associated with Social Insurance over the next 75 years could significantly exceed the largest liabilities currently recognized in the U.S. Government Balance Sheet.

27. The Board acknowledges that there is great uncertainty inherent in long term projections, but believes that if the uncertainty is suitably disclosed—as is required by SFFAS 17—it need not preclude designating the information as a basic financial statement, essential for fair presentation in conformity with GAAP...

28. Even within the context of historical financial reporting, the Board notes that accrual-basis “historical” financial statements include many measurements that involve assumptions about the future. The distinction between reporting on the financial effects of events that have occurred and the effects of future events depends, obviously, upon the definition of the event. The information required by SFFAS 17 reports on the financial effects of existing law and demographic conditions and assumptions, just as the pension obligation at a point in time is based on existing conditions. In that sense, Social Insurance information can be viewed as reflecting events that have occurred and, therefore, as “historical.”

Applicability

.04 This Statement of Position (SOP) provides guidance to auditors in auditing the statement of social insurance for the following social insurance programs:

- a. Old-Age Survivors and Disability Insurance (OASDI or Social Security)
- b. Medicare (Hospital Insurance [HI] and Medicare Supplementary Medical Insurance [SMI])
- c. Railroad Retirement benefits
- d. Black Lung benefits

As permitted by AU section 543, *Part of Audit Performed by Other Independent Auditors* (AICPA, *Professional Standards*), a principal auditor may fulfill the requirements of this SOP by using work that other independent auditors have performed in conformity with the provisions of this SOP. For example, for the OASDI program, the auditor of the federal government-wide financial statements may use the work and report of the auditor of the Social Security Administration's statement of social insurance.

Management's Responsibilities

.05 The agency's management (management) is responsible for preparing the statement of social insurance and the estimates underlying it in conformity with generally accepted accounting principles. In doing so, management must determine its best estimate³ of the economic and demographic conditions that will exist in the future. Because estimates in the statement of social insurance are based on subjective as well as objective factors, management must use judgment to estimate amounts included in the statement of social insurance. Management's judgment ordinarily is based on its knowledge and experience about past and current events and its assumptions about conditions it expects to exist. Management is responsible for the accuracy and completeness of the statement of social insurance.

Preparing Social Insurance Estimates

.06 Management is responsible for preparing the estimates underlying the statement of social insurance. That process ordinarily consists of:

- a. Identifying the relevant factors that may affect the estimates
- b. Developing assumptions that represent management's best estimate of circumstances and events with respect to the relevant factors
- c. Accumulating relevant, sufficient, and reliable data on which to base the estimates
- d. Determining the estimated amounts based on assumptions and other relevant factors

³ Paragraph 25 of FASAB Statement of Federal Financial Accounting Standards (SFFAS) No. 17, *Accounting for Social Insurance*, states, in part, "The projections and estimates used should be based on the entity's best estimates of demographic and economic assumptions, taking each factor individually and incorporating future changes mandated by current law." Certain agencies prepare social insurance information using assumptions prepared by a board of trustees. Auditors should consider such assumptions to represent the agency's "best estimates" if the trustees have characterized them as such, and agency management has determined them to be reasonable. With respect to these assumptions, the auditor should perform audit procedures that are consistent with the guidance in paragraphs .09-.35 of this SOP.

- e. Determining that the estimates are presented in conformity with generally accepted accounting principles and that disclosure is adequate

Conceptual Model

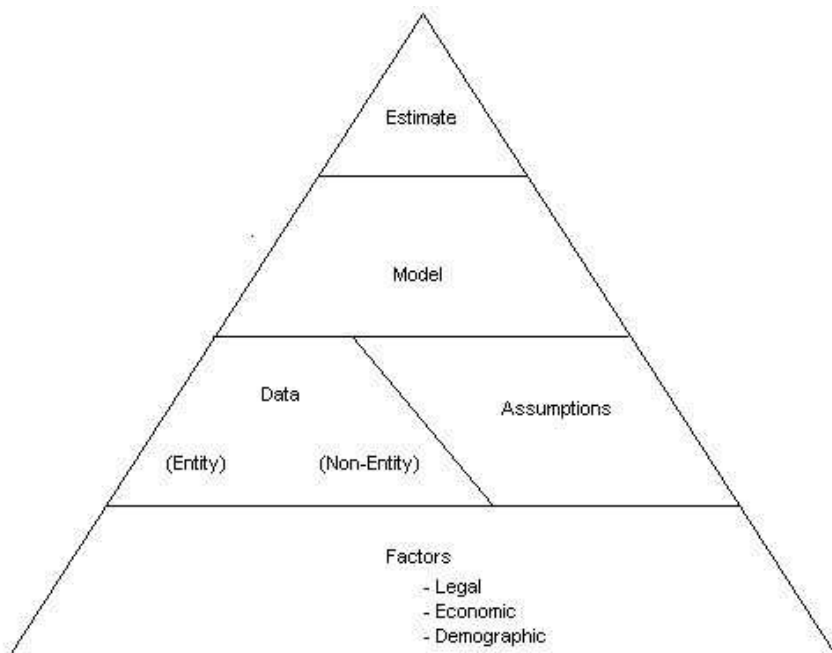


Figure 1: Elements of the Process of Developing Social Insurance Estimates

.07 Figure 1, “Elements of the Process of Developing Social Insurance Estimates,” is a conceptual model depicting the elements of the process that results in the statement of social insurance. It is not intended to depict the⁴ actual process used by an organization to develop the statement of social insurance. With the assistance of internal and external specialists, management considers, identifies, and documents factors, assumptions, and data that serve as input to a model for developing estimates. The factors, data, assumptions, and models used to develop the statement of social insurance are closely interrelated and may not be separable. Following are definitions of the terms used in figure 1:

- a. *Factors.* The elements or variables that affect income or expenditures for a program and for which data must be gathered and assumptions must be generated, for example, legal, economic, and demographic factors. An example of a factor is the number of individuals reaching age 65 in a specific year.

⁴ Office of Management and Budget (OMB) Circular No. A-123, *Management Accountability and Control*, section II, “Establishing Management Controls,” states, in part, “...documentation for transactions, management controls, and other significant events must be clear and readily available for examination.”

- b. *Assumptions.* Expectations about what will happen in the future. An example of an assumption is that there will be a 1 percent increase in the number of women working outside the home in each of the next five years. An assumption is expressed as a value or direction assigned to a factor.
- c. *Data.* Organized factual information used for analysis or to make decisions. An example is census data and classifications of that data, such as the population classified by sex or age. Data may be developed within the entity that prepares the statement of social insurance or it may come from sources outside the entity.
- d. *Models.* Methods or formulas for mathematically expressing how the assumptions and data relate to each other. For example, a model might indicate that a 1 percent decline in the birth rate in a given year will result in a 0.2 percent decrease in social insurance income and benefit payments 10 years later. A model is a set of coded instructions, rules, or procedures used to perform a desired sequence of events or to obtain a result. Typically, models are developed by using various computer applications.
- e. *Estimates.* The amounts or valuations that result after processing the factors, data, and assumptions in a model. These estimates will be used in preparing the statement of social insurance.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Designing and Implementing Internal Control Related to Estimates

.08 Controls that are designed and implemented in a manner consistent with Standards for Internal Control in the Federal Government issued by the Government Accountability Office help ensure the accuracy and completeness of the statement of social insurance. An entity's internal control may reduce the likelihood of material misstatements of financial statement assertions involving estimates. Among the aspects of internal control that are relevant to the process of developing estimates are the following:

- a. Management communication of the need for proper estimates
- b. Accumulation of relevant, sufficient, and reliable data on which to base accounting estimates
- c. Preparation of the estimates by qualified personnel
- d. Adequate review and approval of the estimates by appropriate levels of authority, for example:
 - (1) Review of the sources of the relevant factors
 - (2) Review of the process used to develop assumptions
 - (3) Review of the reasonableness of the assumptions and resulting estimates
 - (4) Consideration of the need to use the work of specialists
 - (5) Consideration of changes in previously established methods for developing estimates
- e. Comparison of prior estimates with actual subsequent results to assess the reliability of the process and models used to develop the estimates

- f. Appropriate general and application controls related to computer-based models used in the calculation of estimates included in the statement of social insurance

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

The Auditor's Responsibility

.09 Paragraph .10 of AU section 342, *Auditing Accounting Estimates*, states that the auditor should obtain an understanding of how management developed the estimate. Based on that understanding, the auditor should use one or a combination of the following approaches to evaluate the reasonableness of an estimate:

- a. Review and test the process used by management to develop the estimate.
- b. Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate.
- c. Review subsequent events or transactions occurring prior to the date of the auditor's report.

In auditing the statement of social insurance, if controls over the estimation process are effective, the most practicable and efficient approach may be to review and test the process used by management. However, if the auditor finds that controls over the estimation process are ineffective, the auditor should consider whether it is practicable to:

- Develop an independent expectation of the estimate, or portions of the estimate, to corroborate management's estimate
- or
- Obtain sufficient appropriate audit evidence from outside the audited agency's process that would support the assertions in the statement of social insurance.

If it is not practicable to mitigate the effects of the ineffective controls through substantive procedures such as these, the auditor's report on the statement of social insurance should be modified. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.10 The auditor's objective when auditing the statement of social insurance is to obtain sufficient appropriate audit evidence to provide reasonable assurance that:

- a. The estimates presented in the statement of social insurance are reasonable in the circumstances.
- b. The statement of social insurance is presented fairly, in all material respects, in conformity with generally accepted accounting principles, including adequate disclosure.

Paragraphs .11-.43 of this SOP describe how the auditor achieves this objective. As discussed in footnote 9 of paragraph .19, if the auditor does not possess the level of competence in actuarial science to qualify as an actuary, it is necessary for the auditor to obtain the services of an independent actuary⁵ to

⁵ The actuary can either be under contract with the audit firm or employed by the audit firm. In either case, the actuary performing services for the audit firm would need to meet the independence standards of generally accepted governmental auditing standards (GAGAS),

assist the auditor in planning and performing auditing procedures. Generally, the auditor will need the assistance of an independent actuary in performing various procedures during all phases of the audit and related to all elements of the estimates. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Obtaining an Understanding of the Entity and Its Environment, Including Its Internal Control

.11 AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, requires the auditor to 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. [Paragraph added, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.12 The procedures the auditor performs to obtain the required understanding are known as *risk assessment procedures*. In an audit of the statement of social insurance, the auditor's risk assessment procedures should include

- a. obtaining knowledge about the agency and its environment including the following matters:
 - (1) The agency's program and its operations including relevant laws and regulations governing the program that have a direct and material effect on the statement of social insurance (paragraphs .13–.14)
 - (2) The agency's process for developing, evaluating, and incorporating estimates in the statement of social insurance (paragraph .15)
 - (3) The work performed by the agency's actuary (paragraphs .16–.20)
 - (4) The work performed and findings reported by any external review groups that have been commissioned by the agency, an appropriate advisory board, or the trustees⁶ (paragraph .21).
- b. considering materiality (paragraphs .22–.23).
- c. obtaining an understanding of the agency's internal control as it relates to the preparation of the statement of social insurance (paragraphs .24–.27).

(footnote continued)

which are applicable to audits of statements of social insurance. For example, for actuaries under contract with the audit firm, the auditor should determine whether the actuary's firm is independent of the agency being audited and then assess the actuary's ability to impartially perform the work and report results. In conducting this assessment, the auditor should provide the actuary with the GAGAS independence requirements and obtain representations from the actuary regarding his or her independence from the audited entity. For actuaries employed by the audit firm, the independence requirements are the same as those for auditors. Paragraphs 3.06–.18 of chapter 3, "General Standards," *Government Auditing Standards: 2003 Revision* (GAO-03-673G) describe applicable independence requirements.

⁶ Certain social insurance programs are overseen by a board of trustees. For example, the Social Security Act establishes a board of trustees to oversee the financial operations of the Federal Old-Age and Survivors Insurance Trust Fund and the Federal Disability Insurance Trust Fund. The board is composed of six members, four of whom serve automatically by virtue of their positions in the federal government: the Secretary of the Treasury (the managing trustee), the Secretary of Labor, the Secretary of Health and Human Services, and the Commissioner of Social Security. The other two members are appointed by the President and confirmed by the Senate to serve as public representatives.

- d. assessing the risk of material misstatement of the financial statements (paragraphs .28–.29).⁷
- e. performing further audit procedures (paragraphs .30–.35).

[Paragraph renumbered and revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Obtaining Knowledge About the Agency's Program and Its Operations

.13 Relevant knowledge about the program and its operations includes the following:

- a. The nature of the program's activities
- b. The source of its funding
- c. Who the beneficiaries are

[Paragraph renumbered and revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.14 An important aspect of the program and its operations are the laws and regulations governing the program that may have a direct and material effect on amounts reported as social insurance income and expenditures. To obtain the laws and regulations governing the operation of the social insurance program, the auditor may request them from agency management. Through inquiry of management, the auditor may obtain information about

- a. the laws and regulations that significantly affect the determination of amounts included in the statement of social insurance and
- b. how management has given effect to changes in laws and to new regulations published in final form in determining future social insurance income and expenditures.

[Paragraph renumbered and revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Obtaining Knowledge About the Agency's Process for Developing, Evaluating, and Incorporating Estimates in the Statement of Social Insurance

.15 The auditor should obtain knowledge about the agency's process for developing, evaluating, and incorporating estimates in the statement of social insurance. Procedures the auditor may perform to obtain that knowledge include the following:

- a. Making inquiries of management; individuals responsible for initiating, processing, or recording estimates; and internal and external specialists with expertise in relevant subject matter, such as actuarial science, economics, and law.
- b. Reading entity or nonentity documents and records used to prepare the statement of social insurance, as well as the agency's documentation of the process for preparing the statement of social insurance.

⁷ The auditor generally would conclude that inherent risk is high for assertions about estimates in the statement of social insurance because of the complexity of such estimates and the need for significant judgment in preparing them. Other factors that may affect inherent risk in auditing the statement of social insurance include the political climate surrounding social insurance programs, budget limitations, and economic conditions.

- c. Observing entity activities and operations used to prepare the statement of social insurance, such as transferring data from a tabulation report to a computerized application.

[Paragraph renumbered and revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Obtaining Knowledge About the Work Performed by the Agency's Actuary

.16 Information presented in the statement of social insurance ordinarily is determined on the basis of an actuarial valuation of the program performed or reviewed by the agency's actuary, using data received from sources inside and outside the agency, and actuarial techniques. Paragraph .12 of AU section 336, *Using the Work of a Specialist*, states the following:

The auditor should (a) obtain an understanding of the methods and assumptions used by the specialist, (b) make appropriate tests of data provided to the specialist, taking into account the auditor's assessment of control risk, and (c) evaluate whether the specialist's findings support the related assertions in the financial statements.

[Paragraph renumbered, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.17 The auditor's qualifications do not encompass actuarial science or the complexities of probability and longevity associated with social insurance income and expenditures. The auditor may have a general awareness and understanding of actuarial concepts and practices; however, he or she does not purport to act in the capacity of an actuary. The auditor, therefore, should follow the guidance in AU section 336 to obtain assurance regarding the work of an actuary on such matters as program income and benefit payments. [Paragraph renumbered, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.18 An audit of the statement of social insurance requires cooperation and coordination between the auditor and the actuary. The auditor uses the work of the actuary as an audit procedure to obtain sufficient appropriate audit evidence; the auditor does not merely rely on the report of an actuary. Although the appropriateness and reasonableness of the methods and assumptions used, as well as their application, are within the expertise of the actuary, the auditor does not divide responsibility with the actuary for his or her opinion on the financial statements taken as a whole. Thus, the auditor should satisfy himself or herself as to the professional qualifications and reputation of the actuary as well as the actuary's objectivity, and should obtain an understanding of the actuary's methods and assumptions, test data provided to the actuary, and consider whether the actuary's findings support the related representations in the financial statements. [Paragraph renumbered and revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.19 If the actuary who has prepared or reviewed the actuarial valuation of the social insurance program was engaged by the agency administering that program, it is necessary for the auditor to obtain the services of an independent actuary⁸ to assist the auditor in performing auditing procedures that assess the agency actuary's methods, assumptions, and estimates, and aid the auditor in determining whether the agency actuary's findings are not unreasonable in the

⁸ See footnote 5.

circumstances.⁹ *Government Auditing Standards*, which are applicable to audits of statements of social insurance, provide independence requirements and examples of personal, external, and organizational impairments to independence. [Paragraph renumbered, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.20 The auditor should document (a) the specific audit procedures that were performed with the assistance of an independent actuary, and the related findings and conclusions, (b) the relationship between the procedures performed with the assistance of an independent actuary and the auditor's assessments of audit risk and materiality, and (c) all other significant matters related to the objectives and scope of the independent actuary's work, including any limitations on the independent actuary's procedures. [Paragraph renumbered, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Obtaining Knowledge About the Work Performed by External Review Groups

.21 In some cases, the agency responsible for the preparation of the statement of social insurance or the program's trustees may commission the services of an external review group comprising technical experts in relevant fields to review the factors, assumptions, data, estimates, and models used to prepare the statement of social insurance. In many instances, individuals assigned to perform these reviews are recognized authorities in their respective fields of study. Because of the nature of these external review groups and the qualifications of the individuals typically assigned to them, information about the work performed by the external review group, how its findings are communicated to the agency, and how the agency has responded to these findings are relevant to an audit of the statement of social insurance.¹⁰ See paragraph A-18c of the appendix of this SOP, entitled "Illustrative Controls and Audit Procedures," for examples of inquiries the auditor may make of management to obtain knowledge about the work performed by external review groups. [Paragraph renumbered and revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Considering Materiality

.22 The auditor's determination 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. Auditors should design audit procedures to obtain reasonable assurance of detecting misstatements that, either individually or when aggregated with other misstatements, could be material to the financial statements

⁹ Although paragraph .11 of AU section 336, *Using the Work of a Specialist*, does not preclude the auditor from using the work of a specialist who is related to the client, because of the significance of the estimates of income and expenditures to the statement of social insurance, and the complexity and subjectivity involved in developing such estimates, auditing estimates in the statement of social insurance requires the use of an outside actuary, that is, an actuary who is not employed or managed by the agency. If the auditor has the requisite knowledge and experience in actuarial science, the auditor may serve as the actuary. If the auditor does not possess the level of competence in actuarial science to qualify as an actuary, the auditor should use the work of an independent outside actuary.

¹⁰ Although reviews by external review groups may not be conducted annually, in auditing the statement of social insurance the auditor should obtain and review the most recent report of such external review groups.

taken as a whole. Auditors should exercise due professional care when setting the materiality base, carefully assessing the information gained from risk assessment procedures and the needs of users of the financial statements. [Paragraph renumbered and revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.23 For certain federal agencies, amounts reported in the statement of social insurance may vary significantly from the amounts reported in the other basic financial statements, or may differ significantly on a qualitative basis. In such cases, it may not be appropriate to establish a single materiality threshold for the entire set of financial statements. Instead, the auditor should consider using a separate materiality level when planning and performing the audit of the statement of social insurance and related disclosures. [Paragraph renumbered, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Obtaining an Understanding of the Agency's Internal Control

.24 AU section 314 defines internal control as a process—effected by those charged with governance, an entity's board of directors, management, and other personnel—designed to provide reasonable assurance regarding the achievement of the entity's objectives with regard to (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, and (c) compliance with applicable laws and regulations. [Paragraph renumbered and revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.25 In auditing the statement of social insurance, the auditor should obtain a sufficient understanding of the agency's internal control by performing risk assessment procedures to evaluate the design of the agency's controls relevant to an audit of the statement of social insurance and to determine whether those controls have been implemented. The auditor should use this knowledge to

- a. identify types of potential misstatements.
- b. consider factors that affect the risks of material misstatement.
- c. design tests of controls, when applicable, and substantive procedures.

[Paragraph renumbered and revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

[.26] [Paragraph renumbered and deleted, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.27 Internal control consists of the following five interrelated components:

- a. *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.
- b. 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.
- c. *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.
- d. *Control activities* are the policies and procedures that help ensure that management directives are carried out.

- e. *Monitoring* is a process that assesses the quality of internal control performance over time.

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. [Paragraph renumbered and revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Assessing the Risks of Material Misstatement

.28 Using the information gained from the auditor's risk assessment procedures, the auditor should identify and assess the risks of material misstatement for assertions in the statement of social insurance. [Paragraph renumbered and revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.29 The risk of material misstatement of estimates ordinarily varies with the complexity and subjectivity of the process, the availability and reliability of the relevant data, the number and significance of assumptions that are made, and the degree of uncertainty associated with the assumptions. [Paragraph added, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Performing Further Audit Procedures

.30 The auditor should design further audit procedures, including tests of the operating effectiveness of controls, where relevant or necessary, and substantive procedures, whose nature, timing, and extent are responsive to the assessed risks of material misstatement at both the financial statement and the relevant assertion level. [Paragraph added, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

[.31] [Paragraph renumbered and deleted, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.32 AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, states that the auditor should perform tests of controls when the auditor's risk assessment 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. However, when auditing the statement of social insurance, the complexity and subjectivity of the estimates, the volume of data involved, and the importance of controls ordinarily would make performing only substantive tests an ineffective strategy.¹¹ [Paragraph renumbered and revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

[.33] [Paragraph renumbered and deleted, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

[.34] [Paragraph renumbered and deleted, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.35 As indicated in paragraph .09 of this SOP, in evaluating the reasonableness of the estimates in the statement of social insurance, the auditor

¹¹ OMB Bulletin No. 01-02 states that "For those internal controls that have been properly designed and placed in operation, the auditor shall perform sufficient tests to support a low assessed level of control risk."

primarily reviews and tests the process used by management. The appendix of this SOP contains examples of

- a. procedures the auditor performs to obtain knowledge about the agency's process for developing, evaluating, and incorporating estimates in the statement of social insurance.
- b. controls that are relevant to an agency's preparation of the statement of social insurance. (The auditor should obtain an understanding of the design of such controls and determine whether they have been placed in operation.)
- c. procedures the auditor performs to test controls, assess control risk, and test assertions in the statement of social insurance.

[Paragraph added, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Testing the Work of the Agency's Actuary

.36 When auditing estimates and considering the related factors, assumptions, data, and models, the auditor should obtain the services of an actuary in accordance with AU section 336.¹² [Paragraph renumbered, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.37 With respect to the actuarial present value of amounts reported in the statement of social insurance, the auditor, in following the guidance in AU section 336, should

- a. read the agency actuary's actuarial report.
- b. evaluate the professional qualifications, competence, and objectivity of the agency's actuary. Examples of factors that should be considered are the actuary's membership in a recognized professional organization and the opinion of other actuaries, whom the auditor knows to be qualified, regarding the actuary's professional qualifications.
- c. obtain an understanding of the actuary's objectives, scope of work, methods, and assumptions, and their consistency of application. The Actuarial Standards Board establishes Actuarial Standards of Practice (ASOPs) that identify what the actuary should consider, document, and disclose when performing an actuarial assignment. The auditor may consult the ASOPs in obtaining an understanding of the methods and assumptions used in the valuation of the social insurance program.¹³ Management, not the actuary, is responsible for the assumptions made and methods used.
- d. test the reliability and completeness of the data provided by the agency and used by the actuary in the actuarial valuation. (See paragraphs A-11–A-14 in the appendix to this SOP.) For example, laws or regulations governing program operations can affect the determination of the data or methods to be used in the actuarial calculations. In testing the reliability and completeness of the data, the auditor may inquire as to whether the actuarial valuation considers all pertinent provisions of laws and regulations governing program operations, including any changes in laws or regulations affecting the actuarial calculations since the date of the latest statement of social insurance. In the event

¹² See footnote 9.

¹³ Relevant standards include Actuarial Standards of Practice No. 21, *The Actuary's Responsibility to the Auditor*, No. 23, *Data Quality*, and No. 32, *Social Insurance*.

that data provided to the actuary are significantly incomplete, the auditor may inquire of the actuary about the treatment of the incomplete data and determine whether the method used by the actuary to give effect to the missing data in his or her valuation is reasonable in the circumstances.

- e. assess the nature and significance of any reservations concerning assumptions or data that the actuary has stated in his or her report.

[Paragraph renumbered and revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Testing the Fund Balance

.38 Paragraph 27(3)(h) of SFFAS No. 17 requires the agency to report “the accumulated excess of all past cash receipts, including interest on investments, over all past cash disbursements within the social insurance program represented by the fund balance at the valuation date.” As noted in paragraph 26 of SFFAS No. 17, the valuation date for the statement of social insurance may differ from the valuation date for the other financial statements. Accordingly, the auditor should conduct appropriate testing of the accumulated cash receipts over the accumulated cash disbursements, as of the social insurance valuation date. The nature and extent of testing is a matter of professional judgment. Examples of procedures the auditor may perform are confirmation testing or roll-forward testing. [Paragraph renumbered, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Obtaining Management’s Representations

.39 AU section 333, *Management Representations*, requires the auditor to obtain a representation letter from management confirming representations given to the auditor during the engagement, for example, a representation regarding the completeness of the information provided to the auditor. In an audit of the statement of social insurance, the representation letter should include, as applicable, the following representations:

- a. The actuarial assumptions and methods used to measure amounts in the statement of social insurance for financial accounting and disclosure purposes represent management’s best estimates regarding future events based on demographic and economic assumptions, and future changes mandated by law.
- b. There were no material omissions from the data provided to the agency’s actuary for the purpose of determining the actuarial present value of the estimated future income to be received, and estimated future expenditures to be paid during a projection period sufficient to illustrate the long-term sustainability of the [*name of the social insurance program*] as of [*dates of statements of social insurance presented*].
- c. Management is responsible for the assumptions and methods used in the preparation of the statement of social insurance. Management of the agency agrees with the actuarial methods and assumptions used by the agency’s actuary and has no knowledge or belief that would make such methods or assumptions inappropriate in the circumstances. Management did not give any instructions, nor cause any instructions to be given to the agency’s actuary with respect to values or amounts derived, and is not aware of any matters that have affected the objectivity of the agency’s actuary. Management believes that the

actuarial assumptions and methods used to measure amounts in the statement of social insurance for financial accounting purposes are appropriate in the circumstances.

- d. The statement of social insurance covers a projection period sufficient to illustrate long-term sustainability of the social insurance program.
- e. Management has provided the auditor with all the reports developed by external review groups appointed by the agency or the program's trustees related to estimates in the statement of social insurance.
- f. The following matters relating to the statement of social insurance have been disclosed properly in the notes to the financial statements:
 - (1) The accumulated excess of all past cash receipts, including interest on investments, over all past cash disbursements within the social insurance program represented by the fund balance at the valuation date
 - (2) An explanation of how the net present value is calculated for the closed group¹⁴ (Paragraph 27(3)(i) of SFFAS No. 17 identifies the information to be included in this explanation.)
 - (3) Comparative financial information for the items in paragraphs .02a, .02b, .02c, and .02d(1) of this SOP, for the current year and for each of the four preceding years
 - (4) Significant assumptions used in preparing the estimates
- g. There have been no changes in [or, Changes in the following have been properly recorded or disclosed in the financial statements]:
 - (1) The actuarial methods or assumptions used to calculate amounts recorded or disclosed in the financial statements between the valuation dates (that is, January 1, 20X8, and January 1, 20X7) or changes in the method of collecting data.
 - (2) The actuarial methods or assumptions used to calculate amounts recorded or disclosed in the financial statements between the valuation date and the financial reporting date (that is, January 1, 20X8, and September 30, 20X8) or changes in the method of collecting data.
- h. There have been no changes in [or, Changes in the following have been properly recorded or disclosed in the financial statements]:
 - (1) Laws and regulations affecting social insurance program income and benefits between the valuation dates (January 1, 20X8, and January 1, 20X7).
 - (2) Laws and regulations affecting social insurance program income and benefits between the valuation date and the financial reporting date (that is, January 1, 20X8, and September 30, 20X8).
- i. Accounting estimates applicable to the financial information of the agency included in the statement of social insurance are based on management's best estimate, after considering past and current events and assumptions about future events.

[Paragraph renumbered, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

¹⁴ The *closed group* is defined as those persons who, as of a valuation date, are participants in a social insurance program as beneficiaries, covered workers, or payers of earmarked taxes or premiums.

Reporting

.40 Because FASAB has defined the statement of social insurance as a basic financial statement, the auditor should report on it as a part of his or her report on the other basic financial statements. In addition to following the requirements of AU section 508, *Reports on Audited Financial Statements*, the auditor's report on a federal agency's financial statements that present a statement of social insurance should include the following elements:

- a. An opinion as to whether the statement of social insurance presents fairly, in all material respects, the financial condition¹⁵ of the agency's social insurance program(s) as of the valuation date in conformity with generally accepted accounting principles.
- b. An explanatory paragraph following the opinion paragraph, describing that (i) the statement of social insurance presents the actuarial present value of the agency's estimated future income to be received from or on behalf of the participants and estimated future expenditures to be paid to or on behalf of participants during a projection period sufficient to illustrate long-term sustainability of the social insurance program; (ii) in preparing the statement of social insurance, management considers and selects assumptions and data that it believes provide a reasonable basis for the assertions in the statement; and (iii) because of the large number of factors that affect the statement of social insurance and the fact that future events and circumstances cannot be known with certainty, there will be differences between the estimates in the statement of social insurance and the actual results, and those differences may be material.
- c. Reference to any standards or regulations in addition to generally accepted auditing standards, such as *Government Auditing Standards*, that apply to audits of federal financial statements and any additional elements of the auditor's report that those standards or regulations require.

[Paragraph renumbered and revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.41 The following is an illustrative auditor's report for a statement of social insurance.

¹⁵ In Statement of Federal Financial Accounting Concepts No. 1, *Objectives of Federal Financial Reporting*, the FASAB articulates a concept of *financial condition*, as distinct from *financial position*. Financial condition is broader and more forward-looking than financial position. Presenting information on financial condition is consistent with FASAB's financial reporting objective of stewardship. In illustrating how the stewardship objective aligns with the needs of users of federal financial statements, FASAB observes that,

All users need information on earmarked revenues recorded in trust funds. They want to know, for example, whether the Social Security Trust funds are likely, in the foreseeable future, to need infusions of new taxes to pay benefits. Citizens need to know the implications of investing trust fund revenues in government securities.

In reporting the actuarial present value of the estimated future income to be received, estimated future expenditures to be paid, and excess of income over expenditures during a projection period sufficient to illustrate the long-term sustainability of an agency's social insurance programs, and in disclosing in the notes to the financial statements comparative financial information for the five most recent years, the statement of social insurance presents the financial condition of the programs. Thus, in reporting on the statement of social insurance, the auditor refers to the financial condition of the agency's social insurance programs.

Independent Auditor's Report¹⁶

We have audited the accompanying consolidated balance sheets of XYZ Social Insurance Agency, as of September 30, 20X8 and 20X7, the related consolidated statements of net cost, of changes in net position and of financing; the combined statements of budgetary resources for the years then ended; and statements of social insurance as of January 1, 20X8, 20X7, 20X6, 20X5, and 20X4.¹⁷ These financial statements are the responsibility of XYZ Social Insurance Agency'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; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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 previously present fairly, in all material respects, the financial position of XYZ Social Insurance Agency as of September 30, 20X8 and 20X7; its net cost of operations; changes in net position, budgetary resources, and financing for the year then ended; and the financial condition of its social insurance programs as of January 1, 20X8, 20X7, 20X6, 20X5, and 20X4, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note X to the financial statements, the statements of social insurance present the actuarial present value of the Agency's estimated future income to be received from or on behalf of the participants and estimated future expenditures to be paid to or on behalf of participants during a projection period sufficient to illustrate long-term sustainability of the social insurance program. In preparing the statements of social insurance, management considers and selects assumptions and data that it believes provide a reasonable basis for the assertions in the statements. However, because of the large number of factors that affect the statement of social insurance and the fact that future events and circumstances cannot be known with certainty, there will be differences between the estimates in the statement of social insurance and the actual results, and those differences may be material.

Accounting principles generally accepted in the United States of America require that Management's Discussion and Analysis (MD&A) and the Required Supplementary Information (RSI) be presented to supplement the basic financial statements. Such information, although not a part of the

¹⁶ Paragraphs .65-.74 of AU section 508, *Reports on Audited Financial Statements*, provide guidance on reporting on comparative financial statements, including guidance on reporting when there has been a change in auditors.

¹⁷ The auditor's report on the statement of social insurance covers a period of five years (see paragraph 27(3)(j) of SFFAS No. 17); whereas, the auditor's report on the other financial statements covers a period of two years. In the first year's audit of the statement of social insurance, the auditor would only express an opinion on one year; in year two, the auditor would express an opinion on two years, and so on, until all five years were covered.

basic financial statements, is required by the Federal Accounting Standards Advisory Board who considers it to be an essential part of financial reporting for placing the financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the MD&A and RSI in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the MD&A and RSI because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

In accordance with *Government Auditing Standards*, we have also issued a report dated [report date] on our consideration of the agency's internal control and a report dated [report date] on its compliance with laws and regulations. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

[Signature]

[Date]

[Paragraph renumbered, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2010, to reflect conforming changes necessary due to the issuance of SAS Nos. 118–120.]

.42 The statement of social insurance does not articulate with the other basic financial statements. For that reason, the portion of the auditor's report that addresses the statement of social insurance ordinarily will not affect the auditor's report on the balance sheet or the statements of net costs, changes in net position, financing, or budgetary resources. The following illustrates a report in which the auditor disclaims an opinion on the statement of social insurance but expresses an unqualified opinion on the other financial statements.

Independent Auditor's Report

We have audited the accompanying consolidated balance sheets of XYZ Social Insurance Agency, as of September 30, 20X8 and 20X7, the related consolidated statements of net cost, of changes in net position and of financing, and the combined statements of budgetary resources for the years then ended, and we were engaged to audit the statements of social insurance as of January 1, 20X8, 20X7, 20X6, 20X5, and 20X4. These financial statements are the responsibility of XYZ Social Insurance Agency'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; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An

audit also includes 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.

[Insert paragraph describing limitation on scope of the audits of the statements of social insurance.]

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 statements of social insurance as of January 1, 20X8, 20X7, 20X6, 20X5, and 20X4.

In our opinion, the financial statements referred to previously present fairly, in all material respects, the financial position of XYZ Social Insurance Agency as of September 30, 20X8 and 20X7, its net cost of operations, changes in net position, budgetary resources, and financing for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[Omit explanatory paragraph required by paragraph .40(b) of this SOP.]

[Modify the paragraph reporting on Management's Discussion and Analysis and Required Supplementary Information for the effects of the scope limitations regarding the statement of social insurance on that information, considering the guidance in AU section 550, Other Information in Documents Containing Audited Financial Statements, AU section 551, Supplementary Information in Relation to the Financial Statements as a Whole, and AU section 552, Reporting on Condensed Financial Statements and Selected Financial Data.]

[Reference to reports on internal control and compliance with laws and regulations in accordance with the Government Auditing Standards is the same as in the illustration in paragraph .41 of this SOP.]

[Signature]

[Date]

[Paragraph renumbered, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2010, to reflect conforming changes necessary due to the issuance of SAS Nos. 118–120.]

.43 If the agency that operates a social insurance program issues financial statements that purport to present financial position, net cost of operations, changes in net position, budgetary resources, and financing for the years then ended, but omits the related statements of social insurance, the auditor ordinarily will conclude that the omission requires qualification of the auditor's opinion in the following manner:

Independent Auditor's Report

We have audited the accompanying consolidated balance sheets of XYZ Social Insurance Agency, as of September 30, 20X8 and 20X7, the related consolidated statements of net cost, of changes in net position and of financing, and the combined statements of budgetary resources for the years then ended. These financial statements are the responsibility of XYZ Social Insurance Agency's management. Our responsibility is to express an opinion on these financial statements based on our audits.

[Same second paragraph as the standard report]

The agency declined to present statements of social insurance as of January 1, 20X8, 20X7, 20X6, 20X5, and 20X4. Presentation of such statements describing the financial condition of its social insurance programs is required by accounting principles generally accepted in the United States of America.

In our opinion, except that the omission of the statements of social insurance results in an incomplete presentation as explained in the preceding paragraph, the financial statements referred to previously present fairly, in all material respects, the financial position of XYZ Social Insurance Agency as of September 30, 20X8 and 20X7; its net cost of operations; and changes in net position, budgetary resources, and financing for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[Omit explanatory paragraph required by paragraph .40(b) of this SOP.]

[Modify, in accordance with the guidance in paragraph .09 of AU section 558, Required Supplementary Information, the paragraph regarding Management's Discussion and Analysis and the Required Supplementary Information (RSI) for the omission of the RSI.]

[Reference to reports on internal control and compliance with laws and regulations in accordance with Government Auditing Standards is the same as in the illustration in paragraph .41 of this SOP.]

[Signature]

[Date]

[Paragraph renumbered, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2010, to reflect conforming changes necessary due to the issuance of SAS Nos. 118–120.]

Effective Date and Transition

.44 This SOP is effective for audits of statements of social insurance for periods beginning after September 30, 2005. SFFAS No. 17 (subparagraph 27(3)(a-h)) requires disclosure of the information for the current year and for each of the four preceding years. Comparative information in the statement of social insurance that has not been audited should be marked as unaudited. Earlier implementation of the provisions of this SOP is permitted. [Paragraph renumbered, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Appendix

Illustrative Controls and Audit Procedures

A-1. This appendix contains examples of:

- a. Procedures the auditor performs to obtain knowledge about the agency's process for developing, evaluating, and incorporating estimates in the statement of social insurance
- b. Controls that are relevant to the agency's preparation of the statement of social insurance (The auditor should obtain an understanding of the design of such controls and determine whether they have been implemented.)
- c. Procedures the auditor performs to tests controls and assertions in the statement of social insurance

A-2. The appendix is divided into the following five sections:

- a. Factors (paragraphs A-3–A-5)
- b. Assumptions (paragraphs A-6–A-10)
- c. Data (paragraphs A-11–A-14)
- d. Models (paragraphs A-15–A-17)
- e. Estimates (paragraphs A-18–A-20)

Each of these sections includes examples of the items described in paragraph A-1. The procedures and controls included in this appendix are illustrative and do not represent a complete list of procedures and controls.

Factors

A-3. In evaluating the reasonableness of an accounting estimate, the auditor ordinarily concentrates on key factors that are significant to the estimate, sensitive to variation, deviations from historical patterns, and subjective and susceptible to misstatement and bias. The following are examples of procedures the auditor performs to obtain knowledge about how the agency generates, evaluates, selects, and reviews factors to be included in estimates in the statement of social insurance:

- a. Identifying the individuals involved in generating, evaluating, selecting, and reviewing factors to be included in estimates in the statement of social insurance
- b. Determining how factors affecting social insurance estimates are generated, evaluated, selected, and reviewed, and how that process is documented¹
- c. Reading documentation of the process for generating, evaluating, selecting, and reviewing estimates to be included in the statement of social insurance

A-4. The auditor should obtain a sufficient understanding of the entity's internal control by performing risk assessment procedures to evaluate

¹ Office of Management and Budget (OMB) Circular No. A-123, *Management and Accountability Control*, and No. A-127, *Financial Management Systems*, outline documentation requirements for manual and automated financial related transactions and systems.

the design of controls relevant to an audit of financial statements and to determine whether they have been implemented. The following are examples of controls related to factors:

- a. Management's process for monitoring the environment to determine the effect that change in the environment (for example, legal, political, health, immigration) might have on the factors considered
- b. Procedures to prevent or detect and correct the inadvertent omission of factors that should be considered in developing the estimate (an example of such a control would be comparing factors considered and selected in the current period with those of prior periods)
- c. Hiring procedures to ensure that individuals responsible for generating, evaluating, selecting, and reviewing factors have the appropriate education and experience

A-5. The following are examples of procedures the auditor performs to test controls and financial statement assertions related to factors:

- a. Reviewing documentation of the factors considered in developing the estimate
- b. Evaluating whether the factors that have been considered are relevant and sufficient for the purpose of preparing the statement of social insurance
- c. Considering whether there are additional key factors that management has not addressed

Assumptions

A-6. In evaluating the reasonableness of an accounting estimate, the auditor ordinarily concentrates on assumptions that are significant to the accounting estimate, sensitive to variation, deviations from historical patterns, and subjective and susceptible to misstatement and bias.

A-7. The following are examples of matters the auditor inquires about in discussions with management and other knowledgeable personnel to determine how the agency generates, evaluates, selects, and reviews assumptions to be included in estimates in the statement of social insurance:

- a. The source of the assumptions for significant estimates²
- b. How the assumptions underlying the estimates are documented

² For some agencies, the assumptions are established by an external board of trustees and provided to the agency. For example, for the Social Security program, the Social Security Act establishes a board of trustees to oversee the financial operations of the Federal Old-Age and Survivors Insurance Trust Fund and the Federal Disability Insurance Trust Fund. The board is composed of six members, four of whom serve automatically by virtue of their positions in the federal government. They are the Secretary of the Treasury (the managing trustee), the Secretary of Labor, the Secretary of Health and Human Services, and the Commissioner of Social Security. The other two members are appointed by the President and confirmed by the Senate to serve as public representatives. In such circumstances, the auditor's procedures generally would focus on testing the work performed by the agency's actuary in reviewing the assumptions developed by the board of trustees. The agency's actuary reports on whether (a) the techniques and methodology used to evaluate the financial and actuarial status of the program is based upon sound principles of actuarial practice and are generally accepted within the actuarial profession; and (b) the assumptions used and the resulting actuarial estimates are, individually and in the aggregate, reasonable for the purpose of evaluating the financial and actuarial status of the trust funds, taking into consideration the past experience and future expectations for the population, the economy, and the program.

- c. The process for determining the best estimate (for example, intermediate) assumptions (possible outcomes)
 - d. How management considers and determines the effect that variation in the underlying assumptions will have on the estimates
- A-8.** The following are examples of controls related to assumptions:
- a. The agency's documentation of the process used to generate, evaluate, select, and review assumptions
 - b. How management monitors the environment for possible changes that might affect the assumptions used to develop estimates, for example, the need to consider alternative assumptions
 - c. Comparing assumptions made in the current period with those of prior periods and reconciling differences
 - d. Hiring procedures to ensure that personnel have the appropriate education and experience to meet job description requirements
- A-9.** The following are examples of procedures the auditor performs to test controls and financial statement assertions related to assumptions:
- a. Identifying the assumptions used and evaluating the reasonableness of those assumptions
 - b. Determining whether data and other related information support the assumptions
 - c. Evaluating whether interrelated assumptions are consistent with each other
 - d. Comparing assumptions made by the entity to the range of assumptions made by entities in other industries, for example, insurance companies, financial institutions, or other government agencies, and evaluating the implications of significant differences
 - e. Considering whether there are alternative assumptions about the factors
 - f. Evaluating whether the assumptions selected are consistent with supporting data, relevant historical data, and industry data
 - g. Reviewing available documentation of the assumptions used in developing the estimates
 - h. Evaluating whether facts and informed judgment about past and future events or circumstances support the underlying assumptions
 - i. Evaluating whether any of the significant assumptions are so subjective that no reasonably objective basis could exist to support the use of the assumption
 - j. Inquiring of program managers regarding the reasonableness of assumptions that are related to the manager's realm of responsibility
 - k. Evaluating whether the assumptions appear to be complete, that is, whether assumptions have been developed for each key factor
 - l. Considering whether the assumptions appear to be relatively objective, that is, are not unduly optimistic or pessimistic
 - m. Evaluating whether the assumptions are consistent with the laws and regulations governing the program

- n. Evaluating whether the assumptions, individually and in the aggregate, make sense in the context of the statement of social insurance taken as a whole
 - o. Evaluating whether significant assumptions are appropriately disclosed in the statement of social insurance
- A-10.** Assumptions that have no material effect on the statement of social insurance may not have to be individually evaluated; however, the aggregate effect of individually insignificant assumptions should be considered in making an overall evaluation of whether the assumptions underlying the reported amounts are reasonable.

Data

- A-11.** The following are examples of matters the auditor inquires about in discussions with management and other knowledgeable personnel, and reads about in agency documentation to determine how the agency generates, evaluates, selects, and reviews data to be included in estimates in the statement of social insurance:
- a. The source of the data for significant estimates and whether the data are developed internally or by outside parties
 - b. How data are collected, maintained, processed, and updated
 - c. How the data underlying the estimates are documented
- A-12.** The following are examples of controls related to data:
- a. Controls over the accuracy and completeness of internally prepared data, for example, review of the data for reasonableness and consistency with other data, and general and application controls over the data such as edit checks and batch totals
 - b. Controls that prevent or detect and correct errors in the collection, maintenance, processing, and updating of the data, for example, manual controls to ensure that data are accurately entered and uploaded to a computerized system
 - c. Controls over the reliability of external sources of data, for example, confirming and verifying data by tracing and agreeing it to census information in reports prepared by the United States Census Bureau
 - d. Procedures to identify and document authorized users of the system and to restrict access to the system, for example, the use of unique user passwords and periodic changes to those passwords
 - e. Preparation and review of a risk assessment on a regular basis or when a significant change occurs in either the internal or external physical environment
 - f. Preventive maintenance agreements or procedures for key system hardware components
 - g. On a regular basis, backing up software and data that are stored offsite
 - h. Restricting access to utility programs that can read, add, change, or delete data or programs to authorized individuals
 - i. Establishing procedures to ensure that original source documents are retained or are reproducible by the agency for an adequate amount of time to facilitate the retrieval or reconstruction of data

A-13. The following are examples of procedures the auditor performs to test controls and financial statement assertions related to data:

- a. Evaluating whether the data used to develop the estimates are relevant, reliable, and sufficient for the purpose
- b. Identifying the source of the data, that is, whether the data were developed by the agency or by an outside entity
- c. Reviewing documentation of the data used to develop estimates
- d. Determining whether data used to develop estimates are consistent with supporting data, historical data, and other related information. An example would be determining whether a positive or negative correlation exists between sets of data if such a correlation would be expected to exist
- e. Evaluating the accuracy and completeness of internally prepared data
- f. Tracing and agreeing internally prepared data to system output reports generated by the agency

A-14. In determining the extent of the procedures to be performed on data obtained from an external source, a factor to consider is whether the data are widely disseminated and used, or whether the data were developed for limited use. An example of data that are widely disseminated and used is a report prepared by the U.S. Census Bureau. For such data, the auditor may trace and agree the information to reports prepared by the U.S. Census Bureau. If management has made adjustments to data obtained from a widely disseminated and used external source, the auditor should evaluate:

- a. Management's reason for adjusting the data
- b. The accuracy and completeness of the adjustments to the externally obtained data
- c. Management's documentation supporting the adjustment

For data meant for limited use, all other factors being equal, the auditor should confirm or otherwise verify data obtained from other federal agencies and other external sources that were used in the actuarial valuation. If management has made adjustments to data developed for limited use, the auditor should evaluate:

- a. Management's reason for adjusting the data
- b. The accuracy and completeness of the adjustments to the externally obtained data
- c. Management's documentation supporting the adjustment

Models

A-15. The following are examples of procedures the auditor performs to obtain knowledge about how the agency generates, evaluates, selects, and reviews models used to develop estimates included in the statement of social insurance:

- a. Inquiring of management and other knowledgeable personnel about how they design or select the model used for the development of estimates and how they document that model

- b. Inquiring of management and other knowledgeable personnel about how they determine the effect that variations in the underlying assumptions have on the estimates
- A-16.** The following are examples of controls related to models:
- a. General and application controls related to the model, such as controls over input to the model and processing of that input
 - b. Controls that prevent or detect and correct errors in the development and processing of the model
 - c. Controls that prevent or detect and correct unauthorized access or changes to the model, for example, an access control table that is a component of the system and prohibits unauthorized users from accessing and changing the model. An example of a detective control is an audit log that tracks any changes made to the model
 - d. Controls designed to ensure that the information contained in the statement of social insurance and related disclosures conforms to generally accepted accounting principles
 - e. Designating responsibility for significant information resources within the agency (for example, data and programs) and establishing and maintaining security over such resources
 - f. Comparing existing system security features to documented system security requirements
 - g. Assigning responsibility to individuals in a manner that ensures that no single individual has the authority to read, add, change, or delete information without an independent review of that activity
 - h. Subjecting hardware and software acquisitions and implementations to extensive testing prior to acceptance in production
- A-17.** The following are examples of procedures the auditor performs to test controls and financial statement assertions related to models:
- a. Reviewing documentation that describes the instructions, rules, or procedures used in the model to calculate estimates
 - b. Reperforming calculations used in the model to translate the assumptions, data, and factors into the estimate
 - c. Reviewing management's documentation of its sensitivity analysis and considering whether the results are consistent with the auditor's expectations
 - d. If available, comparing the results of the model with the results of models used by other organizations for reasonableness

Estimates

- A-18.** The following are examples of matters the auditor inquires about in discussions with management and other knowledgeable personnel to determine how the agency generates, evaluates, selects, and reviews estimates to be included in the statement of social insurance:
- a. How management obtains the expertise to develop and evaluate estimates in the statement of social insurance, including hiring procedures, professional development activities, and procedures for engaging outside specialists
 - b. Who has final authority for reviewing and approving estimates

- c. The work performed by external review groups, their findings, and how those findings are used by the agency, for example:
 - (1) The scope and timing of the work performed by external review groups
 - (2) The composition of external review groups and the qualifications of the members
 - (3) Whether the external review groups are independent of the agency
 - (4) Whether the external review groups issued formal reports including findings or recommendations

A-19. The following are examples of controls related to estimates:

- a. Procedures related to the review and implementation of recommendations developed by external review groups
- b. General and application controls related to estimates, such as evidence of supervisory and management review of estimates and supporting documentation
- c. Controls intended to ensure that the information contained in the statement of social insurance and related notes conforms to Federal Accounting Standards Advisory Board (FASAB) guidance
- d. Controls related to the supervision of individuals who develop estimates, and the review of those estimates and supporting documentation
- e. Controls to regularly verify that personnel developing estimates are qualified to perform those tasks based on their education, training, and experience, as required

A-20. The following are examples of procedures the auditor performs to test controls and financial statement assertions related to estimates:

- a. Developing a trend analysis in which one period is compared to the next period
- b. Determining whether the information in the statement of social insurance, including related disclosure, is supported by sufficient, competent evidential matter
- c. Comparing the estimated future expenditures predicted by the actuarial model to actual expenditures for the previous fiscal year
- d. Evaluating the reasonableness of the time period covered by the statement of social insurance. FASAB standards require that the statement of social insurance cover a projection period sufficient to illustrate long-term sustainability of the social insurance program

[Paragraph renumbered and revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

**Auditing Standards Board
2004**

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[The next page is 31,781.]

Section 14,430

Statement of Position 07-2 Attestation Engagements That Address Specified Compliance Control Objectives and Related Controls at Entities That Provide Services to Investment Companies, Investment Advisers, or Other Service Providers

October 15, 2007

NOTE

This AICPA Statement of Position (SOP) has been developed by the AICPA Chief Compliance Officers Task Force of the AICPA Auditing Standards Board (ASB) to provide guidance regarding the application of Statements on Standards for Attestation Engagements (SSAEs) primarily to examination engagements in which a practitioner reports on the suitability of the design and operating effectiveness of a service provider's controls in achieving specified compliance control objectives. Examples of the service providers addressed by this SOP are investment advisers, custodians, transfer agents, administrators, and principal underwriters that provide services to investment companies (including business development companies), investment advisers, or other service providers (user organizations). A practitioner's report on the suitability of the design and operating effectiveness of a service provider's controls in achieving specified compliance control objectives is used primarily by user organizations because aspects of a user organization's compliance or internal control over compliance with laws, regulations, and rules may be affected by or include controls at service providers.

This SOP is recognized as an attestation interpretation as defined in AT section 50, *SSAE Hierarchy* (AICPA, *Professional Standards*). Attestation interpretations are recommendations on the application of SSAEs in specific circumstances, including engagements for entities in specialized industries. Attestation interpretations are issued under the authority of the ASB. The members of the ASB have found this SOP to be consistent with existing SSAEs.

A practitioner should be aware of and consider attestation interpretations applicable to his or her attestation engagement. If the practitioner does not apply the guidance included in this SOP, the practitioner should be prepared to explain how he or she complied with the SSAE provisions of this SOP.

Introduction and Background

.01 In December 2003, the Securities and Exchange Commission (SEC) adopted Rule 38a-1 under the Investment Company Act of 1940 and Rule 206(4)-7 under the Investment Advisers Act of 1940. The rules were adopted to protect investors by ensuring that (a) each investment company registered with the SEC under the Investment Company Act of 1940, and each business

development company¹ (collectively, funds) has an internal program to enhance compliance with federal securities laws² and (b) each investment adviser registered with the SEC has an internal program to enhance compliance with the Investment Advisers Act of 1940, including SEC rules issued thereunder.

.02 Many operations of funds and, in some instances, operations of investment advisers are carried out by entities that provide services to the funds or investment advisers. In this Statement of Position (SOP), such entities are termed *service providers*. Service providers have their own compliance policies and procedures that may affect or be part of a fund's or investment adviser's compliance or internal control over compliance with federal securities laws, individual statutes or provisions thereof, or corresponding SEC rules (*federal securities laws or elements thereof*).³ Rule 38a-1 requires each fund to adopt and implement written policies and procedures reasonably designed to prevent violation of federal securities laws by the fund or any of the following service providers named in the rule: investment advisers, principal underwriters, administrators, and transfer agents. Accordingly, a fund's compliance policies and procedures provide for oversight of the compliance procedures performed by the named service providers. Further, Rule 206(4)-7 requires an investment adviser to adopt and implement written policies and procedures reasonably designed to prevent violation by the investment adviser and its supervised persons of the Investment Advisers Act of 1940 and SEC rules issued thereunder. In this SOP, the term *service providers* refers to the service providers named in Rule 38a-1 as well as other service providers, such as custodians. The term *user organization* generally refers to a fund or investment adviser that uses the services of a service provider. In some instances, a single entity may be a service provider *and* a user organization. For example, Administrator A, in its capacity as a service provider to a fund, may be responsible for monitoring whether the fund's registration statement filed with the SEC complies with SEC disclosure requirements, but may subcontract that function to Administrator B that specializes in that area. In this situation, Administrator A is also a user organization because it uses the services of Administrator B. In this SOP, Administrator B is referred to as a *subservice provider*. In applying the guidance in this SOP, a subservice provider is considered a service provider.

.03 Among other provisions, the rules mentioned in paragraph .01 require funds and investment advisers to

- adopt and implement written policies and procedures⁴ reasonably designed to prevent violation of, in the case of funds, federal securities laws and, in the case of investment advisers, the Investment Advisers Act of 1940, including SEC rules issued thereunder.

¹ A business development company is a closed-end investment company that, among other requirements, has elected to be subject to the provisions of certain sections of the Investment Company Act of 1940.

² Rule 38a-1 defines *federal securities laws* to include the Securities Act of 1933, the Securities Exchange Act of 1934, the Sarbanes-Oxley Act of 2002, the Investment Company Act of 1940, the Investment Advisers Act of 1940, Title V of the Gramm-Leach-Bliley Act, any rules adopted by the Securities and Exchange Commission (SEC) under any of these statutes, the Bank Secrecy Act as it applies to funds, and any rules adopted thereunder by the SEC or the Department of the Treasury.

³ In this Statement of Position (SOP), *federal securities laws or elements thereof* is defined as federal securities laws (see footnote 2), individual statutes or provisions thereof, or corresponding SEC rules.

⁴ Rule 38a-1 and Rule 206(4)-7 use the term *policies and procedures* to refer to the principles and activities an entity adopts and implements to prevent violation of federal securities laws or elements thereof. In this SOP, the term *controls* is used to refer to the policies and procedures an entity adopts and implements to achieve specified compliance control objectives.

- review those policies and procedures at least annually for their adequacy and the effectiveness of their implementation.⁵
- designate a chief compliance officer (CCO) to be responsible for administering the policies and procedures (for funds, the CCO must report directly to the fund's board of directors).

.04 SEC Release Nos. IC-26299 and IA-2204 adopting the rules note that it may be impractical for a fund or its CCO to directly review all of its named service providers' policies and procedures, particularly if one or more of the service providers are not affiliated with the fund. In these circumstances, the SEC considers the fund to have satisfied the requirements of Rule 38a-1 if the fund's board of directors, in evaluating whether to approve the service provider's compliance program, uses a "third-party report" on the service provider's policies and procedures.⁶ In the United States fund industry, in connection with the audit of a fund's financial statements, a number of service providers are accustomed to engaging an independent auditor to report on the suitability of the design and operating effectiveness of controls at the service provider that may be relevant to the fund's internal control over financial reporting. These engagements are performed under AT section 801, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*), and reports issued thereunder are used by the funds' independent auditor when auditing the fund's financial statements. Similarly, since the adoption of the rules in December 2003, service providers have received requests from funds and investment advisers for information and assurance regarding the suitability of the design and operating effectiveness of the service provider's controls in achieving compliance control objectives. Also, in some circumstances, subservice providers (service providers that provide services to other service providers, for example, a service organization that reports fund share balances and transactions of retirement plan participants, in aggregate, to a fund's transfer agent and maintains records thereof) have received similar requests from service providers. Such information assists funds and investment advisers in fulfilling their responsibilities to perform an annual review of specified compliance activities and assists service providers and subservice providers in their consideration of their own controls. [Revised, August 2011, to reflect conforming changes necessary due to the issuance of SSAE No. 16.]

.05 Specific information about the rules is provided in "Compliance Programs of Investment Companies and Investment Advisers," which can be accessed at the United States SEC website at www.sec.gov/rules/final/ia-2204.htm. The following is a table that briefly summarizes significant provisions of the rules. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

⁵ The annual review requirement is imposed upon the fund or investment adviser. Specifically, the rules do not require the fund or adviser to engage an independent accountant to attest to management's annual review or to perform a separate evaluation of any aspect of the fund's or investment adviser's compliance policies and procedures. Further, the rules do not require that the annual review employ a specific framework or methodology for evaluating the effectiveness of a fund's or investment adviser's compliance policies and procedures. Lastly, there is no requirement that annual or other compliance reports prepared by chief compliance officers of funds or investment advisers be filed with the SEC; however, the SEC may request such reports in connection with their inspection and examination programs of funds and investment advisers or in other circumstances.

⁶ The SEC release states that the third party report must describe the service provider's compliance program as it relates to the types of services provided to the fund, discuss the types of compliance risks material to the fund, and assess the adequacy of the service provider's compliance controls. Information produced as a result of an engagement covered by this SOP may be used by the fund, in part, to meet these provisions. The report must be provided to the fund no less frequently than annually.

SEC Rule and (Section Number)	Rule 38a-1 (§17 CFR 270.38a-1)	Rule 206(4)-7 (§17 CFR 275.206(4)-7) and Amendments to Rule 204-2 (§17 CFR 275.204-2)
Applicable entity	Investment companies and business development companies (funds) must:	Investment advisers must:
Nature of the policies and procedures to be adopted and implemented	Adopt and implement written policies and procedures reasonably designed to prevent violation of federal securities laws by the fund, including policies and procedures that provide for oversight of compliance by each investment adviser, principal underwriter, administrator, and transfer agent (named service providers) of the fund.	Adopt and implement written policies and procedures reasonably designed to prevent violation, by the investment adviser and persons supervised by the investment adviser, of the Investment Advisers Act of 1940 and the SEC rules issued thereunder.
Board approval of policies and procedures	Obtain approval by the fund's board of directors of the fund's policies and procedures and those of each of the named service providers.	
Annual review of policies and procedures	Review, no less frequently than annually, (1) the adequacy of the policies and procedures of the fund and each of the named service providers and (2) the effectiveness of their implementation.	Review, no less frequently than annually, (1) the adequacy of the policies and procedures established pursuant to the rule and (2) the effectiveness of their implementation.
Individual responsible for administering policies and procedures	Designate an individual to be the fund's chief compliance officer (CCO), responsible for administering the policies and procedures adopted under paragraph (a) (1) of the rule. The designation and compensation of the CCO must be approved by the fund's board of directors, and the CCO may be removed only by action and approval of the fund's board of directors.	Designate an individual (who is a supervised person) to be the adviser's CCO, responsible for administering the policies and procedures that are adopted under paragraph (a) of the rule.

SEC Rule and (Section Number)	Rule 38a-1 (§17 CFR 270.38a-1)	Rule 206(4)-7 (§17 CFR 275.206(4)-7) and Amendments to Rule 204-2 (§17 CFR 275.204-2)
Applicable entity	Investment companies and business development companies (funds) must:	Investment advisers must:
Report to the board of directors	<p>The CCO must provide a written report to the fund’s board of directors, no less frequently than annually, that addresses at a minimum:</p> <ul style="list-style-type: none"> • The operation of the fund’s policies and procedures and those of each of the named service providers, any material changes made to those policies and procedures since the last report, and any material changes to the policies and procedures recommended as a result of the annual review. • Each <i>material compliance matter</i>⁷ that occurred since the date of the last report. <p>After the initial report, subsequent CCO reports are expected to cover the period since the date of the last report.</p>	

Objective of the Examination Engagement

.06 Because federal securities laws encompass a significantly comprehensive set of obligations and responsibilities, the compliance control objectives presented by management of the service provider ordinarily would not include all conceivable compliance control objectives related to federal securities laws or elements thereof. Also, although Rule 38a-1 requires a fund’s CCO to include in the fund’s annual compliance report information concerning any material compliance matter(s) that occurred during the relevant period, the objective of the examination engagement described in paragraphs .01–.33 of this SOP is not to identify and report any material compliance matter(s) that may have existed at the service provider during the period covered by the practitioner’s report. Rather, the objective of the examination engagement described in paragraphs

⁷ SEC Rule 38a-1 defines a *material compliance matter* as any compliance matter about which the fund’s board of directors would reasonably need to know to oversee fund compliance and that involves, without limitation, (a) a violation of federal securities laws (as defined in Rule 38a-1) by the fund, its investment adviser, principal underwriter, administrator, or transfer agent (or officers, directors, employees, or agents thereof); (b) a violation of the policies and procedures of the fund, its investment adviser, principal underwriter, administrator, or transfer agent; or (c) a weakness in the design or implementation of the policies and procedures of the fund, its investment adviser, principal underwriter, administrator, or transfer agent.

.01–.33 of this SOP is for the practitioner to report on the suitability of the design (at the end of a specified period) and the operating effectiveness (during the specified period) of the service provider’s controls in achieving the compliance control objectives specified by management of the service provider.

.07 AT section 101, *Attest Engagements* (AICPA, *Professional Standards*), allows a practitioner to report on either management’s assertion or on the subject matter to which it relates.⁸ Paragraph .64 of AT section 101 indicates that when the practitioner reports on an assertion, the assertion should either be (a) bound with or accompany the practitioner’s report or (b) clearly stated in the practitioner’s report. In view of the intended use of the information produced in connection with examination engagements covered by this SOP, practitioners are strongly encouraged to report on management’s assertion rather than on the subject matter to ensure that management’s assertion will be available to users of the report.

Subject Matter of the Examination Engagement

.08 The examination engagement described in paragraphs .01–.33 of this SOP should be performed in accordance with AT section 101. AT section 101 enables a practitioner to design an engagement and report on subject matter (or an assertion thereon) other than financial statements. The subject matter of the engagement described in paragraphs .01–.33 of this SOP is the suitability of the design and operating effectiveness of a service provider’s controls directed at achieving specified compliance control objectives. Use of the practitioner’s examination report is restricted to the CCOs, management, boards of directors, and independent auditors of the service provider and of the entities that use the services of the service provider because these users would be expected to have the requisite knowledge and familiarity with the service provider’s organization to understand the context of the examination report. [Revised, June 2009, to reflect conforming changes due to the issuance of recent authoritative literature.]

Management’s Responsibilities

.09 In an examination engagement in which the practitioner reports on the suitability of the design and operating effectiveness of controls to achieve specified compliance control objectives, management of the service provider is responsible for

- a. specifying compliance control objectives and related controls that are relevant to the services provided to user organizations and their internal control over compliance with federal securities laws or elements thereof.
- b. preparing and providing the practitioner with a written description of the specified compliance control objectives and related controls referred to in paragraph .09a (see appendix A-4 [paragraph .41] of this SOP, “Illustrative Service Provider’s Description of Specified Compliance Control Objectives and Related Controls”). If applicable, the

⁸ When conditions exist that individually or in combination result in one or more material misstatements or deviations from the criteria, to most effectively communicate with the reader of the report, the practitioner should ordinarily express his or her conclusion directly on the subject matter, not on the assertion.

written description should include the applicable information described in paragraphs .16–.17 of this SOP concerning compliance control objectives and related controls of subservice providers.

- c. preparing and providing the practitioner with a written assertion regarding the suitability of the design and operating effectiveness of the controls in achieving the specified compliance control objectives⁹ (see appendix A-3 (paragraph .40) of this SOP for an illustrative management assertion). The criteria management use in evaluating the suitability of the design and operating effectiveness of the controls included in management's description and in making its assertion are the specified compliance control objectives.
- d. identifying and presenting a list of user control considerations if the application of controls by user organizations is necessary to achieve the specified compliance control objectives. In certain circumstances, a service provided by a service provider may be designed with the assumption that certain controls will be implemented by user organizations. For example, the service may be designed with the assumption that user organizations will have controls in place for authorizing transactions before they are sent to the service provider for processing. If such user controls are required to achieve the stated compliance control objectives, the service provider should describe them either in its written description or in a separate list accompanying the description.
- e. preparing and providing the practitioner with a representation letter that ordinarily includes the items listed in paragraph .26a–j of this SOP.

Criteria

.10 Paragraph .23 of AT section 101 states, in part, that “The practitioner must have reason to believe that the subject matter is capable of evaluation against criteria that are suitable....” Paragraph .24 of AT section 101, in turn, indicates that suitable criteria must have each of the following attributes: objectivity, measurability, completeness, and relevance. In the examination engagement covered by this SOP, the criteria to be used to evaluate the suitability of the design and operating effectiveness of the controls are the specified compliance control objectives. The practitioner should consider whether the language used by management to describe the specified compliance control objectives included in the written description is sufficiently precise to permit people having competence in and using the same measurement criterion to ordinarily obtain materially similar measurements (paragraph .29 of AT section 101). Consequently, practitioners should not perform an engagement covered by this SOP if the criteria are so subjective or vague that reasonably consistent measurements, qualitative or quantitative, of the subject matter cannot ordinarily be obtained. For example, the following compliance control objective ordinarily would be too subjective for evaluation:

Advertising and sales literature is frequently and properly reviewed.

The following revision of this control objective improves its objectivity and measurability:

⁹ Paragraph .09 of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*), states that a practitioner should ordinarily obtain a written assertion in an examination engagement, whether reporting on the subject matter or reporting on a written assertion.

At the end of each quarter, advertising and sales literature is reviewed by the service provider's compliance officer for conformity with the service provider's written policies.

Furthermore, although this SOP does not require all service providers to present identical compliance control objectives for similar business activities or services (for example, transfer agency and fund administration) included in the scope of the attestation engagement, compliance control objectives or elements thereof that pertain to those business activities or services and are relevant to user organizations should not be omitted if management of the service provider or the practitioner becomes aware of deficiencies in the suitability of the design or operating effectiveness of controls that would prevent the achievement of such objectives. See also related guidance in paragraphs .12*b* and .21–.22 of this SOP. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Reference to Laws, Regulations, and Rules

.11 The written description of specified compliance control objectives and related controls prepared by management of the service provider should not include general or broad references¹⁰ to federal securities laws or elements thereof that might imply that the specified compliance control objectives completely address or directly correspond to such laws or elements thereof. Such references may mislead user organizations and others because most laws, regulations, and rules contain numerous and detailed provisions, all of which may not be addressed by the compliance control objectives and related controls. Management of the service provider may, however, include a citation from such federal securities laws or elements thereof within the specified compliance control objective, in the written description, if the citation is sufficiently specific. An example is a citation containing the specific section or subsection of the law, regulation, or rule corresponding to the specified compliance control objective as in "For money market mutual funds, investments are monitored on a weekly basis for compliance with the portfolio maturity and quality provisions of SEC Rule 2a-7c.2 and 2a-7c.3, respectively."

Practitioner's Responsibilities

.12 For the practitioner to express an opinion on the suitability of the design¹¹ and operating effectiveness of a service provider's controls in achieving specified compliance control objectives, the practitioner should

- a. obtain an understanding of the nature of the services provided by the service provider to user organizations and determine whether the specified compliance control objectives included in management's description are relevant to the services provided. Methods for obtaining an understanding of the services provided include
 - reading representative contracts between the service provider and user organizations, marketing or other material provided to user

¹⁰ For example, the written description should not include a table that aligns the specified compliance control objectives with generally or broadly described federal securities laws or elements thereof. Such a presentation could cause readers to incorrectly conclude that the specified control objectives address all provisions of the federal securities laws or elements thereof referenced in the table.

¹¹ A control is suitably designed if individually, or in combination with other controls, it is likely to prevent or detect errors that could result in the nonachievement of specified compliance control objectives when the described controls are complied with satisfactorily.

- organizations, reports developed by internal auditors, and correspondence to and from regulatory authorities; and
- making inquiries of management and other service provider personnel.
- b. obtain a written description prepared by management of the service provider of the specified compliance control objectives and related controls that are relevant to the services provided to user organizations and their internal control over compliance with federal securities laws or elements thereof (see appendix A-4 (paragraph .41) of this SOP, “Illustrative Service Provider’s Description of Specified Compliance Control Objectives and Related Controls”). If the practitioner concludes that the description is materially misstated or misleading in the circumstances, the practitioner should inform the service provider’s management and request that the description be amended. If management refuses to amend the description in a manner that addresses the practitioner’s concerns, the practitioner should consider withdrawing from the engagement.
 - c. consider the linkage between the controls and the specified compliance control objectives and the ability of the controls to prevent or detect errors related to the specified compliance control objectives.
 - d. obtain sufficient appropriate evidence regarding the suitability of the design and operating effectiveness of the controls in achieving the specified compliance control objectives. Procedures to obtain evidence regarding the suitability of the design and implementation of relevant controls may include inquiry of appropriate service provider personnel, observation of the application of specific controls, inspection of documents and reports, and tracing transactions relevant to the subject matter of the engagement through the service provider’s applicable information and communication systems. Inquiry alone is not sufficient to evaluate the design of a control relevant to an examination engagement and to determine whether it has been implemented. In testing the operating effectiveness of controls, the practitioner should obtain evidence about how the controls were applied at relevant times during the period under examination, the consistency with which they were applied, and by whom or what means they were applied. Tests of the operating effectiveness of controls ordinarily include the same types of procedures used to evaluate the design and implementation of controls, and may also include reperformance of the application of the control by the practitioner. Since inquiry alone is not sufficient, the practitioner should use a combination of procedures to obtain sufficient appropriate evidence regarding the operating effectiveness of controls.
 - e. ordinarily, obtain a written assertion prepared by management of the service provider regarding the suitability of the design and operating effectiveness of the service provider’s controls in achieving the specified compliance control objectives (see appendix A-3 [paragraph .40] of this SOP for an illustrative management assertion). As noted in paragraph .07 of this SOP, to ensure that management’s assertion will be available to users of the report, practitioners are strongly encouraged to report on management’s written assertion rather than on the subject matter, except when a deficiency or deficiencies in controls exist that, individually or in combination, result in the nonachievement of one or more specified compliance control objectives.

- f. obtain a representation letter from management that ordinarily would include the items in paragraph .26a-j of this SOP.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.13 Ordinarily, for the examination engagement described in this SOP, the relevant aspects of a service provider's internal control over compliance pertaining to its control environment, risk assessment, and monitoring would not be presented in the form of compliance control objectives; however, management of the service provider is not precluded from doing so. The practitioner should perform tests of the relevant aspects of the service provider's control environment, risk assessment, and monitoring that relate to the services provided and should assess their effectiveness in establishing, enhancing, or mitigating the effectiveness of specific controls. If there are weaknesses in relevant aspects of the control environment, risk assessment, and monitoring the practitioner should consider an appropriate response. For example, modifying his or her procedures to obtain more persuasive evidence about the operating effectiveness of the controls and whether the specified compliance control objectives have been achieved. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Matters Addressed by the Compliance Control Objectives

.14 As noted in paragraph .06, because federal securities laws encompass a significantly comprehensive set of obligations and responsibilities, management's description ordinarily would not include all conceivable compliance control objectives related to federal securities laws or elements thereof.

.15 Unless the compliance control objectives have been designated by an outside party, such as a regulatory authority or a user group, management of the service provider is responsible for specifying the compliance control objectives and related controls that are the subject of the engagement. In establishing the compliance control objectives and related controls, management of the service provider should consider

- a. the nature of the services provided to user organizations.
- b. the service provider's contractual obligations to user organizations.
- c. the information and assurance needs of user organizations, including the relevancy of the compliance control objectives and related controls to the services provided to user organizations and their internal control over compliance with federal securities laws or elements thereof.¹²

Further, when circumstances permit, discussions between management of the service provider and user organizations are advisable in determining the compliance control objectives intended to address the needs of user organizations.

.16 Service providers may have contractual or other arrangements with one or more subservice providers or other parties that perform administrative, computer operations, transaction processing, recordkeeping, or other activities on their behalf. In these circumstances, management of the service provider determines whether the subservice provider's relevant control objectives and related controls are to be included or excluded from its written description of

¹² See SEC Release Nos. IC-26299 and IA-2204 adopting Rules 38a-1 and 206(4)-7, respectively (Section IIA., *Adoption and Implementation of Policies and Procedures*).

specified compliance control objectives and related controls. Although the inclusive method provides more information to user organizations, it may not be appropriate or feasible in many or all instances. In determining which approach to use, management of the service provider should consider (a) the nature and extent of information about the subservice provider from which user organizations would derive benefit, (b) the degree of responsibility management would assume by including information about the subservice organization in its description and accompanying written assertion, and (c) the practical difficulties entailed in implementing the inclusive method. Whether the subservice provider's relevant control objectives and related controls are included or excluded from the written description, the description should include a brief statement of the functions and nature of the services performed by the subservice provider. Ordinarily, disclosure of the identity of the subservice provider is not required. If, however, management of the service provider determines that the identity of the subservice provider would be relevant to user organizations, the name of the subservice provider may be included in the written description provided that there are no prohibitions against doing so, by contract or otherwise, and any necessary approvals have been obtained by the service provider. Also, when included, the written description should clearly differentiate between controls of the service provider and controls of the subservice provider.

.17 If the subservice provider's relevant compliance control objectives and related controls are excluded, management of the service provider should state in the written description that the subservice provider's compliance control objectives and related controls are omitted from the description and, unless achievement of the compliance control objectives depends on controls at the subservice provider, that the compliance control objectives included in the written description include only those objectives that the service provider's controls are intended to achieve. Reporting guidance for situations in which the service provider excludes the subservice provider's compliance control objectives and related controls from the service provider's written description is presented in paragraph .31 of this SOP.

.18 As noted in paragraph .13, ordinarily in the examination engagement described in this SOP, the relevant aspects of a service provider's internal control pertaining to its control environment, risk assessment, and monitoring would not be presented in the form of compliance control objectives; however, management of the service provider is not precluded from presenting those aspects in the form of compliance control objectives.

Evaluating Deficiencies in Controls

.19 Paragraph .24 of AT section 101 states, in part, that criteria are the standards or benchmarks against which the practitioner evaluates the subject matter. In this SOP, the criteria used by the practitioner to evaluate the suitability of the design and operating effectiveness of the controls included in management's description are the specified compliance control objectives. The practitioner should evaluate the results of the procedures he or she performed to obtain sufficient appropriate evidence about the suitability of the design and operating effectiveness of the controls and determine the significance of any identified deficiencies in controls, individually and in combination, to the achievement of the specified compliance control objectives. 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 would not always be 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. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.20 The following are examples of factors that are relevant in evaluating the significance of identified deficiencies in controls:

- The existence of effective compensating controls that have been tested and evaluated and limit the severity of the deficiency
- The significance of the control(s) to achieving the compliance control objective
- The existence of multiple deficiencies in controls that, in combination, may be significant to the achievement of a compliance control objective, even if the deficiencies are individually insignificant to the achievement of the compliance control objective

The practitioner may conclude that the specified compliance control objective has been achieved even if a deficiency or deficiencies in controls have been identified. However, if, after performing his or her procedures, the practitioner concludes that the specified compliance control objective was not achieved, the practitioner should modify his or her report. See paragraph .29 of this SOP for related reporting guidance.

User Organizations Affected by a Service Provider's Noncompliance With Federal Securities Laws or Elements Thereof

.21 In the course of performing procedures at a service provider, a practitioner may become aware of a matter or matters constituting noncompliance with federal securities laws or elements thereof (including material compliance matters) that occurred during the period covered by the practitioner's report and relate to business activities or services included in the scope of the attestation engagement. Unless the instance(s) of noncompliance are clearly inconsequential, the practitioner should obtain an understanding of

- the nature of the noncompliance matter(s),
- the cause(s) of such,
- the period during which the noncompliance matter(s) existed or occurred, and
- the nature of any remediation activities taken to subsequently achieve compliance or the status of any remediation activities the service provider plans to take to achieve compliance.

.22 Further, the practitioner should determine whether information about the noncompliance matter(s) has been communicated to affected user organizations. If management of the service provider has not communicated this information and is unwilling to do so, and the practitioner believes the nature of the noncompliance matter(s) could be significant to user organizations, the practitioner should inform management and those charged with governance of the service provider of the circumstances. If management and those charged with governance of the service provider do not respond in an appropriate manner, the practitioner should consider withdrawing from the engagement.

The practitioner generally is not required to confirm with the user organizations that the service provider has communicated such information. If the user organizations have been notified in writing, the practitioner may request a copy from the service provider of the written communication. In all cases, judgment should be used by the practitioner in considering the effect, if any, of all information obtained about the noncompliance matter(s) on (a) the written assertion provided by management of the service provider regarding the suitability of the design and operating effectiveness of controls in achieving the specified compliance control objectives; and (b) the practitioner's procedures and report. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Management Assertion

.23 Paragraph .08 of AT section 101 defines an assertion as any declaration or set of declarations about whether the subject matter is based on or in conformity with the criteria selected. Paragraph .09 of AT section 101 provides the practitioner with additional information about a written assertion. For the examination engagement described in this SOP, whether reporting directly on the subject matter or on the assertion, the practitioner should ordinarily obtain a written assertion from management of the service provider regarding the suitability of the design and operating effectiveness of the service provider's controls in achieving the specified compliance control objectives. Appendix A-3 (paragraph .40) of this SOP contains an illustrative management assertion.

.24 Management's assertion regarding the suitability of the design and operating effectiveness of the controls should specify the "as of" date and period covered by management's assertion. The determination of an appropriate period is at the discretion of management; however, to be useful to user organizations, the assertion and related practitioner's report ordinarily covers a minimum reporting period of six months. The following are examples of factors that are relevant in establishing the reporting period:

- The anticipated needs of users of the report
- The degree and frequency of changes in the service provider's controls related to the specified compliance control objectives
- The period needed to provide sufficient and appropriate evidence regarding the operating effectiveness of the controls

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Management Representations

.25 Paragraphs .59–.60 of AT section 101 state, in part:

59. During an attest engagement, the responsible party makes many representations to the practitioner, both oral and written, in response to specific inquiries or through the presentation of subject matter or an assertion. Such representations from the responsible party are part of the evidential matter the practitioner obtains.

60. Written representations from the responsible party ordinarily confirm representations explicitly or implicitly given to the practitioner, 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. Accordingly, in an examination or a

review engagement, a practitioner should consider obtaining a representation letter from the responsible party.

.26 The representations that a practitioner considers appropriate generally will depend on the subject matter and circumstances of the engagement. In addition to obtaining management's written assertion about the suitability of the design and operating effectiveness of the service provider's controls in achieving the specified compliance control objectives, the practitioner ordinarily would obtain the following written representations from management of the service provider in connection with the examination engagement described in paragraphs .01–.33 of this SOP:

- a. A statement acknowledging management's responsibility for
 - the subject matter of the examination engagement; namely, the suitability of the design and operating effectiveness of the controls in achieving the specified compliance control objectives.
 - selecting the criteria used and determining the appropriateness of such criteria for its purposes, including selecting and presenting compliance control objectives that are relevant to the services provided to user organizations and their internal control over compliance with federal securities laws or elements thereof (practitioners may wish to include in the representation letter the definition of the term *federal securities laws or elements thereof* found in footnotes 2 and 3 of this SOP).
 - its description of specified compliance control objectives and related controls.
 - its written assertion about the suitability of the design and operating effectiveness of the controls in achieving the specified compliance control objectives.
 - establishing and maintaining compliance and effective internal control over compliance with federal securities laws or elements thereof as they relate to the scope of the examination engagement, including establishing and maintaining controls that are suitably designed and operating effectively to achieve the specified compliance control objectives.
- b. A statement that management has disclosed to the practitioner all deficiencies of which it is aware in the design or operation of the service provider's internal control over compliance with federal securities laws or elements thereof, related to the scope of the attestation engagement, that existed during the period covered by the practitioner's report, including those for which management believes the cost of corrective action may exceed the benefits
- c. A statement that management has disclosed to the practitioner any significant changes in the service provider's controls related to the scope of the attestation engagement made since the service provider's last examination
- d. A statement that management has disclosed to the practitioner any instances of which it is aware of the service provider's noncompliance with federal securities laws or elements thereof, related to the scope of the attestation engagement, that existed during the period covered by the practitioner's report and that may affect one or more user organizations

- e. A statement that management has disclosed to the practitioner all instances of which it is aware when the service provider's controls have not operated with sufficient effectiveness during the period covered by the practitioner's report to achieve the specified compliance control objectives
- f. A statement that management has disclosed to the practitioner all known matters contradicting the assertion and any communications from attorneys, regulatory agencies, internal auditors, consultants, other practitioners, or third parties related to the service provider's compliance, or internal control over compliance, with federal securities laws or elements thereof during the period covered by the practitioner's report that may affect one or more user organizations
- g. A statement that management has made available to the practitioner all records and other information it believes are relevant to the service provider's compliance, or internal control over compliance, with federal securities laws or elements thereof, related to the scope of the attestation engagement and the period covered by the practitioner's report
- h. A statement that management has responded fully to all inquiries made by the practitioner during the engagement
- i. A statement that management has disclosed all events of which it is aware that occurred subsequent to the period being reported on that would have a material effect on the subject matter (or management's assertion) to which the practitioner's report relates
- j. Statements regarding other matters the practitioner deems appropriate for inclusion in management's representations to the practitioner

.27 If management refuses to furnish all the written representations that the practitioner deems necessary, the practitioner should consider the effects of such a refusal on his or her ability to express an opinion about the subject matter or assertion. If the practitioner believes that the representations are necessary to obtain sufficient appropriate evidence to express an opinion, management's refusal to furnish such evidence in the form of written representations constitutes a limitation on the scope of an examination sufficient to preclude an unqualified opinion and is ordinarily sufficient to cause the practitioner to disclaim an opinion or withdraw from an examination engagement. However, based on the nature of the representations not obtained or the circumstances of the refusal, the practitioner may conclude, in an examination engagement, that a qualified opinion is appropriate. Further, the practitioner should consider the effects of the refusal on his or her ability to rely on other representations made by management of the service provider. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Reporting

.28 Appendix A-1 (paragraph .38) of this SOP contains an illustrative practitioner's examination report on an assertion by management of a service provider regarding specified compliance control objectives and related controls. The illustrative report includes the required elements of a practitioner's unqualified report on an assertion that are listed in paragraph .86 of AT section 101. Paragraph .85 of AT section 101 presents the required elements of a practitioner's unqualified report on subject matter, and appendix A, "Examination Reports," of AT section 101 presents additional illustrative examination reports.

.29 Paragraph .19 of this SOP notes that criteria are the standards or benchmarks against which a practitioner evaluates the subject matter, and in this SOP, the criteria for evaluating the suitability of the design and operating effectiveness of the controls are the specified compliance control objectives. If, after performing the procedures described in paragraphs .12–.13 and .19–.22 of this SOP, the practitioner concludes that the controls were not suitably designed or operating with sufficient effectiveness to provide reasonable assurance that the specified compliance control objectives were achieved, the practitioner should modify his or her report and include a brief factual description that will enable users of the report to understand the nature of the deficiency or deficiencies in controls. The matter or matters pertaining to the suitability of the design or operating effectiveness of controls and giving rise to a qualified or adverse opinion in a report on the examination engagement described in this SOP should be referred to as a deficiency or deficiencies. Further, paragraph .66 of AT section 101 states, in part, that “...if conditions exist that, individually or in combination, result in one or more material misstatements or deviations from the criteria, the practitioner should modify the report and, to most effectively communicate with the reader of the report, should ordinarily express his or her conclusion directly on the subject matter, not on the assertion.” Appendix B (paragraph .42) of this SOP contains an illustrative practitioner’s examination report containing a qualified opinion on a service provider’s controls in achieving the specified compliance control objectives. In that illustrative report, the practitioner reports on the subject matter rather than on the assertion.

.30 As noted in paragraph .72 of AT section 101, a practitioner may have reservations about the engagement (for example, a restriction on the scope of the engagement), the subject matter, and, if applicable, the assertion. When a practitioner has such reservations, he or she should exercise professional judgment in determining the significance of those reservations and the type of report to be issued. Paragraphs .71–.74 and .76–.77 of AT section 101 provide guidance in this area.

.31 If a subservice provider’s compliance control objectives and related controls are excluded from the service provider’s written description of specified compliance control objectives and related controls (see paragraph .17 of this SOP), the scope paragraph of the practitioner’s report should be modified to

- refer to the disclosure in the written description regarding the service provider’s use of a subservice provider and the functions and nature of the services performed by the subservice provider.
- state that the subservice provider’s compliance control objectives and related controls are omitted from the written description and that the practitioner’s examination did not extend to controls of the subservice provider.

Appendix A-2 (paragraph .39) of this SOP contains an illustrative practitioner’s examination report on a service provider’s specified compliance control objectives and related controls when the service provider uses a subservice provider and the subservice provider’s control objectives and related controls are excluded from the description.

.32 As noted in paragraph .17, situations may arise in which the service provider specifies compliance control objectives whose achievement depends on controls at a subservice provider. In those circumstances, if the service provider has excluded the subservice provider’s controls from the written description, the practitioner should modify the scope and opinion paragraphs of his or her

report to include the phrase “and subservice providers applied the controls contemplated in the design of the service provider’s controls.”

.33 A practitioner may perform significant portions of the engagement before the end of the period covered by the report. If during that time the practitioner identifies compliance control objectives that have not been achieved, he or she should include a description of the condition in his or her report, even if management corrects the condition prior to the end of the period.

Agreed-Upon Procedures

.34 A practitioner may also perform agreed-upon procedures related to compliance control objectives and related controls. Such engagements are performed in accordance with AT section 201, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*). In these engagements, the parties to the engagement (specified parties) and the practitioner agree upon the procedures to be performed. The practitioner performs these procedures and reports his or her findings. The specified parties assume responsibility for the sufficiency of the procedures because they best understand their own needs. In an agreed-upon procedures engagement, the practitioner does not perform an examination or review of an assertion or subject matter or express an opinion or negative assurance about the assertion or subject matter. The practitioner’s report on agreed-upon procedures is in the form of procedures and findings. An illustrative agreed-upon procedures report is presented in appendix E (paragraph .45) of this SOP. Use of an agreed-upon procedures report is restricted to the specified parties that agree upon the procedures and accept responsibility for the sufficiency of the procedures for their purposes.

.35 In accordance with paragraph .10 of AT section 201, a practitioner should establish an understanding with the client regarding the services to be performed. Such an understanding reduces the risk that the client may misinterpret the objectives and limitations of an agreed-upon procedures engagement and also reduces the risk that the client will misunderstand its responsibilities and the responsibilities of the practitioner. Paragraph .46 of AT section 101 provides further guidance on establishing an understanding with a client in an attestation engagement.

.36 Paragraph .36 of AT section 201 enables a practitioner, after considering certain matters, to add a nonparticipant party as a specified party. If the practitioner agrees to add a specified party, he or she should obtain affirmative acknowledgement, normally in writing, from that party agreeing to the procedures performed and taking responsibility for the sufficiency of the procedures.

Effective Date

.37 This SOP is effective upon issuance.

Appendix A-1 — Illustrative Practitioner’s Examination Report on a Service Provider’s Assertion Regarding Specified Compliance Control Objectives and Related Controls

Note: The compliance control objectives and related controls referenced in the following illustrative practitioner’s report are examples only and should not be viewed as representative of or a complete description of the compliance control objectives or related controls a service provider might be expected to (1) establish and implement to meet any contractual responsibilities to funds or any other clients, (2) monitor for investment compliance, or (3) include in its description of specified compliance control objectives and related controls in an examination engagement covered by this Statement of Position (SOP). Additionally, there may be other areas of responsibility (beyond investment compliance) that a service provider might assume on behalf of funds or any other clients that might result in the inclusion and presentation of different or additional compliance control objectives and related controls for engagements covered by this SOP.

Report of Independent Accountants

To the Management of XYZ Service Provider:

[Introductory paragraph]

We have examined the assertion made by the management of XYZ Service Provider pertaining to controls over investment compliance that XYZ Service Provider performs for user organizations. Management’s assertion is included in the accompanying document titled, “Management’s Assertion Regarding XYZ Service Provider’s Specified Compliance Control Objectives and Related Controls” and states that:

- The controls described in the accompanying document titled, “XYZ Service Provider’s Description of Specified Compliance Control Objectives and Related Controls” (management’s description), were suitably designed as of December 31, 20X1 to provide reasonable assurance that the compliance control objectives established by management and described therein would be achieved, if those controls were complied with satisfactorily *[and user organizations applied the controls contemplated in the design of XYZ Service Provider’s controls¹]*; and
- The controls described in management’s description were operating with sufficient effectiveness to provide reasonable assurance that the specified compliance control objectives described therein were achieved during the period from January 1, 20X1 to December 31, 20X1.

Management of XYZ Service Provider is responsible for its assertion. Our responsibility is to express an opinion on management’s assertion based on our examination.

¹ Refer to user controls only in situations in which the application of controls by the user organizations is necessary to achieve specified control objectives. Otherwise omit this reference.

[Scope paragraph]

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 and evaluating the suitability of the design and operating effectiveness of the controls in achieving the specified compliance control objectives, and examining, on a test basis, evidence supporting management's assertion and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

We were not engaged to perform and did not perform an examination of XYZ Service Provider's or user organizations' compliance or internal control over compliance with Federal Securities Laws, as that term is defined by Securities and Exchange Commission (SEC) Rule 38a-1 under the Investment Company Act of 1940 ("Federal Securities Laws"). We also were not engaged to perform and did not perform an examination of XYZ Service Provider's compliance with its contractual obligations to its clients during the period from January 1, 20X1 to December 31, 20X1.

Our examination was limited to examining, for the purposes described above, management's assertion about the specified compliance control objectives and related controls included in management's description and did not consider any other compliance control objectives or controls that may be relevant to XYZ Service Provider's or user organizations' compliance or internal control over compliance with Federal Securities Laws. Further, the relative effectiveness and significance of specific controls at XYZ Service Provider, and their effect on user organizations' compliance or internal control over compliance with Federal Securities Laws 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 such controls or such other factors at individual user organizations.

The compliance control objectives and related controls set forth in management's description have been provided to enable user organizations, when performing their annual compliance reviews as required by SEC Rule 38a-1 under the Investment Company Act of 1940, to consider such information along with information about their own compliance or internal control over compliance with Federal Securities Laws, and any other relevant information.

[Inherent limitations paragraph]

Management's description is as of December 31, 20X1. 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 or controls in existence. The potential effectiveness of controls in achieving the specified compliance control objectives established by XYZ Service Provider is subject to inherent limitations and, accordingly, lack of compliance with controls and instances of errors or fraud may occur and not be detected. Furthermore, the projection of any evaluations, based on our findings, to future periods is subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with such controls may deteriorate, or changes made to the system or controls, or the failure to make needed changes to the system or controls, may alter the validity of such evaluations.

Statements of Position

[Opinion paragraph]

In our opinion, management's assertion referred to above is fairly stated, in all material respects, based on the specified compliance control objectives set forth in management's description.

[Restricted use paragraph]

This report is intended solely for the information and use of chief compliance officers, management, boards of directors, and the independent auditors of XYZ Service Provider and of the entities that use the services of XYZ Service Provider, and is not intended to be and should not be used by anyone other than these specified parties.

[Signature of Independent Accountant]

March 31, 20X2

Appendix A-2 — Illustrative Practitioner’s Examination Report on a Service Provider’s Assertion Regarding Specified Compliance Control Objectives and Related Controls When the Service Provider Uses a Subservice Provider and the Subservice Provider’s Control Objectives and Related Controls are Excluded From the Description and the Scope of the Practitioner’s Engagement

Note: The compliance control objectives and related controls referenced in the following illustrative practitioner’s report are examples only and should not be viewed as representative of or a complete description of the compliance control objectives or related controls a service provider might be expected to (1) establish and implement to meet any contractual responsibilities to funds or any other clients (2) monitor for investment compliance, or (3) include in its description of specified compliance control objectives and related controls in an examination engagement covered by this Statement of Position (SOP). Additionally, there may be other areas of responsibility (beyond investment compliance) that a service provider might assume on behalf of funds or any other clients that might result in the inclusion and presentation of different or additional compliance control objectives and related controls for engagements covered by this SOP.

Report of Independent Accountants

To the Management of XYZ Service Provider:

[Introductory paragraph]

We have examined the assertion made by the management of XYZ Service Provider pertaining to controls over investment compliance that XYZ Service Provider performs for user organizations. Management’s assertion is included in the accompanying document titled, “Management’s Assertion Regarding XYZ Service Provider’s Specified Compliance Control Objectives and Related Controls” and states that:

- The controls described in the accompanying document, “XYZ Service Provider’s Description of Specified Compliance Control Objectives and Related Controls” (management’s description), were suitably designed as of December 31, 20X1 to provide reasonable assurance that the compliance control objectives established by management and described therein would be achieved, if those controls were complied with satisfactorily *[and user organizations applied the controls contemplated in the design of XYZ Service Provider’s controls]*¹:
- The controls described in management’s description were operating with sufficient effectiveness to provide reasonable assurance that the specified compliance control objectives described therein were

¹ Refer to user controls only in situations in which the application of controls by the user organizations is necessary to achieve the specified control objectives. Otherwise omit this reference. Also, if the application of controls by the subservice provider is necessary to achieve the specified compliance control objectives, and the subservice provider’s controls are excluded from the description, the practitioner’s report should be modified to include the phrase, “and the subservice provider applied the controls contemplated in the design of XYZ Service Provider’s controls.”

achieved during the period from January 1, 20X1 to December 31, 20X1.

As stated in management's description, XYZ Service Provider uses a computer processing service provider for all of its computerized application processing. Management's description includes only those compliance control objectives and related controls of XYZ Service Provider, and does not include compliance control objectives and related controls of the computer processing service provider. Our examination did not extend to controls of the computer processing service provider.

Management of XYZ Service Provider is responsible for its assertion. Our responsibility is to express an opinion on management's assertion based on our examination.

[Scope paragraph]

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 and evaluating the suitability of the design and operating effectiveness of the controls in achieving the specified compliance control objectives; and examining, on a test basis, evidence supporting management's assertion and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

We were not engaged to perform and did not perform an examination of XYZ Service Provider's or user organizations' compliance or internal control over compliance with Federal Securities Laws, as that term is defined by Securities and Exchange Commission (SEC) Rule 38a-1 under the Investment Company Act of 1940 ("Federal Securities Laws"). We also were not engaged to perform and did not perform an examination of XYZ Service Provider's compliance with its contractual obligations to its clients during the period from January 1, 20X1 to December 31, 20X1.

Our examination was limited to examining, for the purposes described above, management's assertion about the specified compliance control objectives and related controls included in management's description and did not consider any other compliance control objectives or controls that may be relevant to XYZ Service Provider's or user organizations' compliance or internal control over compliance with Federal Securities Laws. Further, the relative effectiveness and significance of specific controls at XYZ Service Provider, and their effect on user organizations' compliance or internal control over compliance with Federal Securities Laws are dependent on their interaction with the controls and other factors present at individual user organizations and at subservice providers. We have performed no procedures to evaluate the effectiveness of such controls or such other factors at individual user organizations or at subservice providers.

The compliance control objectives and related controls set forth in management's description have been provided to enable user organizations, when performing their annual compliance reviews as required by SEC Rule 38a-1 under the Investment Company Act of 1940, to consider such information along with information about their own compliance or internal control over compliance with Federal Securities Laws, and any other relevant information.

[Inherent limitations paragraph]

Management's description is as of December 31, 20X1. 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 or controls in existence. The potential effectiveness of controls in achieving the specified compliance control

objectives established by XYZ Service Provider is subject to inherent limitations and, accordingly, lack of compliance with controls and instances of errors or fraud may occur and not be detected. Furthermore, the projection of any evaluations, based on our findings, to future periods is subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with such controls may deteriorate, or changes made to the system or controls, or the failure to make needed changes to the system or controls, may alter the validity of such evaluations.

[Opinion paragraph]

In our opinion, management's assertion referred to above is fairly stated, in all material respects, based on the specified compliance control objectives set forth in management's description.

[Restricted use paragraph]

This report is intended solely for the information and use of chief compliance officers, management, boards of directors, and the independent auditors of XYZ Service Provider and of the entities that use the services of XYZ Service Provider, and is not intended to be and should not be used by anyone other than these specified parties.

[Signature of Independent Accountant]

March 31, 20X2

Appendix A-3 — Illustrative Management Assertion Regarding a Service Provider’s Specified Compliance Control Objectives and Related Controls

Management’s Assertion Regarding XYZ Service Provider’s Specified Compliance Control Objectives and Related Controls

XYZ Service Provider provides certain investment compliance services to funds (user organizations). XYZ Service Provider’s description of specified compliance control objectives and related controls is presented in the accompanying document, “XYZ Service Provider’s Description of Specified Compliance Control Objectives and Related Controls” (management’s description). We, as members of management of XYZ Service Provider, are responsible for the description as well as for the suitability of the design and operating effectiveness of those controls.

Management’s description is provided to enable user organizations, when performing their annual compliance review as required by Securities and Exchange Commission (SEC) Rule 38a-1 under the Investment Company Act of 1940, to consider such information, along with information about their own compliance and internal control over compliance with Federal Securities Laws, as that term is defined in Rule 38a-1, and any other relevant information. We have evaluated the suitability of the design and operating effectiveness of these controls in achieving the compliance control objectives included in management’s description during the period from January 1, 20X1 through December 31, 20X1. The criteria against which the controls were evaluated are the specified compliance control objectives included in management’s description. Based on our evaluation, we assert that:

- The controls included in management’s description were suitably designed as of December 31, 20X1 to provide reasonable assurance that the compliance control objectives described therein would be achieved, if those controls were complied with satisfactorily [*and user organizations applied the controls contemplated in the design of XYZ Service Provider’s controls*¹].
- The controls set forth in management’s description were operating with sufficient effectiveness to provide reasonable assurance that the specified compliance control objectives, included in management’s description, were achieved during the period from January 1, 20X1 to December 31, 20X1.

By: _____

[*Signature, name, and title of appropriate official*]

By: _____

[*Signature, name, and title of appropriate official*]

¹ Refer to user controls only in situations in which the application of controls by the user organizations is necessary to achieve the specified control objectives. Otherwise omit the reference. Also, if the application of controls by a subservice provider is necessary to achieve the specified compliance control objectives, and the subservice provider’s controls are excluded from the description, the practitioner’s report should be modified to include the phrase, “and the subservice provider applied the controls contemplated in the design of XYZ Service Provider’s controls.”

Appendix A-4 — Illustrative Service Provider’s Description of Specified Compliance Control Objectives and Related Controls

XYZ Service Provider’s Description of Specified Compliance Control Objectives and Related Controls

Note: The following is an illustration of a description of investment compliance control objectives and related controls for an investment adviser (XYZ Service Provider) performing investment compliance-related services for funds.¹ This illustration is presented solely to provide an example of control objectives and related controls pertaining to investment-compliance related services and should not be viewed as representative of or a complete set of compliance control objectives or related controls that a service provider might be expected to (1) perform in these circumstances or similar circumstances, (2) establish and implement to meet any contractual responsibilities to funds or any other clients, or (3) include in its written description of specified compliance control objectives and related controls in an examination engagement covered by this Statement of Position (SOP). Additionally, there may be other areas of responsibility (beyond investment compliance) that a service provider might assume on behalf of funds or any other clients that might result in the inclusion and presentation of different or additional compliance control objectives and related controls for engagements covered by this SOP.

Monitoring Compliance with Fund Investment Guidelines and Restrictions

[XYZ Service Provider uses a computer processing service provider for all of its computerized application processing.² The accompanying description includes only those compliance control objectives and related controls of XYZ Service Provider, and does not include compliance control objectives and related controls of the computer processing service provider.]

Control Objective 1: Controls provide reasonable assurance that securities trades for the fund and the fund’s securities holdings comply with investment guidelines and restrictions included in the fund’s investment advisory agreement, prospectus, and statement of additional information.

Controls:

1. Before any securities trading commences for a fund (a) XYZ Service Provider’s trading desk representative enters information (coding) in the fund’s securities trading order entry and compliance (STOEC) module to reflect all investment guidelines and restrictions included in the documents identified in Control Objective 1, and (b) a supervisor in XYZ Service Provider’s fund services department compares, for completeness and accuracy, the information (coding) entered in the

¹ In this illustration, the investment adviser performs investment compliance-related services in addition to investment advisory services for funds. In other situations, investment compliance-related services may be performed, in whole or in part, by one or more other service providers or subservice providers.

² If the service provider uses a subservice provider, management’s description should include a brief statement of the functions and nature of the services performed by the subservice provider. In addition, the description should indicate whether the subservice provider’s compliance control objectives and related controls are included in or excluded from the description. See paragraphs .16–.17 of the Statement of Position for additional information about the information to be included in this disclosure.

fund's STOEC module to the corresponding information included in the source documents referred to in Control Objective 1. Any discrepancies that appear to be the result of data entry errors (for example, entering the number 50% when the prospectus states 5%) are corrected upon identification by XYZ Service Provider. Any other discrepancies related to differences in interpretation or uncertainty about the meaning of information in the source documents, are communicated to the fund's treasurer or chief compliance officer for research, clarification, and resolution. Any subsequent changes to the original information (coding) entered by XYZ Service Provider must be approved by the fund's treasurer or chief compliance officer.

2. On a daily basis, a report of all deletions, modifications, and additions made to investment guidelines and restrictions in the fund's STOEC module is reviewed by a supervisor in XYZ Service Provider's fund services department. The supervisor compares each change made to a written authorization to effect the change submitted by the fund's treasurer or chief compliance officer.
3. Annually, a supervisor in XYZ Service Provider's fund services department compares, for completeness and accuracy, the current information (coding) in each fund's STOEC module to the corresponding source documents referred to in the Control Objective.
4. For all securities trades for which the functionality of a fund's STOEC module identifies an apparent or possible noncompliant securities trade order, the order is 'pending' until the fund's treasurer or chief compliance officer reviews the circumstances of the requested trade and determines whether it is permissible. If permissible, the 'pending' trade is released for processing upon written approval by either the fund's treasurer or chief compliance officer. If not permissible, the trade is cancelled. On the basis prescribed in the fund's compliance policies and procedures (daily, weekly, monthly, or quarterly), members of the compliance staff of XYZ Service Provider review reports generated by the STOEC module to ascertain that no violations of the fund's investment guidelines and restrictions have occurred. Any violations are researched, and XYZ Service Provider's compliance staff ascertains that corrective actions were approved by the fund's treasurer or chief compliance officer, and effected.

Control Objective 2: Controls provide reasonable assurance that the dollar-weighted average portfolio maturities (WAPM) of money market funds do not exceed 90 days, as required by Securities and Exchange Commission (SEC) Rule 2a-7.

Controls:

1. For each new security purchased, a trade department analyst at XYZ Service Provider compares the terms entered in the trade system to the corresponding information in the documentation of the security purchase, including the date used for the WAPM calculation (for example, interest-rate reset date or maturity date).
2. On a quarterly basis, XYZ Service Provider's compliance staff verifies that the computation logic in its securities accounting system (SAS), which affects the calculation of the funds' WAPM, is consistent with applicable provisions of SEC Rule 2a-7 and regulatory guidance issued.

3. On a daily basis, using reports and information produced by the SAS, XYZ Service Provider's compliance staff determines whether any of the funds' WAPM exceeds 75 days. If so, the compliance staff alerts the portfolio manager so that this information can be taken into account by the portfolio manager when making prospective investment management decisions for the fund. If a fund's WAPM exceeds 80 days, the compliance staff also alerts the fund's treasurer.
4. On a daily basis, using reports and information produced by the SAS, XYZ Service Provider's compliance staff identifies changes of 3 days or more in any fund's WAPM from the fund's prior day WAPM, and researches the fund's investing activities sufficiently to identify the reason for the change and whether there is a reasonable basis for the change. The results of the research are documented and provided to a compliance department manager for his or her written review and approval.

Appendix B — Illustrative Practitioner’s Examination Report Containing a Qualified Opinion on the Suitability of the Design and Operating Effectiveness of a Service Provider’s Controls in Achieving Specified Compliance Control Objectives

Paragraph .66 of AT section 101 (AICPA, Professional Standards) states, in part, “If conditions exist that individually or in combination result in one or more material misstatements or deviations from the criteria, the practitioner should modify the report and, to most effectively communicate with the reader of the report, should ordinarily express his or her conclusion directly on the subject matter, not on the assertion.” The following illustrative practitioner’s report relates to an examination engagement in which the practitioner identified a control deficiency in the operating effectiveness of the service provider’s controls; accordingly, the practitioner reports on the subject matter, rather than on the assertion. Also, in an explanatory paragraph preceding the opinion paragraph, the practitioner describes the matters giving rise to the qualification. In this engagement, the practitioner has concluded that the deficiency in controls is not sufficiently pervasive to warrant an adverse opinion.

Report of Independent Accountants

To the Management of ABC Service Provider:

[Introductory paragraph]

We have examined whether the controls described in the accompanying document, “ABC Service Provider’s Description of Specified Compliance Control Objectives and Related Controls” (management’s description), were:

- Suitably designed, as of December 31, 20X1, to provide reasonable assurance that the specified compliance control objectives established by management of ABC Service Provider and described therein would be achieved, if those controls were complied with satisfactorily; *[and user organizations applied the controls contemplated in the design of ABC Service Provider’s controls¹]*; and
- Operating with sufficient effectiveness to provide reasonable assurance that the specified compliance control objectives described therein were achieved during the period from January 1, 20X1 to December 31, 20X1.

Management of ABC Service Provider is responsible for the suitability of the design and operating effectiveness of these controls in achieving the specified compliance control objectives. Our responsibility is to express an opinion based on our examination.

¹ Refer to user controls only in situations in which the application of controls by the user organizations is necessary to achieve the specified control objectives. Otherwise omit this reference.

[Scope paragraph]

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 suitability of the design and operating effectiveness of the controls in achieving the specified compliance control objectives and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

We were not engaged to perform and did not perform an examination of ABC Service Provider's or user organizations' compliance or internal control over compliance with Federal Securities Laws, as that term is defined by Securities and Exchange Commission (SEC) Rule 38a-1, under the Investment Company Act of 1940 ("Federal Securities Laws"). We also were not engaged to perform and did not perform an examination of ABC Service Provider's compliance with its contractual obligations to its clients during the period from January 1, 20X1 to December 31, 20X1.

Our examination was limited to examining, for the purposes described above, the suitability of the design and operating effectiveness of the controls in achieving the specified compliance control objectives included in management's description and did not consider any other compliance control objectives or controls that may be relevant to ABC Service Provider's or user organizations' compliance or internal control over compliance with Federal Securities Laws. Further, the relative effectiveness and significance of specific controls at ABC Service Provider, and their effect on user organizations' compliance or internal control over compliance with Federal Securities Laws 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 such controls or such other factors at individual user organizations.

The compliance control objectives and related controls set forth in management's description have been provided to enable user organizations, when performing their annual compliance reviews as required by SEC Rule 38a-1 under the Investment Company Act of 1940, to consider such information along with information about their own compliance or internal control over compliance with Federal Securities Laws, and any other relevant information.

[Inherent limitations paragraph]

Management's description is as of December 31, 20X1. 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 or controls in existence. The potential effectiveness of controls in achieving the specified compliance control objectives established by ABC Service Provider is subject to inherent limitations and, accordingly, lack of compliance with controls and instances of errors or fraud may occur and not be detected. Furthermore, the projection of any evaluations, based on our findings, to future periods is subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with such controls may deteriorate, or changes made to the system or controls, or the failure to make needed changes to the system or controls, may alter the validity of such evaluations.

[Explanatory paragraph]

Management of ABC Service Provider has included in its description a control requiring that the manager of the advertising and sales department review and approve performance data used in ABC Service Provider's advertising and sales

literature prior to its release to the public. Our tests of operating effectiveness noted that the manager of the advertising and sales department did not review and approve the aforementioned performance data prior to its release to the public. The manager's failure to perform this control is a deficiency in the operating effectiveness of the service provider's controls that resulted in the nonachievement of the compliance control objective included in management's description: "Performance data used in advertising and sales literature are accurate and approved before release to the public."

[Opinion paragraph]

In our opinion ABC Service Provider's controls were suitably designed at December 31, 20X1 to provide reasonable assurance that the specified compliance control objectives, as described in management's description, would be achieved, if those controls were complied with satisfactorily *[and user organizations applied the controls contemplated in the design of ABC Service Provider's controls²]*. Also, in our opinion, except for the deficiency described in the preceding paragraph, ABC Service Provider's controls were operating with sufficient effectiveness to provide reasonable assurance that the specified compliance control objectives were achieved during the period from January 1, 20X1 through December 31, 20X1, based on the specified compliance control objectives set forth in management's description.³

[Restricted use paragraph]

This report is intended solely for the information and use of chief compliance officers, management, boards of directors, and the independent auditors of ABC Service Provider and of the entities that use the services of ABC Service Provider, and is not intended to be and should not be used by anyone other than these specified parties.

[Signature of Independent Accountant]

March 31, 20X2

² Refer to user controls only in situations in which the application of controls by the user organizations is necessary to achieve the specified control objectives. Otherwise omit this reference.

³ In instances in which a control is not suitably designed, the phrase "except for the deficiency described in the preceding paragraph" would be inserted in the first sentence of the opinion paragraph, which relates to the suitability of the design of controls.

Appendix C — Additional Illustrative Compliance Control Objectives

Note: The following are additional illustrative compliance control objectives pertaining to various services service providers might provide. These illustrative compliance control objectives are only examples and should not be viewed as representative of or a complete set or description of compliance control objectives that a service provider might be expected to (1) establish and implement to meet any contractual responsibilities to funds or any other clients, (2) monitor for achievement, or (3) include in its description of specified compliance control objectives and related controls in an attestation engagement covered by this Statement of Position (SOP). Additionally, there may be other areas of responsibility (beyond those listed below) that a service provider might assume on behalf of funds or any other clients that might result in the inclusion and presentation of different or additional compliance control objectives and related controls for engagements covered by this SOP.

Fund Advertising and Sales Literature

Controls provide reasonable assurance that:

1. Advertising and sales literature is reviewed for compliance with the service provider's established policies and is timely submitted to the National Association of Securities Dealers (NASD) for approval
2. Comments from the NASD on advertising and sales literature are reviewed and timely reflected in advertising and sales literature as required
3. Performance data used in advertising and sales literature are accurate and approved before release
4. Expiring advertisement and sales literature is identified and updated or disposed of before the expiration date
5. Regulatory changes are monitored and reflected in current and future advertising and sales literature

Valuation of Client Assets or Investments

Controls provide reasonable assurance that:

1. Securities price information is received from authorized sources in accordance with client instructions and is entered completely and accurately into the portfolio accounting system
2. Foreign exchange rates are received from authorized sources in accordance with client instructions and are entered completely and accurately into the portfolio accounting system
3. Securities that do not have readily determinable market values (for example, those valued at fair value in good faith), including international equity securities whose values are determined by adjusting the closing price on the foreign securities exchange, are valued according to consistently applied policies and procedures established by the service provider's client

4. For registered money-market-fund securities valued at amortized cost, valuation is monitored for compliance with the “mark-to-market” provision of Securities and Exchange Commission (SEC) Rule 2a-7 and deviations in excess of established thresholds are reported in accordance with client instructions

Privacy

Controls provide reasonable assurance that:

1. The use of and access to nonpublic client information is restricted to authorized personnel
2. Customers of the fund are provided with a notice of privacy policies at the time they become a customer and in the event of a change to the privacy policy
3. Access to and use of material nonpublic information is restricted to authorized personnel
4. At least annually, employees are provided with written policies related to material nonpublic information and instruction about those policies
5. Customer information is disclosed only to authorized third parties

Transfer Agency

Controls provide reasonable assurance that:

1. As required by policies and procedures, the identity of any person seeking to open an account with the fund is verified by examining specified documents and other information and maintaining records of the information used to verify the person’s identity
2. Cash equivalents under \$10,000 are monitored and tracked for a rolling 12-month period; Internal Revenue Service (IRS) Form 8300 is filed, and the shareholder is notified as required by the IRS
3. Certificate redemption requests are processed in a timely manner and archived in a secure manner for subsequent inquiry
4. Missing, lost, stolen, or counterfeit certificate notifications are processed in a timely manner, and Form X-17F-1A is filed with the Securities Information Center within the required number of business days
5. Transfer agent employees are fingerprinted and the related records are maintained for the required time period
6. Shareholder financial-related transactions are priced using the appropriate net asset value per share
7. Dividends are processed completely and accurately; dividend distributions are reconciled between the fund’s general ledger and the shareholder accounting system; and any exceptions are researched and resolved by the next reporting period
8. Signature guarantees pertaining to shareholder transactions are reviewed upon presentment; rejected signature guarantees are communicated to the compliance department for tracking

Investment Compliance

Controls provide reasonable assurance that on a weekly basis:

1. Securities holdings are monitored for compliance with prospectus guidelines

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2. Securities holdings are monitored to ensure that the portfolio meets a 15 percent liquidity standard
3. Securities of money market funds are monitored for compliance with the portfolio maturity and credit quality provisions of SEC Rules 2a-7c.2 and 2a-7c.3, respectively

Appendix D — Matters Identified in Securities and Exchange Commission Release Nos. IC-26299 and IA-2204 Adopting Rules 38a-1 and 206(4)-7 Pertaining to Compliance Policies and Procedures of Funds and Investment Advisers

As described in paragraph .15 of this Statement of Position (SOP), when management of the service provider establishes the compliance control objectives and related controls that are the subject of the engagement, it should consider, among other things, the compliance matters identified in Securities and Exchange Commission (SEC) Release Nos. IC-26299 and IA-2204 adopting Rule 38a-1 under the Investment Company Act of 1940 and Rule 206(4)-7 under the Investment Advisers Act of 1940, respectively. The SEC Release indicates that the SEC expects the policies and procedures of funds and their advisers to, at a minimum, address the following specified areas if those areas are relevant to the services the entity provides:

- Portfolio management processes, including allocation of investment opportunities among clients, and consistency of portfolios with clients' investment objectives, disclosures by the adviser, and applicable regulatory restrictions
- Trading practices, including procedures by which the adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services (soft dollar arrangements), and allocates aggregated trades among clients
- Proprietary trading of the adviser and personal trading activities of supervised persons
- Accuracy of disclosures made to investors, clients, and regulators, including account statements and advertisements
- Safeguarding of client assets from conversion or inappropriate use by advisory personnel
- Accurate creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction
- Marketing advisory services, including the use of solicitors
- Processes to value client holdings and assess fees based on those valuations
- Safeguards for the privacy protection of client records and information
- Business continuity plans

Additional matters that the SEC expects funds (or their service providers) to address are listed in paragraph .02. This SOP does not require that a service provider's compliance control objectives address all of the relevant areas identified in the SEC Release; however, the areas listed in this paragraph and in paragraph .02 comprise matters that, if relevant in the circumstances, should

be considered by management of the service provider in determining compliance control objectives to be included in the scope of the attestation engagement.

The following is a summary of the additional areas, identified in the SEC Release, for which a fund or its service providers would be expected to have policies and procedures.

Pricing of portfolio securities and fund shares. The Investment Company Act of 1940 requires funds to sell and redeem their shares at prices based on their current net asset value, to pay redemption proceeds promptly, and, when market quotations are readily available, to calculate net asset values using the market value of the portfolio securities. If a market quotation is not readily available, the fund should use the fair value of the security, as determined in good faith by the fund's board. Further, Rule 38a-1 requires funds to adopt policies and procedures requiring 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.

Processing of fund shares. Pursuant to SEC rules, an investor submitting a purchase order or redemption request must receive the price next calculated after receipt of the purchase order or redemption request. A fund must have procedures in place that segregate investor orders received before the fund prices its shares (which will receive that day's price) from those that were received after the fund prices its shares (which will receive the following day's price). Rule 38a-1 requires funds to approve and periodically review the policies and procedures of transfer agents. Funds should also take affirmative steps to protect themselves and their shareholders against late trading by obtaining assurances that those policies and procedures are effectively administered.

Identification of affiliated persons. To prevent self-dealing and overreaching by persons in a position to take advantage of the fund, the Investment Company Act of 1940 prohibits funds from entering into certain transactions with affiliated persons. Funds should have policies and procedures in place to identify these persons and to prevent unlawful transactions with them.

Protection of nonpublic information. The federal securities laws prohibit insider trading, and section 204A of the Investment Advisers Act of 1940 requires investment advisers (including advisers to funds) to establish, maintain, and enforce policies and procedures designed to prevent the adviser or any of its associated persons from misusing material, nonpublic information. Fund advisers should incorporate their section 204A policies into the policies required by Rule 38a-1. A fund's compliance policies and procedures should also address other potential misuses of nonpublic information, including the disclosure to third parties of material information about the fund's portfolio, its trading strategies or pending transactions, and the purchase or sale of fund shares by advisory personnel based on material, nonpublic information about the fund's portfolio.

Compliance with fund governance requirements. Fund boards are responsible for, among other things, approving the fund's advisory contracts, underwriting agreements, and distribution plans. The Investment Company Act of 1940 requires that fund boards be elected by fund shareholders and that a certain percentage of the board be "independent directors." To rely on many of the SEC's exemptive rules, independent directors must constitute a majority of the

board, must be selected and nominated by other independent directors, and, if they hire legal counsel, must hire independent legal counsel. A fund's policies and procedures should be designed to guard against, among other things, an improperly constituted board, the failure of the board to properly consider matters entrusted to it, and the failure of the board to request and consider information required by the Investment Company Act of 1940 from the fund adviser and other service providers.

Market timing. Under Rule 38a-1, a fund must have procedures reasonably designed to ensure compliance with its disclosed policies regarding market timing. Market timing is the excessive short-term trading of mutual fund shares that may be harmful to the fund. These procedures should provide for monitoring of shareholder trades or flows of money in and out of the funds in order to detect market timing activity, and for consistent enforcement of the fund's policies regarding market timing. If the fund permits any waivers of those policies, the procedures should be reasonably designed to prevent waivers that would harm the fund or its shareholders or subordinate the interests of the fund or its shareholders to those of the adviser or any other affiliated person or associated person of the adviser. Fund boards are strongly urged by the SEC to require fund advisers, or other persons authorized to waive market timing policies, to report to the board at least quarterly all waivers granted so that the board can determine whether the waivers were proper. Many funds' prospectuses already disclose market timing policies, and failure to adhere to those disclosed policies violates the antifraud provisions of the federal securities laws. Moreover, a fund adviser who waives or disregards those policies for the benefit of itself or a third party has breached its fiduciary responsibilities to the fund.

Appendix E — Illustrative Practitioner’s Agreed-Upon Procedures Report

The following is an illustrative agreed-upon procedures report for procedures performed at a service provider.

Independent Accountant’s Report on Applying Agreed-Upon Procedures

To the Management of XYZ Service Provider:

We have performed the procedures enumerated in Attachment X which were agreed to by XYZ Service Provider, solely to assist you in evaluating XYZ Service Provider’s internal control over compliance during the year ended December 31, 20X1. Management of XYZ Service Provider is responsible for maintaining effective internal control over compliance with federal securities laws, regulations, and related SEC rules. 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 XYZ Service Provider. Consequently, we make no representation regarding the sufficiency of the procedures described in Attachment X either for the purpose for which this report has been requested or for any other purpose.

The procedures performed and the findings are included in Attachment X.

We were not engaged to and did not conduct an examination, the objective of which would be the expression of an opinion on internal control over compliance by XYZ Service Provider for the year ended December 31, 20X1. 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 XYZ Service Provider and is not intended to be and should not be used by anyone other than this specified party.¹

[Signature of Independent Accountant]

March 31, 20X2

¹ Paragraph .36 of AT section 201, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*), and paragraph .36 of this SOP address adding specified parties as users of an agreed-upon procedures report.

Chief Compliance Officers Task Force

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The AICPA is grateful to Stephen Callahan, Matthew Epp, Michael P. Fay, Kevin W. O'Connell, and Mark Twerdok for their technical assistance with this document.

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[The next page is 31,901.]

Section 14,450

Statement of Position 12-1 — Reporting Pursuant to the Global Investment Performance Standards

October 2012

NOTE

This Statement of Position (SOP) is an interpretative publication, and it represents the recommendations of the AICPA's Investment Performance Standards Task Force regarding the application of Statements on Standards for Attestation Engagements (SSAEs) to engagements to report pursuant to Global Investment Performance Standards. The Auditing Standards Board (ASB) has found the recommendations in this SOP to be consistent with existing standards covered by Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, ET sec. 202 par. .01), of the AICPA Code of Professional Conduct.

Interpretative publications are not as authoritative as a pronouncement of the ASB; however, if a practitioner does not apply the attestation guidance included in this SOP, the practitioner should be prepared to explain how he or she complied with the SSAE provisions addressed by this SOP.

Introduction and Background

.01 To promote fair representation, full disclosure, and greater comparability of investment performance, the CFA Institute developed the Global Investment Performance Standards (GIPS® standards).¹ Although compliance with the GIPS standards is voluntary, an investment management firm's claim of compliance with the GIPS standards gives current and potential clients more confidence in the integrity of the performance presentations and the general practices of a compliant firm.

.02 All references to the GIPS standards in this Statement of Position (SOP) refer to the 2010 edition of the GIPS standards. The GIPS standards specify that they include any updates, guidance statements, interpretations, questions and answers, and clarifications published by the CFA Institute and the GIPS Executive Committee, all of which are available at www.gipsstandards.org, as well as in the *GIPS Handbook*.

.03 The GIPS standards recommend that investment management firms obtain independent third-party verification. *Verification* is a process in which an independent third party, referred to as a verifier, assesses whether (a) the firm has complied with all the composite construction requirements of the GIPS standards on a firmwide basis, and (b) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification is intended to provide a firm and its existing and prospective clients with greater confidence in the firm's claim of compliance with the GIPS standards. Verification does not provide absolute assurance that a firm is in compliance with the GIPS standards.

¹ For information on the appropriate use of the Global Investment Performance Standards registered trademark, see the CFA Institute website at www.cfainstitute.org.

.04 In addition to verification, a firm may choose to have a verifier perform a specifically focused performance examination of any of the firm's composites and their associated compliant presentations. A *compliant presentation* is defined as a presentation for a composite that contains all the information required by the GIPS standards and that may also include additional or supplemental information. The GIPS standards permit a report on the performance examination of a composite and its associated compliant presentation to be issued only if a verification report has also been issued.

.05 A verifier may or may not be a CPA. A CPA in the practice of public accounting hired to perform a verification or performance examination is referred to in this SOP as a practitioner.

Scope

.06 This SOP provides guidance to practitioners for engagements to examine and report on aspects of a firm's claim of compliance with the GIPS standards (a verification). It also provides guidance on engagements to examine and report on any of the firm's composites and their associated compliant presentations (a performance examination). Practitioners are required to perform such engagements pursuant to AT section 101, *Attest Engagements* (AICPA, *Professional Standards*).

.07 Although a verification consists of examining aspects of a firm's compliance with the GIPS standards and the design of certain policies and procedures, a verification is not a compliance attestation engagement or an internal controls attestation engagement as governed by AT section 601, *Compliance Attestation*, and AT section 801, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*), respectively.

.08 This SOP supersedes SOP 06-1, *Reporting Pursuant to the Global Investment Performance Standards*. This SOP also supersedes paragraphs 11.37–42 of chapter 11, "Independent Auditor's Reports and Client Representations," of the AICPA Audit and Accounting Guide *Investment Companies* (as of May 1, 2012).

Overview of the GIPS Standards

Compliance With the GIPS Standards

.09 The GIPS standards establish both requirements and recommendations for firms to follow when calculating and presenting investment performance. Adherence to the recommendations of the GIPS standards is encouraged. The GIPS standards use the term *must* to indicate requirements and the term *should* to indicate recommendations. AT section 101 uses the terms *must*, *is required*, or *should* to indicate requirements and *may* to indicate recommendations. To avoid confusion, this SOP uses the terms *is required* or *must* to indicate requirements of AT section 101 or the GIPS standards.

.10 The GIPS standards require an entity to define itself as a firm. For a firm to claim compliance with the GIPS standards, the firm must meet all the requirements of the GIPS standards on a firmwide basis. Firms are prohibited from claiming compliance "except for ..." or making any other statements that may indicate partial compliance with the GIPS standards.

.11 The GIPS standards provide *suitable criteria*, as defined in AT section 101, for verifications and performance examinations. The criteria are available

to *users*, as defined in AT section 101, as they are posted to www.gipsstandards.org. The GIPS standards require verifiers to use the criteria set forth therein. Consequently, practitioners who perform a verification or performance examination pursuant to the GIPS standards are required to understand the GIPS standards, including interpretative guidance.

.12 Practitioners are required to be independent of the firm, in accordance with the AICPA Code of Professional Conduct and the *GIPS Guidance Statement on Verifier Independence*.

Verification

- .13 A verification tests whether the
- firm has complied with all the composite construction requirements of the GIPS standards on a firmwide basis.
 - firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards.

The GIPS standards specify procedures that practitioners are required to perform for a verification, as well as recommendations and guidance (see chapter IV of the GIPS standards, the *GIPS Guidance Statement on Verification*, and the *GIPS Guidance Statement on Verifier Independence*).

.14 According to the GIPS standards, when a firm has obtained a verification report, the firm may state that it is verified. This statement may or may not be accompanied by a presentation of performance history for a specific composite. A verification, however, does not imply that the verifiers have examined the accuracy of the performance results of any specific composite presentation that may accompany the verification report (see paragraph .39).

Performance Examination

.15 In addition to a verification, a firm may choose to have a verifier conduct a performance examination. The GIPS standards specify procedures that practitioners are required to perform for a performance examination and also include recommendations and guidance (see the *GIPS Guidance Statement on Performance Examinations*). A verification is required to be performed prior to, or concurrent with, any performance examination. A firm is not permitted to state that a particular composite and its associated compliant presentation have been independently examined with respect to the GIPS standards unless the firm has also obtained a firmwide verification report covering the periods of the performance examination. Firms cannot state that a particular composite and its associated compliant presentation have been GIPS verified or make any claim to that effect.

Verification and Performance Examination Engagements

Engagement Objectives

.16 Practitioners are required to conduct verifications and performance examinations in accordance with attestation standards established by the AICPA. In addition, the GIPS standards specify that these engagements must be conducted in accordance with the procedures required in the GIPS standards. This SOP is not intended to provide all the required and recommended procedures set forth in the GIPS standards or all the applicable attestation standards established by the AICPA.

.17 For a verification, the practitioner's objective is to express an opinion on whether, in all material respects, the

- a. firm has complied with all the composite construction requirements of the GIPS standards on a firmwide basis.
- b. firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards.

.18 For a performance examination of a specific composite, the practitioner's objective is to express an opinion on whether, in all material respects, the firm has

- a. constructed the composite and calculated the composite performance in compliance with the GIPS standards.
- b. prepared and presented the composite presentation in compliance with the GIPS standards.

A firm that has met the requirements of the GIPS standards with regard to a specific composite presentation is considered to have prepared and presented that composite presentation in compliance with the GIPS standards.

Planning the Engagement

.19 Paragraph .44 of AT section 101 specifies that planning an attest engagement involves developing an overall strategy for the expected conduct and scope of the engagement. To develop such a strategy, practitioners need to have sufficient knowledge to enable them to adequately understand the events, transactions, and practices that, in their judgment, have a significant effect on the subject matter or assertions. Such knowledge includes a sufficient understanding of the investment management industry and the GIPS standards, AICPA interpretive guidance, and applicable laws and regulations regarding the calculation and presentation of investment performance. The GIPS standards also address qualifications for verifiers.

Establishing an Understanding With the Client

.20 The practitioner is required to establish an understanding with the client regarding the services to be performed to reduce the risk that either the practitioner or client may misinterpret the needs or expectations of the other party. The understanding is required to include the objectives of the engagement, management's responsibilities, the practitioner's responsibilities, limitations of the engagement, and any limitations on the use of the practitioner's name and report. The understanding may include a statement that if the client intends to use the practitioner's report(s) or refer to the practitioner in connection with any sales or advertising literature, the client will provide a draft of such literature to the practitioner for his or her review and comment prior to issuance.

.21 The practitioner is required to document the understanding in the working papers, preferably through a written communication with the client, such as an engagement letter (see appendix A, "Example Engagement Letter — Verification and Performance Examination," of this SOP for an example engagement letter).

Obtaining Sufficient Evidence

.22 In conducting an attest examination, the practitioner's objective is to accumulate sufficient evidence to restrict attestation risk² to a level that is, in the practitioner's professional judgment, appropriately low for the high level of assurance that may be inferred by his or her report. A practitioner is required to select from all available procedures (that is, procedures that assess inherent and control risk and that restrict detection risk) any combination that can mitigate attestation risk to such an appropriately low level.

.23 When conducting an attest examination, the practitioner is required to consider the following presumptions, bearing in mind they are not mutually exclusive and may be subject to important exceptions:

- Evidence obtained from independent sources outside an entity provides greater assurance about the subject matter or assertion than evidence secured solely from within the entity.
- Information obtained from the practitioner's direct personal knowledge (such as through physical examination, observation, computation, operating tests, or inspection) is more persuasive than information obtained indirectly.
- The more effective the controls over the subject matter, the more assurance they provide about the subject matter or assertion.

.24 As noted previously, the GIPS standards specify procedures that practitioners are required to perform for a verification and performance examination of one or more specific composites and their associated compliant presentations, as well as recommendations and guidance (see chapter IV of the GIPS standards, the *GIPS Guidance Statement on Verification*, the *GIPS Guidance Statement on Performance Examinations*, and the *GIPS Guidance Statement on Verifier Independence*). A practitioner may perform other procedures in addition to those specified in the GIPS standards. Regardless of the scope of the engagement, the practitioner is required to obtain sufficient evidence to provide a reasonable basis for the opinion expressed in the report.

.25 The GIPS standards permit the use of a sampling methodology when performing verification or performance examination procedures. The practitioner may find it helpful to consider the guidance in the AICPA Audit Guide *Audit Sampling* when performing procedures that involve the use of sampling.

.26 The GIPS standards specify that a verifier must understand the firm's policies and procedures for establishing and maintaining compliance with all the applicable requirements and adopted recommendations of the GIPS standards, evaluate whether all applicable policies are properly included and adequately documented, and then test the firm's compliance with the established policies and procedures.

.27 When a performance examination of one or more composites and their associated presentations is conducted subsequent to, not concurrent with, a verification, the practitioner is required to update the practitioner's understanding of the firm's policies and procedures and inquire about any other changes that may affect the planning and conduct of the performance examination. In addition, the practitioner is required to follow the preperformance examination procedures required by the GIPS standards.

² See footnote 9 in paragraph 45 of AT section 101, *Attest Engagement* (AICPA, *Professional Standards*), for the definition of *attestation risk*.

.28 The GIPS standards require that firms initially claiming compliance with the GIPS standards report, at a minimum, 5 years of investment performance for each composite presented (or performance since inception of the composite or firm if the period since inception is less than 5 years). After the initial presentation of GIPS-compliant performance, the firm must add an additional year of performance until the firm presents a 10-year GIPS-compliant performance record. Thereafter, at a minimum, a 10-year GIPS-compliant performance record must be presented.

.29 The initial minimum period for which verifications can be performed is one year of the firm's presented performance or from firm inception date to period-end if less than one year. Subsequent verifications may cover any additional time periods, with annual updates being common and quarterly updates also performed. After the initial verification or performance examination is complete, it is industry practice to append subsequent verification or performance examination periods to the initial period. For example, if an initial performance examination was completed on a firm from January 1, 2006, to December 31, 2010, the following year's performance examination period would cover from January 1, 2006, to December 31, 2011. Documentation for each annual engagement is required to indicate the procedures performed supporting the consideration of prior period opinions. Such procedures may include inquiries and evaluation of the implication of the findings of current year's procedures for prior periods.

.30 During a verification or performance examination, the practitioner is required to consider information about subsequent events and subsequently discovered facts that come to his or her attention. Such subsequent events and subsequently discovered facts include circumstances and events that affect prior period-compliant presentations. Errors in prior period-compliant presentations would be assessed in accordance with the firm's error correction policies. If a correction is required by the firm's error correction policy, and the firm does not correct the error, the practitioner is required to consider the implications for the performance examination and, if applicable, the related verification. If the firm corrects, or has corrected, a prior period-compliant presentation, the practitioner would perform appropriate testing of material revisions to previously reported information, including disclosures, regarding the changes and would consider the implications on the practitioner's ability to issue his or her report (see paragraph .34).

Representation Letter

.31 The GIPS standards specify that the verifier must obtain a representation letter from the firm before issuing an opinion on a verification or performance examination. The representations for a verification and performance examination(s) can be included in one letter. Appropriate parties to sign the representation letter are responsible persons with an appropriate level of authority (for example, chief executive officer, chief financial officer, chief compliance officer, or chief investment officer).

.32 The GIPS standards include a listing of required representations, as well as a listing of other representations that are typically included, for both verifications and performance examinations. The GIPS standards require that the representation letter include, among other representations, confirmation that policies and procedures used in establishing and maintaining compliance with the GIPS standards are as described in the firm's policies and procedures documents and have been consistently applied throughout the period(s). The representation letter must also include confirmation that the firm complies

with the GIPS standards for the period(s) and any other relevant representations made to the practitioner during the engagement. Because the practitioner is concerned with events occurring up to the date of the practitioner's report, the written representations are dated as of the date of the practitioner's report.

.33 Appendix B, "Example Representation Letter," of this SOP contains an example representation letter that includes required and recommended management representations. Management's refusal to furnish all appropriate written representations constitutes noncompliance with the GIPS standards that would preclude the practitioner from rendering an opinion (see paragraph .34).

Reporting

.34 The GIPS standards do not permit the issuance of a report with a qualified or an adverse opinion or a disclaimer of opinion for either a verification or performance examination. After conducting the procedures for a verification or performance examination, the practitioner may conclude that

- a. the records of the firm cannot support a verification or performance examination, or
- b. the firm is not in compliance with the GIPS standards, including situations in which the composite presentation does not comply with the GIPS standards.

In such situations, the GIPS standards specify that the practitioner must issue a statement to the firm clarifying why it was not possible to issue a verification or performance examination report.

.35 When a performance examination report cannot be issued, the GIPS standards require the practitioner and firm to consider the impact of the practitioner's inability to provide the performance examination report on the investment management firm's claim of compliance with the GIPS standards.

.36 AT section 101 permits the practitioner to report either on the assertions or directly on the subject matter to which the assertions relate. According to AT section 101, when the practitioner is reporting on management's assertion, the practitioner's examination report is required to include an identification of the assertion and responsible party. When the assertion does not accompany the practitioner's report, the first paragraph of the report is required to contain a statement of the assertion. The illustrative reports in appendix C, "Illustrative Attest Report: Verification (Reporting Directly on the Subject Matter)," and appendix D, "Illustrative Attest Reports: Verification and Performance Examination (Reporting Directly on the Subject Matter)," of this SOP present examples of reporting directly on the subject matter because that is industry practice.

.37 The first standard of reporting in AT section 101 specifies that "the practitioner must identify the subject matter or the assertion being reported on and state the character of the engagement in the report." Accordingly, for engagements covered by this SOP, the practitioner is required to clearly indicate in the report whether a verification, performance examination, or both have been performed. The GIPS standards require that the report state the period(s) covered.

.38 Appendix C of this SOP presents an illustrative report for a verification. Appendix D of this SOP presents illustrative reports for a verification and performance examination.

.39 The GIPS standards require that the verification report include a statement indicating that verification does not ensure the accuracy of any specific composite presentation (see the verification report in appendix C of this SOP). This disclaimer of opinion is an acknowledgement of the fact that the practitioner cannot control whether the verification report may accompany a composite presentation distributed by the firm, even though no performance examination was conducted.

.40 The GIPS standards specify that the compliant presentation for the specified composite(s) that is (are) the subject of a performance examination report must be included in, or attached to, the performance examination report. The practitioner may request that the firm's composite presentation for an examined composite disclose that publically available benchmark returns have not been examined by the practitioner to avoid the implication that the practitioner is providing assurance on the development of the benchmark. The practitioner also should add a paragraph to a performance examination report disclaiming an opinion on composite presentations included or attached for any periods that were not examined by the practitioner or stating that the report does not relate to any composite presentations other than those identified in the report.

.41 When a firm has changed verifiers, and prior periods presented were subject to verification or performance examination by another verifier, the firm may request that the practitioner refer to all verified or examined periods in his or her report. A practitioner may decide to refer to the report(s) of a predecessor verifier. The successor practitioner would consider the appropriateness of referring to reports on verifications or performance examinations conducted by other verifiers in the specific circumstances. If the successor practitioner decides to refer to the report(s) of the predecessor verifier, the report would be modified appropriately. Appendix E, "Illustrative Attest Report: Successor Practitioner Report — Verification and Performance Examination," of this SOP contains an example of a successor practitioner's report referring to the predecessor verifier's performance examination report.

Other Information

.42 When other information is included in a document containing a composite compliant presentation or presentations and the practitioner's performance examination report thereon to which the practitioner, at the firm's request, devotes attention, the practitioner's responsibility with respect to other information in such a document does not extend beyond the information identified in his or her report, and the practitioner has no obligation to perform any procedures to corroborate any other information contained in the document. However, the practitioner is required to read the other information not covered by the practitioner's report and consider whether it or the manner of its presentation is materially inconsistent with the information appearing in the practitioner's report. If the practitioner believes the other information is materially inconsistent with the information appearing in the practitioner's report, the practitioner is required to request the firm to revise the other information. If the other information is not revised to eliminate the material inconsistency, the practitioner may conclude that it is necessary to withdraw the report and may wish to seek legal advice.

.43 If, while reading the other information, as required in paragraph .42, the practitioner becomes aware of information that he or she believes is a material misstatement of fact that is not a material inconsistency, as described in paragraph .42, the practitioner is required to discuss the matter with the

firm. In connection with this discussion, the practitioner is required to consider that he or she may not have the expertise to assess the validity of the statement, there may be no standards by which to assess its presentation, and there may be valid differences of judgment or opinion. If the practitioner concludes there is a valid basis for concern, the practitioner is required to propose that the client consult with some other party whose advice may be useful, such as the entity's legal counsel. If, after discussing the matter, the practitioner concludes that a material misstatement of fact remains, the action taken will depend on the practitioner's judgment in the circumstances. The practitioner is required to consider steps such as notifying in writing the client's management and, when appropriate, those charged with governance of his or her views concerning the information and consulting legal counsel about further action appropriate in the circumstances.

Effective Date

.44 This SOP is effective upon issuance.

Appendix A — Example Engagement Letter — Verification and Performance Examination

The following is an illustration of an example engagement letter that may be used for this kind of engagement.

[Practitioner Letterhead]

[Client's Name and Address]

Dear _____:

This will confirm our understanding of the arrangements for our examination of whether (1) Investment Firm (the Firm) has complied with all the composite construction requirements of the Global Investment Performance Standards (GIPS® standards) on a firmwide basis for the periods from January 1, 20X1, to December 31, 20Y0, and (2) the Firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards as of December 31, 20Y0; this is referred to as a verification under the GIPS standards. *[When also conducting a performance examination, add: We have also been engaged to conduct an examination (referred to as a performance examination under the GIPS standards) of [specify composites] and their associated compliant presentations for the periods from January 1, 20X1, to December 31, 20Y0, in compliance with the GIPS standards.]*

Our examination will be conducted in accordance with the attestation standards established by the American Institute of Certified Public Accountants and criteria set forth in the GIPS standards. Our responsibility is to express an opinion based on our examination. Our examination will include examining, on a test basis, evidence about the Firm's compliance with the previously mentioned requirements; evaluating the design of the Firm's policies and procedures previously referred to; and performing the procedures for a verification required by the GIPS standards and such other procedures as we considered necessary in the circumstances.

The Firm's management is responsible for

- selecting the GIPS standards as the criteria against which we will evaluate its compliance and for determining that the GIPS standards are appropriate criteria for its purposes.
- compliance with all applicable laws, regulations, contracts, and agreements, including the GIPS standards.
- the design, implementation, and monitoring of the policies and procedures upon which compliance is based.
- making available to us all records and related information relevant to your examination.
- providing a signed representation letter at the completion of our examination.¹

If conditions not now anticipated preclude us from performing our examination procedures and issuing a report, as contemplated by the preceding

¹ The independent practitioner may wish to include in the engagement letter an understanding with the Firm about any limitation or other arrangements regarding liability of the practitioner or Firm.

paragraph, we will advise you promptly and take such action as we deem appropriate.

Working papers that are prepared in connection with this engagement are our property. The working papers are prepared for the purpose of providing principal support for our report(s).

As you are aware, there are inherent limitations in the examination process, including, for example, selective testing and the possibility that collusion or forgery may preclude the detection of material errors, fraud, and illegal acts.

Our fees will be billed as work progresses and are based on the amount of time required at various levels of responsibility plus actual out-of-pocket expenses. Invoices are payable upon presentation. We will notify you immediately of any circumstances we encounter that could significantly affect our initial estimate of total fees. The quoted fees assume that you will provide an accumulation of data for the period to be tested and that the records provided to us are clear, concise, and accurate.

In the event we are requested or authorized by management or required by government regulation, subpoena, or other legal process to produce our documents or personnel as witnesses with respect to our engagement, the Firm will reimburse us for our professional time and expenses, as well as any fees and expenses of our counsel, incurred in responding to such requests.

If the Firm intends to use our report in whole or part or refer to [*name of practitioner*] in connection with any sales or advertising literature, a draft of such literature will be provided to us for review and comment prior to issuance.

Either party may terminate this agreement at will.

If these arrangements are acceptable, please sign one copy of this letter and return it to us. We appreciate the opportunity to serve you.

Very truly yours,

[*Name of Practitioner*]

Accepted and agreed to:

[*Client Representative's Signature*]

[*Title*]

[*Date*]

Appendix B — Example Representation Letter

[Date]

[Name of Practitioner]

We are providing this letter in connection with your examination of whether (1) Investment Firm (the Firm) has complied with all the composite construction requirements of the Global Investment Performance Standards (GIPS® standards) on a firmwide basis for the periods from January 1, 20X1, to December 31, 20Y0, and (2) the Firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards as of December 31, 20Y0. [When also conducting a performance examination, add: (3) constructed the [specify composite(s)] and calculated the [specify composite(s)] performance for the periods from January 1, 20X1, to December 31, 20Y0, in compliance with the GIPS standards; and (4) prepared and presented the compliant presentation(s) for [specify composite(s)] for the periods from January 1, 20X1, to December 31, 20Y0, in compliance with the GIPS standards.]

We confirm, to the best of our knowledge and belief, the following representations made to you during your examination(s):

1. We are responsible for (a) compliance with all the composite construction requirements of the GIPS standards on a firmwide basis for the periods from January 1, 20X1, to December 31, 20Y0, and (b) the design of the Firm's policies and procedures to calculate and present performance in compliance with the GIPS standards as of December 31, 20Y0. We further confirm that we are responsible for the selection of the GIPS standards as the criteria against which you are evaluating our compliance and for determining that the GIPS standards are appropriate criteria for our purposes.
2. We assert to you that (a) we have complied with all the composite construction requirements of the GIPS standards on a firmwide basis for the periods from January 1, 20X1, to December 31, 20Y0; (b) the Firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards as of December 31, 20Y0; and (c) the Firm's policies and procedures are as described in the firm's GIPS policies and procedures documents and have been consistently applied for the periods from January 1, 20X1, to December 31, 20Y0.
3. We assert that we are in compliance with the GIPS standards on a firmwide basis for the periods from January 1, 20X1, to December 31, 20Y0, and we are not aware of any matters contradicting the assertions nor have we received any communications from the CFA Institute or regulatory agencies concerning (a) noncompliance with the GIPS standards or our assertions with regard thereto or (b) noncompliance with any other criteria relevant to investment performance.
4. We have [no knowledge of] [disclosed to you all information that we are aware of regarding] (a) fraud or alleged fraud involving management or employees who have significant roles in the Firm's policies and procedures relating to compliance with the GIPS standards or (b) fraud or alleged fraud involving others that could have a material effect on the Firm's compliance with the GIPS standards.

5. We have made available to you all records relevant to your examination.
6. There are no violations or possible violations of laws or regulations, including the Investment Advisers Act of 1940 (*if applicable*), whose effects should be considered for disclosure in your report or in the composite compliant presentations.
7. We acknowledge responsibility for maintaining sufficient books and records, as required by the GIPS standards and/or applicable regulatory requirements, and we have maintained such records to comply with those requirements.
8. We are not aware of any events that occurred subsequent to the period being reported on and through the date of this letter that would have a material effect on the outcome of the examination.

When also conducting a performance examination, add:

9. We assert that we have constructed [*specify composite(s)*] and calculated the composite performance for the periods from January 1, 20X1, to December 31, 20Y0, in compliance with the GIPS standards; and that [*refer to accompanying composite compliant presentation(s)*] of [*specify composite(s)*] for the periods from January 1, 20X1, to December 31, 20Y0, is prepared and presented in compliance with the GIPS standards.

[*Name of Chief Executive Officer and Title*]

[*Name of Chief Financial Officer and Title*]

Appendix C — Illustrative Attest Report: Verification (Reporting Directly on the Subject Matter)

Independent Accountant's Verification Report

Investment Firm
10 Main Street
Anytown, USA

We have examined whether (1) Investment Firm (the Firm) has complied with all the composite construction requirements of the Global Investment Performance Standards (GIPS® standards) on a firmwide basis for the periods from January 1, 20X1, to December 31, 20Y0, and (2) the Firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards as of December 31, 20Y0. The Firm's management is responsible for compliance with the GIPS standards and the design of its policies and procedures. Our responsibility is to express an opinion 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 examining, on a test basis, evidence about the Firm's compliance with the previously mentioned requirements; evaluating the design of the Firm's policies and procedures previously referred to; and performing the procedures for a verification required by the GIPS standards and 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, in all material respects

- the Firm has complied with all the composite construction requirements of the GIPS standards on a firmwide basis for the periods from January 1, 20X1, to December 31, 20Y0; and
- the Firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards as of December 31, 20Y0.

We have not been engaged to examine and did not examine any presentations of the Firm's composites for any period, including any presentations that may accompany this report, and accordingly, we express no opinion on any such performance.¹

[Signature]

September 1, 20Y1

¹ If the verifier has issued a separate performance examination report concurrently, it may insert the following instead: "This report does not relate to any composite presentation of the Firm that may accompany this report, and accordingly, we express no opinion on any such performance."

Appendix D — Illustrative Attest Reports: Verification and Performance Examination (Reporting Directly on the Subject Matter)

Example 1 — Verification and Performance Examination Report

Independent Accountant's Verification and Performance Examination Report

Investment Firm
10 Main Street
Anytown, USA

We have examined whether (1) Investment Firm (the Firm) has complied with all the composite construction requirements of the Global Investment Performance Standards (GIPS® standards) on a firmwide basis for the periods from January 1, 20X1, to December 31, 20Y0, and (2) the Firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards as of December 31, 20Y0. We have also examined the accompanying [*refer to accompanying composite compliant presentation*] of the Firm's XYZ Composite for the periods from January 1, 20X1, to December 31, 20Y0. The Firm's management is responsible for compliance with the GIPS standards and the design of its policies and procedures and for the [*refer to accompanying composite compliant presentation*]. Our responsibility is to express an opinion 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 examining, on a test basis, evidence about the Firm's compliance with the previously mentioned requirements; evaluating the design of the Firm's policies and procedures previously referred to; examining, on a test basis, evidence supporting the accompanying composite compliant presentation; and performing the procedures for a verification and performance examination required by the GIPS standards and 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, in all material respects,

- the Firm has complied with all the composite construction requirements of the GIPS standards on a firmwide basis for the periods from January 1, 20X1, to December 31, 20Y0; and
- the Firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards as of December 31, 20Y0.

Also, in our opinion, in all material respects, the Firm has

- constructed the XYZ Composite and calculated the XYZ Composite performance for the periods from January 1, 20X1, to December 31, 20Y0, in compliance with the GIPS standards; and
- prepared and presented the [*refer to accompanying composite compliant presentation*] of the Firm's XYZ Composite for the periods from January 1, 20X1, to December 31, 20Y0, in compliance with the GIPS standards.

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Statements of Position

This report does not contain an opinion on accuracy of any composite presentation of the Firm other than the [*refer to accompanying composite compliant presentation*] of the Firm's XYZ Composite for the periods from January 1, 20X1, to December 31, 20Y0.

[*Signature*]

September 1, 20Y1

Example 1A — Illustrative GIPS-Compliant Presentation for Report Example 1

Investment Firm
XYZ Composite

January 1, 20X1, to December 31, 20Y0

Year	Composite Gross Return (%)	Composite Net Return (%)	Custom Benchmark Return (%)	Composite 3-Yr St Dev (%)	Benchmark 3-Yr St Dev (%)	Number of Portfolios	Internal Dispersion (%)	Composite Assets (\$ M)	Firm Assets (\$ M)
20X1	-10.5	-11.4	-11.8			31	4.5	165	236
20X2	16.3	15.1	13.2			34	2.0	235	346
20X3	7.5	6.4	8.9			38	5.7	344	529
20X4	1.8	0.8	0.3			45	2.8	445	695
20X5	11.2	10.1	12.2			48	3.1	520	839
20X6	6.1	5.0	7.1			49	2.8	505	1,014
20X7	-21.3	-22.1	-24.9			44	2.9	475	964
20X8	16.5	15.3	14.7			47	3.1	493	983
20X9	10.6	9.5	13.0			51	3.5	549	1,114
20Y0	2.7	1.7	0.4	7.1	7.4	54	2.5	575	1,236

Investment Firm (the Firm) claims compliance with the Global Investment Performance Standards (GIPS® standards) and has prepared and presented this report in compliance with the GIPS standards. The Firm has been independently verified for the periods from January 1, 20X1, to December 31, 20Y0. The verification report is available upon request. Verification assesses whether (1) the Firm has complied with all the composite construction requirements of the GIPS standards on a firmwide basis, and (2) the Firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.

Notes:

1. The Firm is a balanced portfolio investment manager that invests solely in U.S. securities. The Firm is defined as an independent investment management firm that is not affiliated with any parent organization. Firm policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.
2. The composite includes all institutional balanced portfolios that invest in large-cap U.S. equities and investment-grade bonds with the goal of providing long-term capital growth and steady income from a well-diversified strategy. Although the strategy allows for equity exposure ranging between 50 percent and 70 percent, the typical allocation is between 55 percent and 65 percent. The account minimum for the composite is \$5 million.
3. The custom benchmark is 60 percent YYY U.S. Equity Index and 40 percent ZZZ U.S. Aggregate Bond Index. The benchmark is rebalanced monthly.
4. Valuations are computed and performance reported in U.S. dollars.
5. Gross-of-fees returns are presented before management and custodial fees but after all trading expenses. Composite and benchmark returns are presented net of nonreclaimable withholding taxes. Net-of-fees returns are calculated by deducting the highest fee of 0.083 percent from the monthly gross composite return. The management fee schedule is as follows: 1 percent on the first \$25 million and 0.60 percent thereafter.
6. This composite was created in February 20X1. A complete list of composite descriptions is available upon request.
7. Internal dispersion is calculated using the equal-weighted standard deviation of annual gross returns of those portfolios that were included in the composite for the entire year.
8. The 3-year annualized standard deviation measures the variability of the composite and the benchmark returns over the preceding 36-month period. The standard deviation is not presented for 20X1 to 20X9 because monthly composite and benchmark returns were not available and is not required for periods prior to 20Y0.

Example 2 — Performance Examination Report With a Reference to a Separate Verification Report

Independent Accountant's Performance Examination Report

Investment Firm
10 Main Street
Anytown, USA

We have examined the accompanying¹ [*refer to accompanying composite compliant presentations*] of Investment Firm's (the Firm's) ABC and XYZ Composites for the periods from January 1, 20X1, to December 31, 20Y0. The Firm's management is responsible for these compliant presentations. Our responsibility is to express an opinion based on our examination. We previously conducted an examination (also referred to as a verification) of whether (1) the Firm has complied with all the composite construction requirements of the Global Investment Performance Standards (GIPS® standards) on a firmwide basis for the periods from January 1, 20X1, to December 31, 20Y0, and (2) the Firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards as of December 31, 20Y0; our report dated August 7, 20Y1, with respect thereto is attached.

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 accompanying composite compliant presentations and performing the procedures for a performance examination required by the GIPS standards and 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, in all material respects, the Firm has

- constructed the Firm's ABC and XYZ Composites and calculated the composite performance for the periods from January 1, 20X1, to December 31, 20Y0, in compliance with the GIPS standards; and
- prepared and presented the [*refer to accompanying composite compliant presentations*] of the Firm's ABC and XYZ Composites for the periods from January 1, 20X1, to December 31, 20Y0, in compliance with the GIPS standards.

This report does not attest to the accuracy of any composite presentation of the Firm other than the Firm's ABC and XYZ Composites.

[*Signature*]

September 1, 20Y1

¹ See example 1A for an illustrative composite-compliant presentation that would accompany the report.

Appendix E — Illustrative Attest Report: Successor Practitioner Report — Verification and Performance Examination

Reporting Directly on the Subject Matter (Verification and Performance Examination Report) in Successor Practitioner's Report When the Predecessor Verifier's Report Is Not Presented

Independent Accountant's Verification and Performance Examination Report

Investment Firm
10 Main Street
Anytown, USA

We have examined whether (1) Investment Firm (the Firm) has complied with the composite construction requirements of the Global Investment Performance Standards (GIPS® standards) on a firmwide basis for the period from January 1, 2011, to December 31, 2011, and (2) the Firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards as of December 31, 2011. We have also examined the accompanying [*refer to accompanying composite compliant presentation*] of the Firm's XYZ Composite for the period from January 1, 2011, to December 31, 2011. The Firm's management is responsible for compliance with the GIPS standards and the design of its policies and procedures and for the [*refer to accompanying composite compliant presentation*]. Our responsibility is to express an opinion based on our examination. [*Refer to accompanying composite compliant presentation*] of the Firm's XYZ Composite for the periods from January 1, 2002, to December 31, 2010, was examined by other independent verifiers, whose report is dated August 27, 2011.

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 about the Firm's compliance with the previously mentioned requirements; evaluating the design of the Firm's policies and procedures previously referred to; examining, on a test basis, evidence supporting the accompanying composite compliant presentation; and performing the procedures for a verification and performance examination required by the GIPS standards and 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, in all material respects

- the Firm has complied with all the composite construction requirements of the GIPS standards on a firmwide basis for the period from January 1, 2011, to December 31, 2011; and
- the Firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards as of December 31, 2011.

Also, in our opinion, in all material respects, the Firm has

- constructed the Firm's XYZ Composite and calculated the composite performance for the period from January 1, 2011, to December 31, 2011, in compliance with the GIPS standards; and

- prepared and presented the [*refer to accompanying composite compliant presentation*] of the Firm's XYZ Composite for the period from January 1, 2011, to December 31, 2011, in compliance with the GIPS standards.¹

We have not been engaged to examine and did not examine the Firm's XYZ Composite for any period prior to January 1, 2011, as shown in the accompanying [*refer to the accompanying composite compliant presentation*], and accordingly, we express no opinion on any such performance.

This report does not attest to the accuracy of any composite presentation of the Firm other than the Firm's XYZ Composite.

[*Signature*]

March 1, 2012

¹ See example 1A in appendix D, "Illustrative Attest Reports: Verification and Performance Examination (Reporting Directly on the Subject Matter)," of this Statement of Position for an illustrative composite-compliant presentation that would accompany the report.

Investment Performance Standards Task Force

Todd Johnson, *Chair*
Jonathan Boersma
Kimberly S. Cash
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Steve Perazzoli
Kenneth Robinson
John Stomper
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Audit and Attest Standards

[The next page is 32,101.]

Section 14,460

Statement of Position 13-1 — Attest Engagements on Greenhouse Gas Emissions Information

April 2013

NOTE

This Statement of Position (SOP) is an interpretative publication, and it represents the recommendations of the AICPA's Sustainability Task Force regarding the application of Statements on Standards for Attestation Engagements (SSAEs) to attest engagements on greenhouse gas emissions information. The Auditing Standards Board (ASB) has found the recommendations in this SOP to be consistent with existing standards covered by Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, ET sec. 202 par. .01), of the AICPA Code of Professional Conduct.

Interpretative publications are not as authoritative as a pronouncement of the ASB; however, if a practitioner does not apply the attestation guidance included in this SOP, the practitioner should be prepared to explain how he or she complied with the SSAE provisions addressed by this SOP.

Introduction

.01 Certain atmospheric gases (carbon dioxide, methane, nitrous oxide, water vapor, and others) are called greenhouse gases (GHGs) because they are believed to contribute to the retention of outgoing energy, trapping heat somewhat like the glass panels of a greenhouse. For the purposes of GHG emissions reporting, GHGs include carbon dioxide and any other gases required by the applicable criteria to be included in the GHG emissions schedules, such as

- methane (CH₄);
- nitrous oxide (N₂O);
- perfluorocarbons (PFCs);
- hydrofluorocarbons (HFCs); and
- sulphur hexafluoride (SF₆).

.02 Gases other than carbon dioxide are often expressed in terms of carbon dioxide equivalents (CO₂-e). Due to a number of global and national initiatives to reduce GHG emissions, many entities are quantifying their GHG emissions for internal management purposes, and many are also preparing a GHG emissions schedule

- as part of a regulatory disclosure regime.
- as part of an emissions trading program.
- to inform investors and others on a voluntary basis. Voluntary disclosures may be, for example, published as a stand-alone document, included as part of a broader sustainability report or in an entity's annual report, or made to support inclusion in a public carbon registry.

.03 Entities may also participate in *emission reduction*¹ projects to reduce the emission of GHGs, such as by setting emission limits or modifying the emission source. Emission reduction is measured in relation to a *baseline*. Emission reductions may be registered and traded (that is, purchased and sold). Paragraphs .29–.30 describe the attributes to be met by an emission reduction for it to be registered or traded, and paragraph .45 provides examples of GHG emission reduction projects.

GHG Reporting in the United States

.04 Voluntary reporting programs in which some U.S. companies participate include the following:

- The Carbon Disclosure Project (CDP), an organization based in the United Kingdom that works with shareholders and corporations to encourage them to disclose their GHG emissions. The CDP scores entities based on factors such as the extent to which a company measures its carbon emissions, the frequency and relevance of its disclosure to key corporate stakeholders, and whether the company engages a third party to verify emissions data to promote greater confidence and use of the data. Entities with sufficiently high scores are listed in the Carbon Disclosure Leadership Index (CDLI).
- The Climate Registry (www.theclimateregistry.org) is a nonprofit collaboration among North American states, provinces, territories, and Native Sovereign Nations that sets standards to calculate, verify, and publicly report GHG emissions into a single registry.

Certain industries and jurisdictions require GHG emissions reporting but may not require attestation services.

.05 Reasons that entities report GHG emissions and request attestation services related to GHG emissions include the following:

- To participate in GHG emissions reductions programs.
- To respond to shareholder resolutions calling for companies to report and have their corporate social responsibility or GHG emissions information verified by a third party.
- To demonstrate responsible corporate behavior.
- The desire to be listed in the CDLI.
- To satisfy requests from customers regarding information about GHG emissions within their supply chain. For example, in October 2009, Section 13 of Executive Order 13514, Federal Leadership in Environmental, Energy, and Economic Performance, directed the U.S. General Services Administration (GSA) with the Department of Defense and the Environmental Protection Agency to assess the feasibility of requiring federal suppliers to provide GHG emissions data to the government. In August 2010, GSA launched the Federal Supplier Greenhouse Gas Emissions Inventory Pilot, a three-year program in which small businesses are required to develop annual GHG emissions inventories through September 2013. The program's purpose is to assess the benefits and challenges experienced by small businesses when completing a GHG emissions inventory.

¹ Terms defined in the glossary are italicized the first time they appear in this statement of position.

Terms and Definitions Used by Registries and Regulatory Frameworks

.06 Appendix A, “Glossary,” in this statement of position (SOP) contains a glossary of common terms relating to GHG engagements. Different registries and regulatory frameworks may use different terms and definitions for similar services. A *validation* is a service that would provide assurance on the feasibility of the design of an emission reduction project, usually before inception of the project; an entity would typically engage an engineering or a consulting firm to provide such a service. This SOP does not provide guidance on validation standards. A *verification* is the objective and independent assessment of whether the reported GHG emissions properly reflect the GHG impact of the entity in conformance with preestablished GHG accounting and reporting standards. Various GHG registries and regulatory frameworks may not define these terms in exactly the same way; thus, the practitioner should obtain the official definitions of such terms under the registry or regulatory framework relevant to the engagement. However, practitioners should not use terms such as *validation* or *verification* in their attest reports on GHG emissions regardless of whether the registry or regulatory framework uses such terms because AT section 101, *Attest Engagements* (AICPA, *Professional Standards*), requires the terms *examination* or *review* to be used to describe such engagements.

Scope of This SOP

.07 This SOP provides guidance for practitioners performing

- an examination or
- a review

of a GHG emissions statement containing either

- a schedule with the subject matter or
- an assertion

relating to information about an entity’s GHG emissions, such as

- a GHG *inventory* (an entity’s emissions of GHGs for a specified period, typically, a year or a series of years, or a baseline *GHG inventory*), or
- a GHG emission reduction in connection with
 - the recording of the reduction with a registry or
 - a trade of that reduction or *credit*.

Such engagements should be performed pursuant to AT section 101. This SOP provides guidance on the application of AT section 101 to GHG emissions attest engagements. This SOP is not intended to provide all the guidance set forth in the applicable standards established by the AICPA. This SOP supersedes SOP 03-2, *Attest Engagements on Greenhouse Gas Emissions Information*.

.08 In an examination engagement of a GHG emissions statement, the practitioner chooses a combination of attestation procedures, which can include inspection, observation, confirmation, recalculation, reperformance, analytical procedures, and inquiry. In a review engagement, the types of procedures performed generally are limited to inquiries and analytical procedures (see paragraph .59 for further description of review procedures). Determining the attestation procedures to be performed on a particular engagement is a matter of professional judgment. Because GHG emissions reporting covers a wide

range of circumstances, the nature, timing, and extent of procedures are likely to vary considerably from engagement to engagement.

.09 Unless otherwise stated, the matters discussed in this SOP apply to both examination and review engagements. Because a review engagement is substantially less in scope than an examination, the procedures the practitioner will perform in a review engagement will vary in nature and extent from those performed in an examination engagement. Paragraphs .59 and .64 describe in tabular form procedures that are relevant to an examination or review engagement. Procedures that would ordinarily be performed in both an examination and a review are shown in one column across a row. Similar procedures are shown in separate columns in a row, and when a procedure is not ordinarily performed in a review engagement, the review column in that row has been deliberately left blank. Although some procedures are shown only for examination engagements, they may nonetheless be appropriate in review engagements in circumstances in which procedures, in addition to inquiry and analytical procedures, are determined to be necessary by the practitioner.

Engagement Acceptance Considerations

.10 The following are examples of matters addressed in AT section 101 that are relevant to a practitioner's decision about whether to accept an engagement:

- Independence (see paragraphs .11–.12).
- Whether the practitioner has adequate technical knowledge of the subject matter to perform the engagement, including evaluation of the work of any specialists involved in the engagement (see paragraphs .13–.19).
- Whether the practitioner will be performing a sufficient portion of the engagement to assume overall responsibility (see paragraphs .20 and .54).
- Considerations in selecting and using the work of a specialist, when applicable (see paragraphs .21–.23).
- Existence of suitable criteria (see paragraphs .24–.30).
- Materiality considerations (see paragraph .31).
- Expectations of users of the GHG inventory or reduction information and the practitioner's report thereon.
- Whether the entity is likely to have adequate information systems and controls to provide reliable GHG information.
- Whether sufficient evidence is likely to exist, including when the entity has changed measurement methods for GHG emissions from one period to the next (see paragraphs .33 and .66).
- The scope of the entity's GHG inventory (see paragraphs .34–.35 for a discussion of *boundaries* and paragraphs .36–.38 for a discussion of direct and indirect emissions for a GHG inventory).
- Availability of historical data. If the practitioner is engaged to perform the attest service at a date considerably later than the base year, there is a risk that historical data for the base year may not be available (see paragraph .39 for a discussion of baselines).

Independence

.11 The practitioner performing an attest engagement is required to be *independent* pursuant to Rule 101, *Independence* (AICPA, *Professional Standards*, ET sec. 101 par. .01), of the Code of Professional Conduct.

.12 Certain GHG registries and regulatory frameworks set rules that prohibit professionals who provide attest services on GHG emissions statements from providing other services to the entity for a period of time. For example, a GHG framework or registry may set independence requirements that specifically prohibit a practitioner who has performed certain services for an entity from also providing a verification (that is, an examination or review) of an entity's GHG emissions statement for a certain period of time. Such independence requirements, which may be beyond those of the AICPA, or other limitations on the scope of services set by the relevant framework or registry may preclude the practitioner from performing an attestation engagement that is acceptable under such GHG framework or to such registry.

Adequate Knowledge of Subject Matter and Use of a Specialist

.13 Paragraph .02 of AT section 50, *SSAE Hierarchy* (AICPA, *Professional Standards*), states that "the engagement must be performed by a practitioner having adequate knowledge of the subject matter." Paragraph .22 of AT section 101 states that "this knowledge requirement may be met, in part, through the use of one or more specialists on a particular attest engagement if the practitioner has sufficient knowledge of the subject matter (a) to communicate to the specialist the objectives of the work and (b) to evaluate the specialist's work to determine if the objectives were achieved." Relevant considerations in determining whether to accept an attest engagement on a GHG emissions statement include whether the practitioner's involvement in the engagement and understanding of the subject matter are sufficient to enable the practitioner to discharge his or her responsibilities. The practitioner may involve internal specialists as part of the engagement team or engage external specialists to assist the team. The practitioner should accept an attest engagement on a GHG emissions statement only if the practitioner is satisfied that the engagement team, along with a practitioner's external specialist, collectively possesses the necessary professional competencies to perform the GHG emissions engagement.

.14 Professional competencies necessary to perform a GHG emissions engagement may include

- understanding emissions trading programs and related market mechanisms, when relevant.
- understanding who the intended users of the information in the entity's GHG emissions statement are and how they are likely to use that information.
- knowledge of applicable laws and regulations, if any, that affect how the entity should report its emissions or impose a limit on the entity's emissions.
- GHG quantification and measurement methodologies, including the associated scientific and measurement uncertainties, and alternative methodologies available.
- knowledge of the applicable criteria, including, for example

- identifying appropriate *emissions factors*.
- identifying those aspects of the criteria (see paragraphs .24–.28) that call for significant or sensitive estimates to be made or for the application of considerable judgment.
- methods used for determining organizational boundaries (that is, the entities whose emissions are to be included in the GHG emissions statement).
- which emissions reductions are permitted to be included in the entity's GHG emissions statement.

.15 In most attest engagements on GHG emissions, the nature of the entity's operations, emissions, or the emissions measurement methodology in general requires specialized skill or technical knowledge in a particular field other than accounting or auditing, such as environmental engineering. The practitioner should possess adequate technical knowledge of the subject matter to understand how GHG emissions information might be misstated and to design procedures to respond to the risks of material misstatement. A practitioner may obtain adequate knowledge of the subject matter through formal or continuing education, including self-study, or through practical experience. When determining whether the practitioner has adequate technical knowledge, the practitioner should read the criteria selected by the *responsible party* (defined as the person or persons, either as individuals or representatives of the entity, responsible for the subject matter)² to understand what is involved in the measurements.

.16 Particular areas of expertise that may be relevant in such cases include the following:

- Information systems expertise
 - Understanding how emissions information is generated, including how data is initiated, recorded, processed, corrected as necessary, and reported in the GHG emissions statement.
- Scientific and engineering expertise
 - Mapping the flow of materials through a production process and the accompanying processes that create emissions, including identifying the relevant points at which source data is gathered. This may be particularly important when considering whether the entity's identification of emissions sources is complete.
 - Analyzing chemical and physical relationships between inputs, processes, and outputs and relationships between emissions and other variables. The capacity to understand and analyze these relationships will often be important when designing analytical procedures.
 - Identifying the effect of uncertainty on the measurement of GHG emissions.
 - Knowledge of the quality control policies and procedures implemented at testing laboratories, whether internal or external.
 - Experience with specific industries and related emissions creation and removal processes. Creation and removal procedures for scope 1 emissions quantification (see paragraph .36) vary greatly depending on the industries and processes involved (for

² Paragraph .11 of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*).

example, the nature of electrolytic processes in aluminum production, combustion processes in the production of electricity using fossil fuels, and chemical processes in cement production are all different).

- The operation of physical sensors and other quantification methods and the selection of appropriate emissions factors.

.17 If the entity is a service entity whose GHG emissions are limited to the use of purchased electricity and natural gas or oil, the practitioner may be able to use published factors to convert the electricity, gas, or oil used to GHGs emitted to obtain evidence about how the entity calculated its emissions. Under those circumstances, the practitioner may not need to use a specialist, provided that the practitioner possesses sufficient technical knowledge regarding the published factors, including an understanding of the nature of each factor and the distinctions between alternatives. If the entity has significant industrial operations with numerous sources of emissions, however, it is more likely that the practitioner will need to use a specialist.

.18 If specialized skills are needed to supplement the practitioner's technical knowledge, the practitioner should seek the assistance of a professional possessing such skills, who may be either a member of the engagement team or an outside professional. The practitioner should possess adequate technical knowledge to direct, supervise, and review the specialist's work in the former situation and understand and evaluate the specialist's work in the latter situation.

.19 When the responsible party employs a specialist to develop evidence that is used to support the assertion or presentation, the practitioner should evaluate whether the practitioner or another member of the engagement team possesses adequate technical knowledge to understand and evaluate the specialist's work or whether the practitioner should seek assistance from an external specialist. The practitioner may find it helpful to consider the provisions of AU-C section 500, *Audit Evidence (AICPA, Professional Standards)*, when evaluating the competence, capabilities, and objectivity of the responsible party's specialist.

.20 When using the work of an external specialist, the practitioner should consider the nature and magnitude of the specialist's work in relation to the overall engagement to determine whether the practitioner will be performing a sufficient portion of the engagement to assume overall responsibility.

Considerations When Selecting and Using the Work of a Specialist

.21 Considerations when selecting a specialist include the following:

- The specialist's expertise and competence in the subject matter
- The relevance of the specialist's expertise to the practitioner's objectives in the attest engagement
- The objectivity of the specialist
- The nature and extent of the anticipated use of the specialist

.22 Examples of matters that may require the practitioner to consider using the work of a specialist or having a specialist participate in the GHG engagement include

- reviewing the quality of client-provided data (for example, appropriateness and accuracy).
- evaluation of the reasonableness of emission factors, such as
 - whether it is necessary or appropriate to use a derived emissions factor versus a published emissions factor.
 - the population and selection of appropriate published emissions factors.
 - assessment of the methodology used to calculate the specific GHG emissions (see paragraphs .33 and .66).
- reviewing the work of the responsible party's specialist (for example, to assess whether the assumptions underlying the methodology are reasonable).

.23 Regardless of whether the specialist is employed by the practitioner's firm or an external specialist is engaged by the practitioner, the practitioner should follow the guidance in this SOP and may find it helpful to consider the provisions of AU-C section 620, *Using the Work of an Auditor's Specialist* (AICPA, *Professional Standards*). When the practitioner considers using the work of a specialist engaged by the responsible party, the practitioner should follow the guidance contained in this SOP and may find it helpful to consider the provisions of AU-C section 500, including evaluating the relationship of the specialist to the responsible party.

Criteria

.24 AT section 101 states that in order for the engagement to be performed, the practitioner must have reason to believe that the subject matter is capable of evaluation against criteria that are suitable and available to users.

.25 Criteria that are established or developed by groups composed of experts that follow due process procedures, including exposure of the proposed criteria for public comment, ordinarily should be considered suitable.

.26 Frameworks establishing criteria for GHG emissions statements usually include measurement, presentation, and disclosure considerations. Different industries, regulatory organizations, or organizations acting in a standard-setting role may have developed guidance on measurement relevant to an industry, regulated group, or GHG emissions in general. Alternatively, an entity may develop its own criteria for measurement of emissions.

.27 The practitioner should consider whether criteria selected by the responsible party are suitable (see paragraphs .23–.32 of AT section 101 for guidance on suitability of criteria). For guidance on the availability of criteria, see paragraphs .33–.34 of AT section 101.

.28 Most entities will need to select a framework and refine the application of measurement criteria, perhaps using software tools for measuring emissions in specific industries or using certain industrial processes, such as cement production or aluminum smelting. The practitioner should review the entity's measurement protocol and consider whether the entity's measurement methods are appropriate. See appendix B, "Sources for GHG Emission Protocols and Calculation Tools."

Attributes to Be Met by GHG Emission Reductions

.29 Various registries and GHG emissions trading programs have specified attributes to be met by an emission reduction for it to be registered or traded. Common attributes are identified and described in the following list; however, definitions may vary by trading program. In the context of a specific registry or emissions trading program, additional requirements to be met by the emission reduction may exist:

- a. *Ownership.* In many cases, ownership is clear. Examples of such cases include efficiency upgrades at a manufacturing facility or fuel-switching at a power plant. However, for some project types, particularly those with renewable energy and demand-side management projects that offset or displace fossil-fuel emissions, demonstrating ownership can be challenging. Ownership of the reductions may be open to dispute because the reductions do not occur on the site of the project but, rather, on the site of a fossil-fueled facility whose power was displaced. These are known as *indirect emission reductions* because the reductions occur at facilities other than the one where the project has been undertaken. The possibility that the direct source of emissions would claim title to the same reductions claimed by the project developer or that the joint venture partners would claim title to the same reductions of their joint venture (referred to as *double-counting*) represents a risk that buyers prefer to avoid. It is possible that multiple claimants, such as the owner of the emitting source, technology vendors, and the entity installing the technology, could claim ownership of these reductions.
- b. *Real.* An emission reduction is real if it is a reduction in actual emissions that results from a specific and identifiable action or undertaking that is not a mere change in activity level (for example, due to typical business fluctuations) and net of any leakage to a third party or jurisdiction. *Leakage* occurs when an emission reduction project causes emissions to increase beyond the project's boundaries. Entities entering into an emission reduction project typically must demonstrate that the emission reduction will not cause emissions to increase beyond the project's boundaries.
- c. *Quantifiable or measurable.* An emission reduction is quantifiable or measurable if the total amount of the reduction can be determined, and the reduction is calculated in an accurate and replicable manner.
- d. *Surplus.* An emission reduction is surplus if the reduction is not otherwise required of a source by current regulations or a voluntary commitment to reduce emissions to a specified level.
- e. *Establishment of a credible emissions baseline.* Many programs measure emission reductions by comparing a credible emissions baseline without the project to the emissions baseline with the project. A reduction quantity is not meaningful unless it is compared with a credible baseline (that is, a baseline compiled in accordance with the current protocol, using the same boundaries and scope).
- f. *Unique.* Credits should be created and registered only once from a specific reduction activity and time.

.30 Some registries or emissions trading programs may have a requirement for *additionality*. Environmental additionality requires that the emission reductions achieved by the project would not have occurred in the absence of the project (the reduction must be additional to any required reductions; that

is, if the entity has taken on a cap, the reduction must be additional to the cap). A credible emission baseline is crucial for an entity to demonstrate additionality. Various GHG registries and regulatory frameworks may not define additionality and the terms referred to in paragraph .29 in exactly the same way; thus, the practitioner should obtain the official definitions of such terms under the registry or regulatory framework relevant to the engagement.

Materiality

.31 Paragraph .67 of AT section 101 addresses materiality in attestation engagements. Also, the applicable GHG registry or voluntary or regulatory framework may set specific materiality limits. If a GHG registry or framework sets specific materiality requirements that are more stringent than those of AT section 101, before accepting the engagement the practitioner should consider whether it is possible to meet such requirements.

Uncertainty in the Measurement of GHG Emissions

.32 The term *uncertainty* as used in the field of GHG emissions refers to variability in the measurement of GHG emissions rather than the term *uncertainty* as defined in the auditing literature. Uncertainty in GHG emissions estimates can be due to a variety of factors. Examples of matters that may create or increase uncertainty in GHG emissions estimates include the following:

- Use of factors that are poorly researched or uncertain (for example, factors for CH₄ and N₂O from combustion processes)
- Use of average case factors not perfectly matched to specific and varying circumstances (for example, miles per gallon, average kgCO₂/MWh generated)
- Deliberate estimation to compensate for missing data (for example, nonreporting facilities or missing fuel bills)
- Assumptions that simplify calculation of emissions from highly complex processes
- Imprecise measurement of emissions-producing activity (for example, miles traveled in airplanes or rental vehicles, hours per year specific equipment is used)
- Insufficient frequency of measurement to account for natural variability
- Poor calibration of measuring instruments

Consistency

.33 Measurement of the GHG inventory requires consistent application of measurement methods. If the entity has changed measurement methods from one period to the next, the practitioner should consider the implications on the engagement (for example, whether it is essential that the same methods be used because either comparative information is presented or a reduction is being calculated and, if so, whether the entity has restated the prior period's results using the same measurement method as the current period). (See paragraphs .39, .66, and .72.)

Boundaries

.34 Determining which operations owned or controlled by the entity to include in the entity's GHG emissions statement is known as "determining the entity's organizational boundary." In some cases, laws and regulations define the boundaries of the entity for reporting GHG emissions for regulatory purposes. In other cases, the applicable criteria may allow a choice between different methods for determining the entity's organizational boundary (for example, the criteria may allow a choice between an approach that aligns the entity's GHG emissions reporting with its financial statements and another approach that treats, for example, joint ventures or associates differently). Determining the entity's organizational boundary may require the analysis of complex organizational structures such as joint ventures, partnerships, and trusts and complex or unusual contractual relationships. For example, a facility may be owned by one party, operated by another, and process materials solely for another party.

.35 Determining the entity's organizational boundary is different from what some criteria describe as determining the entity's "operational boundary." The operational boundary relates to which categories of scope 1, 2, and 3 emissions will be included in the GHG emissions statement and is determined after setting the organizational boundary. Leakage may affect the choice of operational boundaries. When planning the engagement, the practitioner should obtain an understanding of the boundaries that have been set by the entity and the potential for leakage. If leakage has occurred, the entity may account for it by adjusting its baseline or by changing its boundaries.

Scopes for Reporting GHG Emissions: Direct and Indirect Emissions

.36 Reporting GHG emissions and emission reductions may encompass one or more of the following three scopes of emissions:

- a. Scope 1: *Direct GHG Emissions*. Emissions from sources that are owned or controlled by the entity. These are emissions associated with the following:
 - Stationary combustion from fuel burned in the entity's stationary equipment, such as boilers, incinerators, engines, and flares
 - Mobile combustion from fuel burned in the entity's transport devices, such as trucks, trains, airplanes and boats
 - Process emissions from physical or chemical processes, such as cement manufacturing, petrochemical processing, and aluminum smelting
 - Fugitive emissions, which are intentional and unintentional releases, such as equipment leaks from joints and seals and emissions from wastewater treatment, pits, and cooling towers
- b. Scope 2: *Indirect GHG Emissions From the Generation of Imported or Purchased Electricity, Heat, or Steam*. Emissions that are a consequence of the activities of the entity, but which occur at sources that are owned or controlled by another entity. Scope 2 emissions are associated with energy that is transferred to, and consumed by, the entity.

- c. Scope 3: *Other Indirect Emissions*, including the following:
- Employee business travel
 - Outsourced activities, contract manufacturing, and franchises
 - Transportation by the vendor or contractor of, for example, materials, products, waste, and employees
 - Emissions from product use and end of life
 - Employee commuting
 - Production of imported materials

.37 The practitioner should determine whether the proposed scope of the engagement is appropriate and whether it covers one or more of the following:

- a. Direct GHG emissions
- b. Indirect GHG emissions associated with the generation of imported or purchased electricity, heat, or steam
- c. Other indirect emissions

.38 Some reporting programs may classify these emissions sources differently than those noted in paragraph .36. The practitioner should evaluate the potential for double-counting of emissions and reductions, especially in instances of indirect emissions and shared ownership or control. If the practitioner has been engaged to report on an entity's indirect emissions, especially those emissions for a supplier not under the direct control of the entity, the practitioner should consider whether he or she can obtain a written assertion from the responsible party and obtain sufficient evidence to form a conclusion. The practitioner also should consider the availability or existence of data for emitting sources not under the direct control of the entity.

Baselines

.39 A *baseline* is the amount of the entity's emissions for a specified base year against which any future changes in emissions are evaluated. Management should recalculate the baseline, however, for changes in scope and boundaries, subsequent acquisitions, and sales or closing of emitting sources. If the practitioner is engaged to perform the attest service at a date considerably later than the base year, there may be differences in the quality of the data and consistency of methodology between the base year and the current year.

Objective of the Engagement

GHG Inventory

.40 The criteria selected are used by the entity to measure and present and by the practitioner to evaluate the specific subject matter of the attestation engagement. It is anticipated that appropriate disclosures will be included in the presentation, not just the quantity of GHG emissions for a period of time. The presentation may include, or be accompanied by, other information that is not subject to the practitioner's engagement, such as the discussion of the responsible party's commitment and strategy, projections, and targets related to its GHG emissions. Therefore, the form of the conclusion will vary depending upon the information presented under the selected criteria on which the practitioner is engaged to report.

.41 The practitioner's objective for an examination of GHG emissions information typically is to express an opinion about whether

- a. the entity's schedule of GHG emissions is presented, in all material respects, in conformity with the criteria selected by the responsible party (see paragraphs .24–.28), or
- b. the responsible party's written assertion about the schedule of GHG emissions is fairly stated, in all material respects, based on the criteria selected by the responsible party.

.42 The practitioner's objective for a review of GHG emissions information typically is to express a conclusion, based on the work performed, about whether any information came to the practitioner's attention that indicates that

- a. the entity's schedule of GHG emissions is not presented, in all material respects, in conformity with the criteria selected by the responsible party, or
- b. the responsible party's written assertion about the schedule of GHG emissions is not fairly stated, in all material respects, based on the criteria selected by the responsible party.

GHG Emission Reduction Information

.43 The practitioner's objective in an examination of GHG emission reduction information typically is to express an opinion about whether

- a. the entity's GHG emission reduction information related to a specific project or on an entity-wide basis is presented, in all material respects, in conformity with the criteria selected by the responsible party, or
- b. the responsible party's written assertion about the GHG emission reduction information related to a specific project or on an entity-wide basis is fairly stated, in all material respects, based on the criteria selected by the responsible party.

.44 The practitioner's objective in a review of GHG emission reduction information is to express a conclusion, based on the work performed, about whether any information came to the practitioner's attention that indicates that

- a. the entity's GHG emission reduction information related to a specific project or on an entity-wide basis is not presented, in all material respects, in conformity with the criteria selected by the responsible party, or
- b. the responsible party's written assertion about the GHG emission reduction information related to a specific project or on an entity-wide basis is not fairly stated, in all material respects, based on the criteria selected by the responsible party.

Examples of GHG Emission Reduction Projects

.45 Examples of GHG emission reduction projects include, but are not limited to, the following:

- Use of renewable energy systems, such as wind, solar, and other low emission technologies, in place of higher emission technologies
- Change in processes to increase energy efficiency, such as the installation and use of more energy-efficient equipment

- Carbon sequestration: no-till farming; agricultural grass and tree plantings
- Change from more GHG-intensive fuels to less GHG-intensive fuels (for example, from coal to natural gas or nuclear power)
- Recovery and use of agricultural and landfill methane
- Improvement in the fuel efficiency of vehicle fleets
- Reduction in venting or flaring on offshore oil production platforms (installation of zero flare systems; rapid response to unplanned events)
- Cessation of operations at noneconomical plants and transfer of production to more efficient plants
- Demand-side management projects

Prerequisite for Engagements Related to GHG Emission Reduction Information

.46 As a prerequisite to performing an examination or review of GHG emission reduction information, the practitioner should obtain sufficient evidence about the entity's GHG emissions for the period in which the project took effect to provide a reasonable basis for the conclusion that is expressed in the practitioner's report on the GHG emission reduction information.

.47 In some cases, one practitioner has reported on an entity's GHG inventory, but another practitioner is engaged to report on the entity's GHG emission reduction information. When the practitioner engaged to report on the GHG emission reduction information is deciding whether he or she may rely on the work of the other practitioner, the practitioner may find it helpful to consider the provisions of AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* (AICPA, *Professional Standards*). Other important considerations in this situation are the level of assurance obtained by the other practitioner and the consistency of the assumptions and methods used to measure the GHG emission reduction with those used to measure the GHG inventory reported on by the other practitioner. (See paragraphs .33 and .66).

.48 Members of professions other than public accounting are subject to their own professional requirements; those requirements may differ from those of the public accounting profession. When a non-CPA has provided verification services (see paragraph .06) with respect to an entity's GHG inventory and the practitioner is engaged to examine or review an entity's GHG reduction, the practitioner should perform procedures to obtain sufficient evidence with respect to the entity's GHG inventory as part of performing the attest engagement to report on the entity's GHG emission reduction (for example, evaluating the appropriateness of the methodology and any emission factors used and whether the base year emissions were adjusted if needed). The practitioner may find it helpful to consider certain aspects of the specialist's work in accordance with AU-C section 620.

Written Assertion by the Responsible Party

.49 A written assertion by a responsible party may be presented to a practitioner in a number of ways, such as in a narrative description, within a schedule, or as part of a representation letter appropriately identifying what is being presented and the point in time or period of time covered. An example of a written assertion on a GHG inventory is as follows:

XYZ Company asserts that its schedule of GHG emissions for the year ended December 31, 20XX, is presented in conformity with *[identify criteria selected by the responsible party]*.

An example of a written assertion on a GHG emission reduction project is as follows:

XYZ Company reduced GHG emissions in connection with project ABC by 50,000 tons of CO₂ equivalents for the year ended December 31, 20XX, from its GHG emissions in the prior year, based on *[identify criteria selected by the responsible party]*.

Engagement Performance

Agreement on Engagement Terms

.50 The practitioner should establish an understanding with the client regarding the services to be performed. The understanding should include the objectives of the engagement, management's responsibilities, the practitioner's responsibilities, and the limitations of the engagement. The practitioner should document the understanding in the working papers, preferably through a written communication with the client, such as an engagement letter.

Planning the Engagement

.51 Relevant information about obtaining an understanding and other considerations when planning an examination or review engagement typically includes the following:

- Applicable to GHG inventories and reductions
 - The nature of the entity's business and whether the entity has operations, and, therefore, GHG emission sources, in multiple locations and the types of GHG emissions produced
 - The business purpose or reason behind emissions measurements or emission reductions
 - The oversight of, and responsibility for, emissions information within the entity
 - The organizational and operational boundaries used for the emissions inventory
 - Whether there have been any mergers, acquisitions, divestitures, sales of emitting sources, or outsourcing of functions with significant emissions that may require adjustment of the entity's baseline
 - Whether all significant sources of emissions have been identified by the entity
 - The potential for double-counting of emissions and, if applicable, reductions
 - When applicable, any regulatory framework(s) (for example, state- or country-specific regulations, *permits*, or operating licenses governing emissions where the entity has operations) or any requirements relevant to a voluntary commitment to register or reduce GHG emissions

- How GHG emissions have been calculated and reported, including emissions factors and their justification, and any assumptions on which estimates are based
- The protocols that were used for measurement of emissions and whether they were used in a consistent manner throughout the entity over the period under examination or review
- Whether there is a need to use the work of a specialist
- Whether the entity's internal audit function is relevant to the engagement
- Whether to obtain a legal letter (legal letters are generally not obtained in a review engagement)
- Applicable to GHG reductions only
 - The type(s) of emission reduction(s) (for instance, a switch in fuel type or change in production process) (see paragraph .33).
 - Whether the emitting entity is required by a registry or regulatory framework to engage an outside specialist to evaluate the scientific or engineering basis for the proposed reduction project (sometimes referred to as a *validation*). Those rules may further specify that the party evaluating the science cannot be the same party as the verifier. When applicable, whether another reputable party has evaluated the science and found it to be acceptable and the implications of findings in the report.
 - Whether there are any ownership issues relating to the GHG emission reduction credits to be sold. (For example, in the case of a landfill, the seller may own the landfill or have ownership rights over the emission reduction by virtue of a contract.)

Consideration of Internal Control Over Gathering and Reporting GHG Emissions Data

.52 Paragraph .52c of AT section 101 states “the more effective the controls over the subject matter, the more assurance they provide about the subject matter or the assertion.” For an examination engagement, obtaining an understanding of internal control over gathering and reporting GHG emissions data, including *data assembly* and data retention, assists the practitioner in assessing control risk and planning the engagement. Relevant matters to understand regarding internal control include the following components of the entity's internal control:

- a. The control environment.
- b. The information system, including the related business processes, and communication of emissions-reporting roles and responsibilities and significant matters relating to emissions reporting.
- c. The entity's risk assessment process related to gathering, processing, and reporting GHG emissions data.
- d. Control activities relevant to the engagement. An attest engagement does not require an understanding of all the control activities related to each significant type of emission and disclosure in the GHG emissions schedule or to every assertion relevant to them.
- e. Monitoring of controls

.53 For a review engagement, obtaining an understanding of the entity's internal control over gathering and reporting GHG emissions data, including data assembly and data retention, may assist the practitioner with

- a. identifying types of potential misstatements in the GHG emissions statement, including types of omissions, and considering the likelihood of their occurrence.
- b. selecting the inquiries and analytical procedures, and other procedures if necessary, that will provide a basis for reporting whether any information causes the practitioner to believe
 - i. the entity's GHG emissions statement is not presented, in all material respects, in conformity with the criteria selected by the responsible party, or
 - ii. the responsible party's written assertion about the GHG emissions statement is not fairly stated, in all material respects, based on the criteria selected by the responsible party.

Part of Attest Engagement Performed by Other Practitioners

.54 If another practitioner is reporting on the GHG emissions information for a subsidiary of the entity, that practitioner also should follow the guidance in this SOP. The practitioner who is engaged to report on the entity as a whole should consider whether the practitioner for the subsidiary has the skill and knowledge required to conduct the engagement. AU-C section 600 provides guidance on the professional judgments the auditor makes when deciding whether the auditor may serve as group engagement partner and use the work and reports of component auditors who have audited the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the financial statements presented. The practitioner who is engaged to report on the entity as a whole may find that guidance helpful when performing an attest engagement on GHG emissions, and another practitioner is reporting on the GHG emissions of a subsidiary or other component of the client entity. Other relevant information for the practitioner reporting on the subsidiary is whether the subsidiary is using the same protocol, scope of reporting, and boundaries as the parent entity.

Attestation Risk

.55 *Attestation risk* is the risk that the practitioner may unknowingly fail to appropriately modify his or her attest report on the subject matter or assertion that is materially misstated. It consists of (a) the risk (consisting of *inherent risk* and *control risk*) that the subject matter or assertion contains deviations or misstatements that could be material and (b) the risk that the practitioner will not detect such deviations or misstatements (*detection risk*).

.56 Examples of causes of possible misstatements of GHG inventory or GHG emission reduction information include the following:

- Human error in calculations
- Use of incorrect emissions factors
- Omission from the inventory of emissions from one or more emitting sources
- Omission from the inventory of one or more GHG emissions (for example, omission of methane emissions)

- Failure to properly account for leakage (for example, when the entity has outsourced a major function that accounted for a significant part of its GHG emissions baseline but has not adjusted its baseline to reflect such change)
- Failure to appropriately adjust the baseline for events such as sales or acquisitions of emitting sources
- Existence of one or more significant deficiencies in the entity's internal control over reporting of emissions information
- Double counting of an emission source within the entity

Obtaining Sufficient Evidence

.57 When conducting an examination engagement, the practitioner should accumulate sufficient evidence to restrict attestation risk to a level that is, in the practitioner's professional judgment, appropriately low for the high level of assurance that may be imparted by his or her report. A practitioner should select from all available procedures—that is, procedures that assess inherent and control risk and restrict detection risk—any combination that can restrict attestation risk to such an appropriately low level. (See paragraph .54 of AT section 101.)

.58 In a review engagement, the objective is to accumulate sufficient evidence to restrict attestation risk to a moderate level. To accomplish this, the types of procedures performed generally are limited to inquiries and analytical procedures (rather than also including search and verification procedures). Nevertheless, there will be circumstances in which inquiry and analytical procedures (a) cannot be performed, (b) are deemed less efficient than other procedures, or (c) yield evidence indicating that the subject matter or assertion may be incomplete or inaccurate. In the first circumstance, the practitioner should perform other procedures that he or she believes can provide him or her with a level of assurance equivalent to that which inquiries and analytical procedures would have provided. In the second circumstance, the practitioner may perform other procedures that he or she believes would be more efficient to provide him or her with a level of assurance equivalent to that which inquiries and analytical procedures would provide. In the third circumstance, the practitioner should perform additional procedures.

.59 The procedures listed in the following table may be performed, among others, in an examination or review engagement of a GHG inventory or an emission reduction to restrict attestation risk to an appropriate level for the engagement:

<i>Examination</i>	<i>Review</i>
<i>a.</i> Obtaining evidence about how emissions were calculated and any underlying methodologies, emission factors, and assumptions used.	<i>a.</i> Inquiring about how emissions were calculated and any underlying methodologies, emission factors, and assumptions used.
<i>b.</i> Evaluating the appropriateness of techniques used to calculate the emissions or emission reduction, including how completeness and uncertainty are addressed in those calculations (see paragraphs .61–.63).	

<i>Examination</i>	<i>Review</i>
c. Determining whether there have been any changes in the protocol(s) used to calculate emissions and, when applicable, determine whether a subsidiary uses the same protocol.	c. Inquiring about whether there have been any changes in the protocol(s) used to calculate emissions and, when applicable, about whether a subsidiary uses the same protocol.
<p>d. Conducting site visits as considered appropriate. To obtain adequate coverage of total emissions, particularly in an examination, the practitioner may decide that it is appropriate to perform procedures on location at a selection of facilities. Factors that may be relevant to such a decision include</p> <ul style="list-style-type: none"> • the nature of emissions at different facilities. • the number and size of facilities and their contribution to the entity's overall emissions. • whether facilities use different processes or processes using different technologies. When this is the case, it may be appropriate to perform procedures on location at a selection of facilities using different processes or technologies. • the methods used at different facilities to gather emissions information. • the experience of relevant staff at different facilities. • varying the selection of facilities over time. 	
e. Determining whether there have been any changes in baselines, such as sales or acquisitions of operational facilities or subsidiaries.	e. Inquiring about whether there have been any changes in baselines, such as sales or acquisitions of operational facilities or subsidiaries.
f. When applicable, obtaining information about the frequency of meter readings and calibration and maintenance of meters.	f. When applicable, inquiring about the frequency of meter readings and calibration and maintenance of meters.
g. Reading relevant contracts.	
h. Tracing information to supporting documents.	
i. Inquiring about the existence of fraud or illegal acts or suspected fraud or illegal acts affecting the entity involving (1) management, (2) employees who have significant roles in the entity's processes and procedures relating to measurements of emissions in conformity with the criteria specified previously, or (3) others when the fraud or illegal acts could have a material effect on measurements of emissions in conformity with the selected criteria.	

(continued)

<i>Examination</i>	<i>Review</i>
<p><i>j.</i> Inquiring about the nature of significant judgments and estimates made by management and any uncertainties regarding measurements; considering management's process for, and internal control over, developing those estimates; inquiring about key factors and assumptions underlying those estimates; and evaluating the reasonableness thereof.</p>	
<p><i>k.</i> When applicable, tracing emissions factors used to recognized sources.</p>	<p><i>k.</i> When applicable, inquiring about the source of emissions factors.</p>
<p><i>l.</i> Determining whether emissions factors have been properly applied and whether the underlying assumptions are documented and have a reasonable basis.</p>	<p><i>l.</i> Inquiring about whether emissions factors have been properly applied and whether the underlying assumptions are documented and have a reasonable basis.</p>
<p><i>m.</i> Performing analytical procedures (for example, change in amounts from the previous year, fluctuations in amounts during the present year, and variation from an independent expectation developed by the practitioner).</p>	
<p><i>n.</i> When applicable, comparing emission data to records of number of units sold or produced for the period.</p>	<p><i>n.</i> When applicable, performing analytical comparisons of emission data to number of units sold or produced for the period.</p>
<p><i>o.</i> When applicable, confirming details of the transaction(s) (for example, quantity of methane sold or purchased) with the other party to the transaction.</p>	
<p><i>p.</i> Inquiring about whether there have been any changes in production levels (lower emissions due to a drop in production level might not be permanent) and obtaining evidence supporting production levels.</p>	<p><i>p.</i> Inquiring about whether there have been any changes in production levels (lower emissions due to a drop in production level might not be permanent).</p>
<p><i>q.</i> Inquiring about whether there have been any communications from regulators concerning emission levels or noncompliance with permits or regulatory programs.</p>	

<i>Examination</i>	<i>Review</i>
r. Obtaining supporting evidence for any emission reduction credits that are banked, purchased from, or sold to a third party (such information may be included in a public report on a GHG inventory).	r. Inquiring about any emission reduction credits that are banked, purchased from, or sold to a third party (such information may be included in a public report on a GHG inventory).
s. Obtaining and reading environmental (or Environmental, Health and Safety [EH&S]) internal audit reports and minutes of audit committee meetings (or other relevant board committees to which the environmental or EH&S internal auditors report).	s. Inquiring about relevant information in environmental or EH&S internal audit reports and minutes of audit committee meetings (or other relevant board committees to which the environmental or EH&S internal auditors report).
t. Inquiring about whether there have been any subsequent events that would affect the subject matter or the assertion (see paragraph .66).	
u. Obtaining a legal letter when considered appropriate (for example, to address [1] noncompliance with regulatory programs [emissions exceed permitted amount], [2] ownership of credits, or [3] the existence of any unasserted claims).	
v. Obtaining written representations from management.	

.60 In a review engagement, the practitioner ordinarily is not required to corroborate management’s responses to inquiries with other evidence; however, the practitioner should consider the reasonableness and consistency of management’s responses in light of the results of other review procedures and the practitioner’s knowledge of the entity’s business and the industry in which it operates and, as noted in paragraph .58, the practitioner may need to perform additional procedures.

Techniques to Calculate Emissions and Reductions

.61 Reductions are calculated by comparing the amount of emissions from one period to another. For entities reporting on a facility basis, this will usually be calculated annually. For entities reporting on a project basis, the period may vary depending on the nature of the project.

.62 Measurement techniques include, but are not limited to, the use of mass balance equations, emissions factors, stack tests, and direct measurement of emissions, including continuous emission monitors.

.63 For reductions calculated in comparison to a base year, adjustments are evaluated to the base year based on structural changes with the entity’s organization and changes in ownership or control of the emitting source(s), or

both. (Mergers, acquisitions, sales of emitting sources, outsourcing of certain functions, and entering into joint ventures would likely require adjustment of the baseline.) Note that adjustments of the baseline based on organic growth or decline are generally not appropriate.

Procedures Specific to GHG Emission Reduction Engagements

.64 In addition to the procedures described in paragraph .59, procedures that may be relevant, among others, in an examination or review engagement of GHG emission reduction information are included in the following table:

<i>Examination</i>	<i>Review</i>
a. Obtaining evidence of significant changes in the production process, switches from one fuel type to another, or other changes resulting in the emission reduction.	a. Making inquiries about whether there have been any significant changes in the production process, switches from one fuel type to another, or other changes resulting in the emission reduction.
b. Evaluating techniques used by the entity to calculate the emission reduction (see paragraphs .61–.63).	
c. Inquiring about the reason or business purpose for the reduction and considering the possible implications with respect thereto. Consider obtaining from management a written representation regarding the reason for the reduction project (see paragraph .30 on additionality).	
d. Inquiring about whether there are any permits applicable to the facility and, if so, examine the permit for factors that may have a bearing on the reduction project (for example, reductions that meet other requirements cannot be transferred); obtaining a management representation specific to permits.	d. Inquiring about whether there are any permits applicable to the facility and, if so, about how they might bear on the reduction project (for example, reductions that meet other requirements cannot be transferred); consider obtaining a management representation specific to permits.
e. When applicable, reading reports prepared by the seller for purposes other than the sale of the GHG emission reduction credits (for example, an emission report filed with a regulatory agency) and checking for consistency of information related to the sale.	
f. Agreeing or confirming details of GHG emission reduction credits with the relevant GHG registry.	f. If information is publicly available, comparing detail of GHG emission reduction credits with the relevant GHG registry.

Consideration of Subsequent Events

.65 Events or transactions sometimes occur subsequent to the point in time or period of time of the subject matter being tested, but before the date of the practitioner's report, that have a material effect on the subject matter and, therefore, require adjustment or disclosure in the presentation of the subject matter or the assertion. These occurrences are referred to as *subsequent events*. When performing an attest engagement, the practitioner should consider information about subsequent events that comes to his or her attention. Although the practitioner has no responsibility to detect subsequent events, the practitioner should inquire of the responsible party (and his or her client, if the client is not the responsible party) about whether they are aware of any subsequent events through the date of the practitioner's report that would have a material effect on the subject matter or the assertion. If the practitioner has decided to obtain a representation letter from the responsible party, the letter ordinarily would include a representation concerning subsequent events. (Paragraphs .95–.99 of AT section 101 provide additional guidance on the consideration of subsequent events in an attest engagement.) Types of events that may represent a subsequent event in the context of an attest engagement on GHG emissions include the following:

- Changes in baseline emissions due to events such as acquisition or disposition of facilities, change in number of shifts at a facility, or change in production levels
- Destruction of the facility to which an emission reduction relates
- In the case of a GHG emission reduction, unplanned or accidental release of sequestered carbon
- Investigations or regulatory actions related to emissions

Adequacy of Disclosure

.66 The practitioner is required by AT section 101 to consider the adequacy of disclosure of material matters. (See paragraphs .70 and .76–.77 of AT section 101.) Examples of matters that may be material include

- changes in the entity's boundaries or emissions calculation methodologies.
- mergers, divestitures, acquisitions, or closures.
- uncertainties in the measurement of GHG emissions (see paragraph .32).

Representation Letter

.67 In an examination or review engagement, the practitioner should consider obtaining a representation letter from the responsible party. Written representations from the responsible party ordinarily confirm representations explicitly or implicitly given to the practitioner, 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. Examples of matters that might appear in such a representation letter include the following:

- a. Management's (responsible party's) assertion about the subject matter based on the criteria selected

- b.* A statement acknowledging responsibility for the subject matter and, when applicable, the assertion
- c.* A statement acknowledging responsibility for selecting the criteria, when applicable
- d.* A statement acknowledging responsibility for determining that such criteria are appropriate for its purposes, when the responsible party is the client
- e.* A statement acknowledging ownership of the emissions or emission reductions
- f.* A statement that all known matters contradicting the assertion or presentation and any communication from regulatory agencies affecting the subject matter or the assertion have been disclosed to the practitioner
- g.* A statement regarding the absence of undisclosed or unrecorded emission sources
- h.* A statement that knowledge of illegal acts, fraud, or suspected illegal acts or fraud affecting the entity involving (i) management, (ii) employees who have significant roles in the entity's processes and procedures relating to measurements of emissions in conformity with the criteria specified previously, or (iii) others when the illegal acts or fraud could have a material effect on measurements of emissions in conformity with the selected criteria has been disclosed to the practitioner
- i.* A statement that management (responsible party) has disclosed to the practitioner all significant deficiencies in the design or operation of internal control over its GHG inventory
- j.* A statement regarding the availability of all records relevant to the subject matter
- k.* A statement that management (responsible party) has responded fully to all inquiries made by the practitioner during the engagement
- l.* A statement that any known events subsequent to the period (or point in time) of the subject matter being reported on that would have a material effect on the subject matter (or, if applicable, the assertion) have been disclosed to the practitioner
- m.* Other matters as the practitioner deems appropriate
- n.* Relevant to an emission reduction, a statement regarding the business purpose of the emission reduction project
- o.* Relevant to an emission reduction, a statement that the reduction is both real and additional to any requirements

Appendix C, "Illustrative Management Representation Letter," includes an illustrative management representation letter.

.68 When the client is not the responsible party, the practitioner should consider obtaining a letter of written representations from the client as part of the attest engagement. Examples of matters that might appear in such a representation letter include the following:

- a.* A statement regarding whether the client is aware of any matters that might contradict the subject matter or the assertion
- b.* A statement that all known events subsequent to the period (or point in time) of the subject matter being reported on that would have a

material effect on the subject matter (or, if applicable, the assertion) have been disclosed to the practitioner

- c. A statement acknowledging the client's responsibility for selecting the criteria, when applicable
- d. A statement acknowledging the client's responsibility for determining that such criteria are appropriate for its purposes
- e. Other matters as the practitioner deems appropriate

.69 If the responsible party or the client refuses to furnish all written representations that the practitioner deems necessary, a scope limitation exists, and the practitioner should consider the effects of such a refusal on his or her ability to issue a conclusion about the subject matter. In an examination, if the practitioner believes that the representation letter is necessary to obtain sufficient evidence to issue a report, the responsible party's or the client's refusal to furnish such evidence in the form of written representations is sufficient to preclude an unqualified opinion and is ordinarily sufficient to cause the practitioner to disclaim an opinion or withdraw from an examination engagement. However, based on the nature of the representations not obtained or the circumstances of the refusal, the practitioner may conclude, in an examination engagement, that a qualified opinion is appropriate. Further, the practitioner should consider the effects of the refusal on his or her ability to rely on other representations. When a scope limitation exists in a review engagement, the practitioner should withdraw from the engagement. (See paragraph .75 of AT section 101.)

Reporting

.70 AT section 101 permits the practitioner to report either on the written assertion or directly on the subject matter to which the assertion relates. However, as stated in paragraph .66 of AT section 101, if conditions exist that, individually or in combination, result in one or more material misstatements or deviations from the criteria, the practitioner should modify the report and, to most effectively communicate with the readers of the report, should ordinarily express his or her conclusion directly on the subject matter, not on the assertion.

.71 The report may contain a paragraph emphasizing measurement uncertainties, such as the following:

As described in footnote X, environmental and energy use data are subject to measurement uncertainties resulting from limitations inherent in the nature and methods used for determining such data. The selection of different but acceptable measurement techniques can result in materially different measurements. The precision of different measurement techniques may also vary.

.72 When the measurement methods, and the application thereof, have not been consistent from period to period, the practitioner should consider whether to modify the practitioner's report. The form of the modification depends on the circumstances (for example, whether the presentation or management's assertion appropriately disclose those facts or whether prior periods, if presented or used in the calculation of a reduction, are restated). If the responsible party (that is, in most cases, the client) does not appropriately restate the baseline and prior period(s) inventory for a material change, the practitioner should include an explanatory paragraph in the practitioner's report describing the lack of consistency and should express a qualified or adverse opinion in an

examination report or a modified conclusion in a review report due to a departure from the criteria. If the responsible party does appropriately restate, the practitioner should consider including an explanatory paragraph (following the opinion or conclusion paragraph) in his or her report that refers to the change in the measurement methods or application.

.73 When the practitioner is engaged to report on GHG emissions of one or more particular locations or subsidiaries or on reductions related to one or more specific projects, the report may include a paragraph stating that the practitioner was not engaged to examine or review the entity-wide emissions or reductions and, accordingly, the practitioner is not expressing any form of conclusion on such entity-wide information.

.74 When the trading program or GHG registry contains specific materiality requirements that are more stringent than those of AT section 101, the practitioner may include a reference to those requirements in the attest report.

.75 AT section 101 requires the report on an attest engagement to contain a statement of management's responsibility for the subject matter or the assertion. The statement of management's responsibility may also address management's responsibility for selecting and adhering to the criteria used.

.76 Illustrative reports for the following are included in the appendixes noted:

- Appendix D, "Illustrative Examination Reports on GHG Emissions Information": Examination of an entity's GHG emissions information for a period of time
- Appendix E, "Illustrative Examination Reports on GHG Emission Reduction Information": Examination of an entity's GHG emission reduction information
- Appendix F, "Illustrative Review Reports on GHG Emissions Information": Review of an entity's GHG emissions information for a period of time
- Appendix G, "Illustrative Review Reports on GHG Emission Reduction Information": Review of an entity's GHG emission reduction information

.77 The practitioner, in his or her attest report, may refer to the report of another practitioner under the following circumstances:

- When reporting on an attest engagement on GHG emissions and another practitioner has reported on the GHG emissions of a subsidiary or other component of the client entity
- When reporting on an attest engagement on an emission reduction and another practitioner has reported on the entity's GHG inventory for the prior period

See example 3 in appendix D and appendix F in this SOP, respectively, for an example examination and review report that refers to the report of another practitioner.

.78 The practitioner reporting on the emission reduction would only be able to make reference to the report of the practitioner reporting on the GHG inventory information if both practitioners are reporting at the same level of assurance on emissions information for the same emission source(s) addressed by the reduction project. For example, in an emission reduction engagement

- if practitioner A reported on an examination of GHG inventory for Plant X for which practitioner B is reporting on an examination of the emission reduction, practitioner B may divide responsibility by referring to the work of practitioner A in his or her report. However, if practitioner A reported on an examination of the company's GHG inventory for its nationwide operations taken as a whole, practitioner B, who is reporting only on an examination of the reduction project at Plant X, would need to perform sufficient additional procedures on the GHG inventory at Plant X and would not refer to the work of practitioner A in his or her report.
- if practitioner A reported on a review of GHG inventory for Plant X for which practitioner B is reporting on an examination of the emission reduction, practitioner B would need to perform sufficient additional procedures on the GHG inventory at Plant X and should not refer to the work of practitioner A in his or her report.

Attest Documentation

.79 Paragraphs .100–.107 of AT section 101 set documentation requirements. The practitioner should be aware that the GHG registry or regulatory program relevant to the attest engagement may have set additional documentation requirements for those providing assurance on GHG emissions inventories or reductions (sometimes referred to as *verifiers*).

Effective Date

.80 This SOP is effective for reports on GHG emissions information issued on or after September 15, 2013. Early implementation is permitted.

Appendix A — Glossary

additionality. A project is *additional* if it would not have happened but for the incentive provided by the credit trading program (for example, Clean Development Mechanism [CDM] or Joint Implementation [JI]). The Kyoto Protocol specifies that only projects that provide emission reductions that are *additional* to any that would occur in the absence of the project activity shall be awarded certified emission reductions (CERs) in the case of CDM projects or emission reduction units (ERUs) in the case of JI projects. This is often referred to as *environmental additionality*. *Financial additionality* is the notion that a project is made commercially viable through its ability to generate value in the form of certified emission reductions. Various greenhouse gas (GHG) registries or regulatory frameworks may define these terms differently.

allowance. The unit of trade under a trading system. In a closed trading system, trading of allowances is permitted only between parties subject to the program or regulatory system. Allowances grant the holder the right to emit a specific quantity (for example, one ton) of emissions once. The total quantity of allowances issued by regulators dictates the total quantity of emissions possible under the system. Allowances are typically granted to emitters by governmental entities or agencies either for free or for a fee. At the end of each compliance period, each source must surrender sufficient allowances to cover its emissions during that period. In an open trading system, trades can be made between parties within the system and parties outside the system.

baseline. The amount of the entity's emissions for a specified base year against which any future changes in emissions are evaluated. Emission reductions targets are often expressed as a percent reduction from the baseline emission level.

boundaries. There are two types of boundaries: organizational and operational. When accounting for GHG emissions from partially owned entities, it is important to draw clear organizational boundaries, which should be consistent with the organizational boundaries that have been drawn up for financial reporting purposes. After the entity has determined its organizational boundaries in terms of the entities it owns or controls, it must then set operational boundaries with respect to direct and indirect emissions. The World Resources Institute/ World Business Council for Sustainable Development (WRI/WBCSD) Greenhouse Gas Protocol provides additional guidance on setting organizational and operational boundaries with respect to GHG emissions.

closed trading system. In a closed trading system, trading of allowances is permitted only between parties subject to the program or regulatory system. See also **open trading system**.

credit. The term *credit* is used in a number of contexts, most commonly in relation to emission reductions that have been achieved in excess of the required amount for one of the following:

- The Kyoto Protocol's JI, also known as ERUs
- The Kyoto Protocol's CDM, specifically known as CERs
- The Kyoto-related and voluntary trading programs

data assembly. The process the entity uses to “roll-up” individual site or process level information to a facility- or corporate-level report. For example, the entity may choose to have a manufacturing unit report only the number of widgets it produced each year and have corporate-level environmental staff apply the appropriate emission factors to calculate the resultant emissions. Alternatively, the entity may choose to have all calculations done at the operational level and assign only quality control responsibilities to the corporate staff.

direct GHG emissions. Direct GHG emissions, or scope 1 emissions, are emissions from sources that are owned or controlled by the entity. These are emissions associated with the following:

- Stationary combustion from fuel burned in the entity’s stationary equipment, such as boilers, incinerators, engines, and flares
- Mobile combustion from fuel burned in the entity’s transport devices, such as trucks, trains, airplanes, and boats
- Process emissions from physical or chemical processes, such as cement manufacturing, petrochemical processing, and aluminum smelting
- Fugitive emissions, which are intentional and unintentional releases, such as equipment leaks from joints and seals and emissions from wastewater treatment, pits, and cooling towers

emissions factor. A mathematical factor or ratio for converting the measure of an activity (for example, liters of fuel consumed, kilometers travelled, the number of animals in husbandry, or tons of product produced) into an estimate of the quantity of GHGs associated with that activity.

emission reduction. The process by which an entity reduces its emissions of GHGs as compared to a baseline.

GHG inventory. An entity’s GHG emissions for a specified period, typically a year or a series of years, is referred to as its GHG inventory. See also **baseline**.

indirect GHG emissions. Indirect emissions, or scope 2 reporting under the WRI/WBCSD Greenhouse Gas Protocol, represent emissions from the generation of imported or purchased electricity, heat, or steam. Other indirect emissions, or scope 3 reporting under the GHG Protocol, include the following:

- Employee business travel
- Outsourced activities, contract manufacturing, and franchises
- Transportation by the vendor or contractor of, for example, materials, products, waste, and employees
- Emissions from product use and end of life
- Employee commuting
- Production of imported materials

inventory. See **GHG inventory**.

leakage. Leakage occurs when an emission reduction project causes emissions to increase beyond the project’s boundaries. Entities entering into an emission reduction project typically must demonstrate that the emission reduction will not cause emissions to increase beyond the project’s boundaries.

offset. Offsets are created when a source makes voluntary, permanent emission reductions that are in surplus to any required reductions. Entities that create offsets can trade them to other entities to cover growth or relocation. Regulators may be required to approve each trade. Regulators normally require a portion of the offsets to be retired to ensure an overall reduction in emissions. Offsets are an open system (an open system is one in which trades can be made between parties within the system and parties outside the system). One offset is an emission reduction that a pollution source has achieved in excess of permitted levels or required reductions, or both. The excess amount is the credit and can be sold on the market.

open trading system. In an open trading system, trades can be made between parties within the system and parties outside the system. See also **closed trading system**.

permits. Certificates of operation that allow holders to operate a facility provided they do not exceed a specified rate (kilograms/tons per day). Permits are often designated as an upper limit. Because few systems operate at 100 percent of capacity at all times, actual emissions are usually a fraction of the theoretical upper limit of allowed emissions. However, as new permits become harder to obtain, existing operations are motivated to increase their level of operations under their existing permits (for example, by adding a second shift, thereby legally increasing the overall quantity of emissions). **Allowances** are transferable, whereas the permit itself is attached to a specific installation or site.

uncertainty. As used in the field of GHG emissions, uncertainty refers to uncertainty in the measurement of GHG emissions that arises from imprecise measurement methods and factors.

validation. The process used to ensure that a given project, if implemented, can achieve the projected reduction results. The entity may validate the feasibility of the design of an emission reduction project internally, or the entity may engage an outside party (typically an engineering or a consulting firm) to perform the validation.

verification. The objective and independent assessment of whether the reported GHG inventory properly reflects the GHG impact of the entity in conformance with preestablished GHG accounting and reporting standards. Some registries define *verification* as the process used to ensure that a given participant's GHG inventory (either the baseline or the annual result) has met a minimum quality standard and complied with a specific registry's procedures and protocols for calculating and reporting GHG emissions.

verified emission reductions. Verified emission reductions are created, in the absence of government rules, by project-based activities that are defined by the buyer and seller and verified by a third party.

Emissions Trading Programs

baseline-and-credit program. In a baseline-and-credit program (that is, credit- or project-based trading), each participant is provided a baseline against which its performance is measured. If an action is taken to reduce emissions, the difference between the baseline and the actual emissions, where actual emissions are less than the baseline, can be credited and traded. The baseline established for crediting purposes can be fixed or dynamic, decreasing or increasing over time. The key

distinction between a cap-and-trade program and a baseline-and-credit program is that the former regulated sources' emissions are required to remain under an emissions cap, which is a fixed quantity. Such a limit is not necessarily imposed in a baseline-and-credit program. The Kyoto Protocol's CDM, for example, would operate as a baseline-and-credit program.¹

cap-and-trade program. In a cap-and-trade program (that is, allowance-based trading), the maximum level of emissions that can be released from sources is set by the control authority. This level is the cap. All sources are required to have allowances to emit. The allowances are freely transferable; they can be bought or sold. The control authority issues exactly the number of allowances needed to produce the desired emission level. An example of this kind of system is the U.S. Environmental Protection Agency's nationwide Acid Rain Program, under which allowances of SO₂ and NO_x can be traded to comply with an emissions cap.²

¹ Adapted from Richard Rosenzweig and Josef Janssen, *The Emerging International Greenhouse Gas Market* (Arlington: Pew Center on Global Climate Change, 2002).

² United States Environmental Protection Agency (EPA) (May 10, 2012), Cap and Trade, Retrieved November 29, 2012 from www.epa.gov/captrade/ and U.S. EPA (July 25, 2012), Acid Rain Program, Retrieved November 29, 2012, from www.epa.gov/airmarkets/progsregs/arp/index.html.

Appendix B — Sources for GHG Emission Protocols and Calculation Tools

These tools are included solely as informational resources. They are not, however, endorsed by the AICPA.

<i>Tool Name</i>	<i>Website</i>
World Resource Institute/World Business Council for Sustainable Development (WRI/WBCSD) Greenhouse Gas Protocol	www.ghgprotocol.org/standards/corporate-standard
GHG Calculation Tools (cross-sector and sector specific tools)	<p>www.ghgprotocol.org/calculation-tools</p> <p>This website contains tools for calculating</p> <ul style="list-style-type: none"> • N₂O emissions from the production of adipic acid. • CO₂ and PFC emissions from the production of aluminum. • CO₂ emissions from the production of ammonia. • CO₂ emissions from the production of cement. • HFC-23 emissions from the production of HCFC-22. • CO₂ emissions from the production of iron and steel. • CO₂ emissions from the production of lime. • N₂O emissions from the production of nitric acid. • CO₂ emissions from mobile combustion. • GHG emissions from office-based organizations. • GHG emissions from pulp and paper mills. • PFC emissions from the production of semiconductor wafers. • CO₂ emissions from stationary combustion.
The Climate Registry	<p>www.theclimateregistry.org</p> <p>www.theclimateregistry.org/resources/protocols/</p> <p>www.theclimateregistry.org/resources/verification/</p>

Appendix C — Illustrative Management Representation Letter

[Date]

[Name of CPA Firm]

We are providing this letter in connection with your [examination/review] of our assertion(s) that [describe assertion(s), for example, the accompanying schedule of greenhouse gas (GHG) emissions for XYZ Company for the year ended December 31, 20XX, is presented in conformity with (identify criteria used, for example, the Greenhouse Gas Protocol Corporate Accounting and Reporting Standard and the Corporate Value Chain [Scope 3] Accounting and Reporting Standard published by the World Business Council for Sustainable Development and the World Resource Institute)].

We are responsible for [describe assertions and subject matter]. We further confirm that we are responsible for the selection of [identify criteria] as the criteria against which you are evaluating our assertion(s). Further we confirm that we are responsible for determining that [identify criteria] represent appropriate criteria for our purposes.

We confirm, to the best of our knowledge and belief, the following representations made to you during your [examination/review]:

1. We are not aware of any matters contradicting the assertion(s), nor have we received any communications from regulatory agencies or [identify organizations to which the company reports GHG emissions] affecting the subject matter or our assertion(s) on such subject matter.
2. We have disclosed to you all significant emission sources. There are no material emissions that have not been recorded in the greenhouse gas (GHG) emission records underlying our assertion(s) referred to above. GHG emissions have been reported for the entities where the Company has operational control.
3. There has been no (a) fraud involving management or employees who have significant roles in the Company's processes and procedures relating to measurements of emissions in conformity with the criteria specified above or (b) fraud involving others that could have a material effect on measurements of emissions in conformity with the selected criteria.
4. There are no significant deficiencies in the design or operation of the Company's internal control over its GHG inventory.
5. We have made available to you all records relevant to your [examination/review] of the aforementioned subject matter or assertion(s).
6. We have responded fully to all inquiries made by you during the engagement.
7. [Add additional representations as deemed appropriate.]

We are not aware of any events that occurred subsequent to the period being reported on and through the date of this letter that would have a material effect on the aforementioned subject matter or assertion(s).

[Name of chief executive officer and title]

[Name of corporate environmental officer and title]

[The following illustrates an example of a written assertion and additional representations that should be obtained in connection with GHG emission reductions:]

Example assertion in connection with an emission reduction:

XYZ Company reduced GHG emissions in connection with project ABC by 50,000 tons of CO₂ equivalents for the year ended December 31, 20XX, based on *[identify criteria selected by the responsible party]*.

Additional representations:

The GHG emission reduction project was undertaken for the purpose of *[describe business purpose]*. The GHG emission reductions were achieved as a direct result of the project and not as a result of any changes in activity level. The GHG emission reductions related to the project are both real and additional to any requirements. Further, we have satisfactory title to all GHG emission reduction credits related to the project, and there are no liens or encumbrances on such GHG emission reduction credits, nor have any GHG emission reduction credits been pledged as collateral.

Appendix D — Illustrative Examination Reports on GHG Emissions Information

The examination report examples illustrated herein are for general use. See paragraphs .78–.83 of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*), for requirements and guidance on restricting the use of an attest report.

Example 1—Examination Report on Subject Matter

Independent Accountant’s Report

We have examined the accompanying schedule of greenhouse gas emissions of XYZ Company for [*identify period, for example, the year ended December 31, 20XX*]. XYZ Company’s management is responsible for the schedule. Our responsibility is to express an opinion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the nature of the company’s greenhouse gas emissions; examining, on a test basis, evidence supporting the company’s schedule of greenhouse gas emissions; and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

As described in footnote X, environmental and energy use data are subject to measurement uncertainties resulting from limitations inherent in the nature and methods used for determining such data. The selection of different but acceptable measurement techniques can result in materially different measurements. The precision of different measurement techniques may also vary.

In our opinion, the schedule referred to above presents, in all material respects, the greenhouse gas emissions of XYZ Company for [*identify period, for example, the year ended December 31, 20XX*] in conformity with [*identify criteria*].

[*Signature*]

[*Date*]

Example 2—Examination Report on Management’s Assertion

Independent Accountant’s Report

We have examined management’s assertion that [*identify the assertion, for example, the accompanying schedule of greenhouse gas emissions for XYZ Company for the year ended December 31, 20XX, is presented in conformity with (identify criteria)*]. XYZ Company’s management is responsible for the assertion. Our responsibility is to express an opinion on the assertion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the nature of the company’s greenhouse gas emissions; examining, on a test basis, evidence supporting management’s assertion; and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

As described in footnote X, environmental and energy use data are subject to measurement uncertainties resulting from limitations inherent in the nature and methods used for determining such data. The selection of different but

acceptable measurement techniques can result in materially different measurements. The precision of different measurement techniques may also vary.

In our opinion, management's assertion referred to above is fairly stated, in all material respects, based on *[identify criteria]*.

[Signature]

[Date]

Example 3—Examination Report on Subject Matter; Includes Reference to the Examination Report of Another Practitioner

Independent Accountant's Report

We have examined the accompanying schedule of greenhouse gas emissions of XYZ Company and subsidiaries for the year ended December 31, 20XX. XYZ Company's management is responsible for the schedule. Our responsibility is to express an opinion based on our examination. We did not examine the schedule of greenhouse gas emissions for ABC Company, a wholly owned subsidiary, which reflected 20 percent of the related consolidated emissions. This schedule was examined by other accountants, whose report has been furnished to us and our opinion, insofar as it relates to the amounts included for ABC Company, is based solely on the report of the other accountants.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the nature of the company's greenhouse gas emissions; examining, on a test basis, evidence supporting the company's schedule of greenhouse gas emissions; 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.

As described in footnote X, environmental and energy use data are subject to measurement uncertainties resulting from limitations inherent in the nature and methods used for determining such data. The selection of different but acceptable measurement techniques can result in materially different measurements. The precision of different measurement techniques may also vary.

In our opinion, based on our examination and the report of the other accountants, the schedule referred to above presents, in all material respects, the greenhouse gas emissions of XYZ Company for the year ended December 31, 20XX, in conformity with *[identify criteria]*.

[Signature]

[Date]

Appendix E — Illustrative Examination Reports on GHG Emission Reduction Information

The examination report examples illustrated herein are for general use. See paragraphs .78–.83 of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*), for requirements and guidance on restricting the use of an attest report.

Example 1—Examination Report on Subject Matter

Independent Accountant’s Report

We have examined the schedule of reductions of greenhouse gas emissions of XYZ Company related to the ABC project for the year ended December 31, 20XX, from its GHG emissions in the prior year. XYZ Company’s management is responsible for the schedule. Our responsibility is to express an opinion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the nature of the company’s greenhouse gas emissions; examining, on a test basis, evidence supporting the greenhouse gas emission reduction information; and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

As described in footnote X, environmental and energy use data are subject to measurement uncertainties resulting from limitations inherent in the nature and the methods used for determining such data. The selection of different but acceptable measurement techniques can result in materially different measurements. The precision of different measurement techniques may also vary.

Our engagement related to the specific project identified above. We were not engaged to, and did not, examine XYZ Company’s entity-wide greenhouse gas emissions inventory or whether XYZ Company has reduced its entity-wide greenhouse gas emissions inventory. Accordingly, we do not express an opinion or any other form of assurance on its entity-wide greenhouse gas emissions inventory or changes from prior periods.

In our opinion, the schedule of reductions of greenhouse gas emissions of XYZ Company related to ABC project for the year ended December 31, 20XX is presented, in all material respects, in conformity with [*identify criteria*].

[*Signature*]

[*Date*]

Example 2—Examination Report on Management’s Assertion

Independent Accountant’s Report

We have examined management’s assertion that [*identify the assertion, for example, XYZ Company reduced GHG emissions in connection with project ABC by 50,000 tons of CO2 equivalents for the year ended December 31, 20XX, from its GHG emissions in the prior year*] based on [*identify criteria selected by management*]. XYZ Company’s management is responsible for the assertion. Our responsibility is to express an opinion on the assertion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and,

accordingly, included obtaining an understanding of the nature of the company's greenhouse gas emissions; examining, on a test basis, evidence supporting management's assertion; and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

As described in footnote X, environmental and energy use data are subject to measurement uncertainties resulting from limitations inherent in the nature and methods used for determining such data. The selection of different but acceptable measurement techniques can result in materially different measurements. The precision of different measurement techniques may also vary.

Our engagement related to the specific project identified above. We were not engaged to, and did not, examine XYZ Company's entity-wide greenhouse gas emissions inventory or whether XYZ Company has reduced its entity-wide greenhouse gas emissions inventory. Accordingly, we do not express an opinion or any other form of assurance on its entity-wide greenhouse gas emissions inventory or changes from prior periods.

In our opinion, management's assertion referred to above is fairly stated, in all material respects, based on the *[identify criteria]*.

[Signature]

[Date]

Appendix F — Illustrative Review Reports on GHG Emissions Information

The review report examples illustrated herein are for general use. See paragraphs .78–.83 of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*), for requirements and guidance on restricting the use of an attest report.

Example 1—Review Report on Subject Matter

Independent Accountant’s Report

We have reviewed the accompanying schedule of greenhouse gas emissions of XYZ Company for [*identify period, for example, the year ended December 31, 20XX*]. XYZ Company’s management is responsible for the schedule.

Our review was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. A review consists principally of applying analytical procedures and making inquiries of persons responsible for the greenhouse gas emission information. A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on the company’s schedule of greenhouse gas emissions. Accordingly, we do not express such an opinion.

As described in footnote X, environmental and energy use data are subject to measurement uncertainties resulting from limitations inherent in the nature and the methods used for determining such data. The selection of different but acceptable measurement techniques can result in materially different measurements. The precision of different measurement techniques may also vary.

Based on our review, nothing came to our attention that caused us to believe that the schedule referred to above is not presented, in all material respects, in conformity with [*identify criteria*].

[*Signature*]

[*Date*]

Example 2—Review Report on Management’s Assertion

Independent Accountant’s Report

We have reviewed management’s assertion that [*identify the assertion, for example, the accompanying schedule of greenhouse gas emissions for XYZ Company for the year ended December 31, 20XX, is presented in conformity with (identify criteria)*]. XYZ Company’s management is responsible for the assertion.

Our review was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. A review consists principally of applying analytical procedures and making inquiries of persons responsible for the assertion. A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on management’s assertion. Accordingly, we do not express such an opinion.

As described in footnote X, environmental and energy use data are subject to measurement uncertainties resulting from limitations inherent in the nature and methods used for determining such data. The selection of different but acceptable measurement techniques can result in materially different measurements. The precision of different measurement techniques may also vary.

Based on our review, nothing came to our attention that caused us to believe that management's assertion referred to above is not fairly stated, in all material respects, based on the [*identify criteria*].

[*Signature*]

[*Date*]

Example 3—Review Report on Subject Matter; Includes Reference to the Review Report of Another Practitioner

Independent Accountant's Report

We have reviewed the accompanying schedule of greenhouse gas emissions of XYZ Company and subsidiaries for the year ended December 31, 20XX. XYZ Company's management is responsible for the schedule. We have not reviewed the schedule of greenhouse gas emissions for ABC Company, a wholly owned subsidiary, which reflected 20 percent of the related consolidated emissions. That schedule was reviewed by other accountants, whose report has been furnished to us, and our conclusion, insofar as it relates to the amounts included for ABC Company, is based solely on the report of the other accountants.

Our review was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. A review consists principally of applying analytical procedures and making inquiries of persons responsible for the greenhouse gas emission information. A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on the company's schedule of greenhouse gas emissions. Accordingly, we do not express such an opinion.

As described in footnote X, environmental and energy use data are subject to measurement uncertainties resulting from limitations inherent in the nature and the methods used for determining such data. The selection of different but acceptable measurement techniques can result in materially different measurements. The precision of different measurement techniques may also vary.

Based on our review and the report of the other accountants, nothing came to our attention that caused us to believe that the schedule referred to above is not presented, in all material respects, in conformity with [*identify criteria*].

[*Signature*]

[*Date*]

Appendix G — Illustrative Review Reports on GHG Emission Reduction Information

The review report examples illustrated herein are for general use. See paragraphs .78–.83 of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*), for requirements and guidance on restricting the use of an attest report.

Example 1—Review Report on Subject Matter

Independent Accountant’s Report

We have reviewed the schedule of reductions of greenhouse gas emissions of XYZ Company related to the ABC project for the year ended December 31, 20XX, from its GHG emissions in the prior year. XYZ Company’s management is responsible for the schedule.

Our review was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. A review consists principally of applying analytical procedures and making inquiries of persons responsible for the greenhouse gas emission reduction information. A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on the company’s schedule of reductions of greenhouse gas emissions. Accordingly, we do not express such an opinion.

As described in footnote X, environmental and energy use data are subject to measurement uncertainties resulting from limitations inherent in the nature and methods used for determining such data. The selection of different but acceptable measurement techniques can result in materially different measurements. The precision of different measurement techniques may also vary.

Our engagement related to the specific project identified above. We were not engaged to, and did not, review XYZ Company’s entity-wide greenhouse gas emissions inventory or whether XYZ Company has reduced its entity-wide greenhouse gas emissions inventory. Accordingly, we do not express any conclusion on its entity-wide greenhouse gas emissions inventory or changes from prior periods.

Based on our review, nothing came to our attention that caused us to believe that the schedule of reductions of greenhouse gas emissions of XYZ Company related to ABC project for the year ended December 31, 20XX, is not presented, in all material respects, in conformity with *[identify criteria]*.

[Signature]

[Date]

Example 2—Review Report on Management’s Assertion

Independent Accountant’s Report

We have reviewed management’s assertion that *[identify the assertion, for example, XYZ Company reduced GHG emissions in connection with project ABC by 50,000 tons of CO2 equivalents for the year ended December 31, 20XX from its GHG emissions in the prior year]* based on *[identify criteria selected by management]*. XYZ Company’s management is responsible for the assertion.

Our review was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. A review consists principally of applying analytical procedures and making inquiries of persons responsible for the assertion. A review is substantially less in scope than an

examination, the objective of which is the expression of an opinion on management's assertion. Accordingly, we do not express such an opinion.

As described in footnote X, environmental and energy use data are subject to measurement uncertainties resulting from limitations inherent in the nature and methods used for determining such data. The selection of different but acceptable measurement techniques can result in materially different measurements. The precision of different measurement techniques may also vary.

Our engagement related to the specific project identified above. We were not engaged to, and did not, review XYZ Company's entity-wide greenhouse gas emissions inventory or whether XYZ Company has reduced its entity-wide greenhouse gas emissions inventory. Accordingly, we do not express any conclusion on its entity-wide greenhouse gas emissions inventory or changes from prior periods.

Based on our review, nothing came to our attention that caused us to believe that management's assertion referred to above is not fairly stated, in all material respects, based on *[identify criteria]*.

[Signature]

[Date]

AICPA Sustainability Task Force

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Audit and Attest Standards

Audit and Attest Standards

The Task Force acknowledges the assistance of Raymon Adiletta.

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Section 14,470

Statement of Position 13-2 — Performing Agreed-Upon Procedures Engagements That Address the Completeness, Mapping, Consistency, or Structure of XBRL-Formatted Information

September 2013

NOTE

This AICPA Statement of Position (SOP) has been developed by the AICPA XBRL Assurance Task Force of the AICPA Assurance Services Executive Committee to provide guidance regarding the application of Statements on Standards for Attestation Engagements (SSAEs) to engagements in which a practitioner performs and reports on agreed-upon procedures related to the completeness of the XBRL files, mapping of the source information consistency of the XBRL files with the source information or structure of the XBRL files. In this SOP, the source information consists of the financial statements (including notes) and required schedules to be formatted in XBRL. The terms *completeness*, *mapping*, *consistency*, and *structure* as used in this SOP are defined in paragraph .07 of this SOP. This SOP supersedes SOP 09-1, *Performing Agreed-Upon Procedures Engagements That Address the Completeness, Accuracy, or Consistency of XBRL-Tagged Data*.

This SOP is recognized as an attestation interpretation as defined in AT section 50, *SSAE Hierarchy* (AICPA, *Professional Standards*). Attestation interpretations are recommendations on the application of SSAEs in specific circumstances, including engagements for entities in specialized industries. Attestation interpretations are issued under the authority of the Auditing Standards Board (ASB). The members of the ASB have found this SOP to be consistent with existing SSAEs.

A practitioner should be aware of and consider attestation interpretations applicable to his or her attestation engagement. If the practitioner does not apply the guidance included in this SOP, the practitioner should be prepared to explain how he or she complied with the SSAE provisions of this SOP.

Introduction and Background

.01 This Statement of Position (SOP) provides practitioners with guidance on performing agreed-upon procedures engagements for issuers submitting exhibits to the SEC containing eXtensible Business Reporting Language (XBRL) files¹ and is based on the application guidance of the principles and criteria in the exhibit of *Principles and Criteria for XBRL-Formatted Information*.² However,

¹ Information formatted in interactive data is referred to herein as “XBRL files.”

² *Principles and Criteria for XBRL-Formatted Information* provides preparers, reviewers, practitioners, and users of information formatted in XBRL with criteria for evaluating the completeness of the XBRL files, mapping of the source information, consistency of the XBRL files with the source information, or structure of the XBRL files.

this SOP also may be considered for performing agreed-upon procedures engagements for other applications of XBRL. This SOP supersedes SOP 09-1, *Performing Agreed-Upon Procedures Engagements That Address the Completeness, Accuracy, or Consistency of XBRL-Tagged Data*.

SEC Rules

.02 The SEC issued a release, “Interactive Data to Improve Financial Reporting,” adopting final rules (SEC rules) that require issuers to submit their financial statements and the related notes and required schedules in interactive data format using XBRL, as an exhibit to their financial statements submitted to the SEC via the Electronic Data-Gathering, Analysis, and Retrieval (EDGAR) system and to provide these XBRL files on their corporate websites.

.03 In order for XBRL to be a useful tool for investors and other users of business information, the data contained in XBRL files needs to be accurate and reliable. Preparers of XBRL-formatted information are responsible for providing complete and accurate information in their XBRL files on which investors and other users of business information may rely. For issuers, the SEC rules emphasize the SEC’s expectation that preparers of XBRL-formatted information take the initiative to develop practices to promote tagging processes that result in complete and accurate XBRL files.

.04 The SEC rules³ state that, “an auditor will not be required to apply AU section 550, *Other Information in Documents Containing Audited Financial Statements*, AU section 722, *Interim Financial Information*, or AU section 711, *Filings under Federal Securities Statutes*, to the interactive data provided as an exhibit in a company’s reports or registration statements, or to the viewable interactive data.” Although the SEC rules do not require auditor involvement with the XBRL files, issuers may voluntarily obtain third-party services to assist them in assessing the quality of their XBRL files.

XBRL Terminology

.05 In this SOP, the term *XBRL-formatted information* (commonly referred to as *tagged information*) means information that has been represented using XBRL and included in one or more electronic files. XBRL is a global standard that provides unique electronically readable codes (tags) representing each item in the financial statements or other business reports.

.06 Taxonomies are dictionaries that contain the terms used in financial statements and other business reports and their corresponding XBRL tags. Taxonomies specify the elements to be used for individual items of information, such as the element for the line item “cash and cash equivalents,” and for a group of items, such as narrative disclosures. Taxonomies also identify relationships among terms, (for example, the term *cash and cash equivalents* is related to the term *current assets*). Business rules may be expressed within a taxonomy, such as “gross assets less accumulated depreciation should equal the net assets.” Reporting companies may add to the dictionaries of terms, relationships, and business rules (that is, they may extend the taxonomy).

³ The AU section numbers in the SEC rules refer to *PCAOB Standards and Related Rules*, “Interim Standards.”

Agreed-Upon Procedures Engagements

.07 Given that management of an entity is responsible for the accuracy and reliability of the XBRL files, including identification of and compliance with the SEC's requirements, management (or other specified parties, such as the audit committee) may decide to engage a practitioner to provide attestation services to assist it in assessing the quality of its XBRL files, which may include assessing the completeness of the XBRL files (completeness), the mapping of the source information (mapping), the consistency of the XBRL files with the source information (consistency), or the structure of the XBRL files (structure) as defined here:

Completeness of the XBRL files. All required information is formatted at the required level of detail, as defined by the SEC's requirements. Only permitted information is included in the XBRL files.

Mapping of the source information. The elements selected are consistent with the meaning of the corresponding business reporting concepts in the source information in accordance with the SEC's requirements.

Consistency of the XBRL files with the source information. All formatted information in the XBRL files is consistent with the source information and formatted in accordance with the SEC's requirements.

Structure of the XBRL files. XBRL files are structured in accordance with the SEC's requirements.

.08 The engagement is performed under AT section 201, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*). Not all of the provisions of AT section 201 are discussed in this SOP. Rather, this SOP includes guidance to assist practitioners in applying certain aspects of AT section 201 to the subject matter of XBRL files.

.09 The specified parties are responsible for the sufficiency (nature, timing, and extent) of the agreed-upon procedures because they best understand their own needs. The practitioner performs the procedures and reports his or her findings. Because the procedures are intended to meet the needs of the specified parties and may not be appropriate for others, use of these reports is restricted to the specified parties.

.10 To avoid misunderstanding, it is not appropriate for the entity to refer to services obtained from a practitioner in connection with an agreed-upon procedures engagement in a document that is available to anyone other than the specified parties (for example, general use audited financial statements or SEC filings).

Conditions for Engagement Performance

.11 A practitioner may perform an agreed-upon procedures engagement described in this SOP provided that

- a. the practitioner is independent.
- b. management acknowledges its responsibilities for the XBRL files and provides the practitioner with one or more written assertions about its XBRL files. (Illustrative assertions are presented in appendix A of this SOP.)
- c. the practitioner and the specified parties agree upon the procedures to be performed by the practitioner.

- d. the specified parties take responsibility for the sufficiency of the agreed-upon procedures for their purposes.
- e. criteria for the determination of findings are agreed upon among the practitioner and the specified parties.
- f. the procedures to be applied with respect to the completeness, mapping, consistency, or structure of the XBRL files are expected to result in reasonably consistent measurement using the criteria agreed upon by the specified parties.
- g. evidential matter related to the completeness, mapping, consistency, or structure of the XBRL files is expected to exist to provide a reasonable basis for expressing the findings in the practitioner's report.
- h. when applicable, the practitioner and the specified parties agree on any materiality limits for reporting purposes. (See the materiality discussion in paragraph .27.)
- i. use of the report is restricted to the specified parties.

.12 There are audit committee preapproval requirements applicable to acceptance of agreed-upon procedures engagements. Such requirements have been established by the SEC, PCAOB, and other regulatory bodies.

Agreement on and Sufficiency of Procedures

.13 To satisfy the requirement that the practitioner and the specified parties agree upon the procedures performed or to be performed, and that the specified parties take responsibility for the sufficiency of those procedures for their purposes, ordinarily the practitioner should communicate⁴ directly with and obtain affirmative acknowledgment from each of the specified parties. For example, this may be accomplished by meeting with the specified parties or distributing a draft of the anticipated report or a copy of an engagement letter to the specified parties and obtaining their agreement.

.14 AT section 201 permits an agreed-upon procedures report to be used by multiple specified parties. However, because the objective of the engagement described in this SOP generally is to provide information to management or the audit committee of the entity about its XBRL files, ordinarily it is anticipated that the only specified parties will be management or the audit committee.

.15 The practitioner should not report on an engagement if the specified parties do not agree upon the procedures performed or to be performed and do not take responsibility for the sufficiency of the procedures for their purposes.

Subject Matter and Related Assertions

.16 XBRL files subject to agreed-upon procedures engagements are typically as of a specified date and for a specified period (for example, for SEC purposes the XBRL files may be for comparative financial statements in a

⁴ Paragraph .07 of AT section 201, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*), does not require a written communication with the specified parties; it requires only that the practitioner communicate with and obtain affirmative acknowledgment from each of the specified parties. It generally is preferable that the agreement be in writing to avoid any misunderstandings regarding the procedures to be performed and responsibility for the sufficiency of the procedures.

specific Form 10-K annual report or Form 10-Q quarterly report). It is common for the agreed-upon procedures to be performed on draft, rather than final XBRL files.

.17 Because management may engage a third party to assist in the preparation of the XBRL files, assertions also may be made by a third party, as per paragraph .13 of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*). For example, a service organization may make assertions that the XBRL files comply with specified SEC EDGAR Filer Manual (EFM) guidelines. Management, however, is responsible for all assertions, including any that are made by third parties.

.18 Criteria are the standards or benchmarks used to measure, present, and evaluate the subject matter. Suitable criteria must be objective, measurable, complete, and relevant. Criteria to be used in the determination of findings are agreed upon between the practitioner and the specified parties. The specific procedures to be performed are dependent on the relevant criteria against which the XBRL files are to be evaluated. Examples of criteria include those in the exhibit in *Principles and Criteria for XBRL-Formatted Information*, the SEC rules, and sections of the EFM⁵ that are agreed upon by the specified parties.

.19 Appendix D of this SOP presents certain illustrative procedures aligned with the criteria presented in the exhibit of the *Principles and Criteria for XBRL-Formatted Information* that a practitioner might perform and findings that might be reported as part of an agreed-upon procedures engagement related to the completeness, mapping, consistency, or structure of XBRL-formatted information. *Principles and Criteria for XBRL-Formatted Information* focuses on areas that require judgment. The principles and criteria are not designed for measuring compliance with all of the applicable SEC rules and regulations (that is, the EFM includes additional requirements that are not included in this SOP; for example, certain requirements that are checked in an automated manner and those using the SEC's EDGAR XBRL validation process are excluded as well as some SEC requirements related to structure of the XBRL files and format of the information). Therefore, the procedures herein are illustrative and do not represent a complete set of procedures that might be performed in an agreed-upon procedures engagement relating to XBRL-formatted information.

Establishing an Understanding With the Client

.20 In accordance with paragraph .10 of AT section 201, the practitioner should establish an understanding with the client regarding the services to be performed. Such an understanding reduces the risk that the client may misinterpret the objectives and limitations of an agreed-upon procedures engagement. The understanding also reduces the risk that the client will misunderstand its responsibilities and the responsibilities of the practitioner. When the practitioner documents the understanding through a written communication with the client (an engagement letter), such communication should be addressed to the client and might include statements

- confirming that an agreed-upon procedures engagement will be performed.
- identifying

⁵ Certain sections of the SEC's EDGAR Filer Manual (EFM) may not be objective enough to be considered suitable criteria.

- the subject matter of the engagement (that is, the XBRL-formatted information that the specified parties are evaluating and to which the practitioner is to apply agreed-upon procedures) and any written assertion(s) related thereto.
- the responsible party (for example, management).
- the criteria for evaluating the XBRL-formatted information (for example, *Principles and Criteria for XBRL-Formatted Information*).
- the specified parties.
- any timing sensitivities in the performance of the procedures or delivery of the report.
- indicating that the objective of the practitioner's agreed-upon procedures is to present specific findings to assist the specified parties in evaluating the completeness, mapping, consistency, and structure of the entity's XBRL files.
- acknowledging the specified parties' responsibility for the sufficiency of the enumerated procedures.
- acknowledging management's responsibility for
 - compliance with the SEC's requirements including those related to the completeness, mapping, consistency, and structure of the entity's XBRL files and its assertions thereon.
 - providing accurate and complete information to the practitioner.
- identifying the practitioner's responsibilities, which include, but are not limited to
 - performing the enumerated procedures.
 - providing management with a report and the circumstances under which the practitioner may decline to issue a report.
- indicating that the engagement will be conducted in accordance with attestation standards established by the AICPA.
- enumerating the procedures to be performed.
- acknowledging that
 - the practitioner makes no representation regarding the sufficiency of the enumerated procedures for the specified parties' purposes.
 - the practitioner has no responsibility for the completeness or accuracy of the information provided to the practitioner.
 - an agreed-upon procedures engagement does not constitute an examination, the objective of which would be the expression of an opinion on the completeness, mapping, consistency, and structure of the entity's XBRL files. The report will not express an opinion or any other form of assurance and, if additional procedures were performed, other matters might come to the practitioner's attention.
- identifying any assistance to be provided to the practitioner.
- describing any arrangements to involve a specialist.

- where applicable, agreeing upon materiality limits.
- indicating that use of the report will be restricted to the specified parties.

An illustrative engagement letter is presented in appendix B of this SOP.

Nature, Timing, and Extent of Procedures

Responsibilities of Management

.21 Management is responsible for both the completeness and accuracy of the source information and compliance with the SEC's requirements, including those related to the completeness, mapping, consistency, and structure of its XBRL-formatted information. That responsibility encompasses

- a. identifying the applicable XBRL-formatted information filing requirements of the SEC.
- b. establishing and maintaining controls relating to the preparation and submission of the entity's XBRL-formatted information to the SEC.
- c. evaluating the completeness, mapping, consistency, and structure of the entity's XBRL-formatted information.
- d. providing XBRL-formatted information in a form and manner that satisfies the SEC's requirements.

Responsibilities of the Practitioner

.22 The practitioner is responsible for carrying out the procedures and reporting the findings in accordance with the general, fieldwork, and reporting standards for attestation engagements as established in AT section 50, *SSAE Hierarchy* (AICPA, *Professional Standards*). In order to accomplish this, the practitioner should have adequate knowledge of the specific subject matter to which the agreed-upon procedures are to be applied. That knowledge would include an understanding of XBRL and a familiarity with the applicable XBRL taxonomies used, knowledge of the SEC rules and requirements (including permitted taxonomies, such as the permitted version of the U.S. GAAP Taxonomy), as well as knowledge of the source information and supporting records.⁶

Procedures to Be Performed

.23 The procedures that the practitioner and specified parties agree upon may be as limited or as extensive as the specified parties desire. However, mere reading of an assertion or specific information about the XBRL-formatted information does not constitute a procedure sufficient to permit a practitioner to report on the results of applying agreed-upon procedures. Because of the nature of agreed-upon procedures engagements related to XBRL files, procedures may be modified during the engagement. According to paragraph .15 of AT section 201, in general, there is flexibility in determining the procedures as long as the specified parties acknowledge responsibility for the sufficiency of such procedures for their purposes. However, paragraph .16 of AT section 201 states that the practitioner should not agree to perform procedures that are

⁶ Practitioners performing engagements for audit clients may have specific knowledge of the underlying source information and supporting records and may possess a level of expertise that would significantly lessen the range of judgment needed in performing procedures related to the XBRL-formatted information.

overly subjective and thus possibly open to varying interpretations. Examples of appropriate procedures are included in appendix D of this SOP. Examples of inappropriate procedures include the following:

- Merely reading a description of the services performed by a third party involved in the preparation of XBRL-formatted information (for example, by a service provider)
- Evaluating the competence or objectivity of another party involved in preparing or in providing assistance in the preparation of the XBRL-formatted information
- Obtaining an understanding about XBRL-related requirements⁷

Involvement of a Specialist⁸

.24 Generally, the use of a specialist would not be necessary. However, if specialized matters were included in the engagement that required expertise beyond that possessed by the practitioner (such as compliance with certain highly technical aspects of the EFM), the practitioner and the specified parties should explicitly agree to the involvement of the specialist in assisting the practitioner in the performance of those agreed-upon procedures. This agreement may be reached when obtaining agreement on the procedures performed or to be performed and acknowledgment of responsibility for the sufficiency of the procedures, as discussed in paragraph .13. The practitioner's report should describe the nature of the assistance provided by the specialist.

.25 A practitioner may agree to apply procedures to the report or work product of a specialist that does not constitute assistance by the specialist to the practitioner in an agreed-upon procedures engagement. For example, the practitioner may make reference to information contained in a report of a specialist in describing an agreed-upon procedure. However, it is inappropriate for the practitioner to agree to merely read the specialist's report solely to describe or repeat the findings or to take responsibility for all or a portion of any procedures performed by a specialist or the specialist's work product.

Reporting Considerations

.26 A practitioner's report on agreed-upon procedures should be in the form of procedures and findings. The practitioner should not provide negative assurance in his or her report about the completeness, mapping, consistency, or structure of the XBRL files. For example, the practitioner should not include a statement that "nothing came to our attention that caused us to believe that the assertion is not fairly stated in accordance with the criteria."

.27 The practitioner should report all findings from the application of the agreed-upon procedures. The concept of materiality does not apply to findings to be reported in an agreed-upon procedures engagement unless the definition of materiality is agreed to by the specified parties. Any agreed-upon materiality limits should be described in the practitioner's report.

⁷ Although the practitioner may need to obtain an understanding of XBRL-related requirements, obtaining such an understanding is not in itself an agreed-upon procedure (see paragraph .22 of this SOP).

⁸ A practitioner's specialist is an individual or organization possessing expertise in a field other than accounting or attestation, whose work in that field is used by the practitioner to assist the practitioner in the performance of the agreed-upon procedures engagement. A practitioner's specialist may be either a practitioner's internal specialist (who is a partner or staff, including temporary staff, of the practitioner's firm or a network firm) who does not participate in the engagement or a practitioner's external specialist.

.28 The practitioner's report on agreed-upon procedures should include all of the following elements:

- a. A title that includes the word *independent*
- b. Identification of the specified parties
- c. Identification of the subject matter (and any written assertion related thereto) and the character of the engagement
- d. Identification of the party responsible for the XBRL files (for example, management)
- e. A statement that the subject matter (and any written assertions related thereto) is the responsibility of the responsible party (for example, management)
- f. A statement that the procedures performed were those agreed to by the specified parties identified in the report
- g. A statement that the agreed-upon procedures engagement was conducted in accordance with the attestation standards established by the AICPA
- h. A statement that the sufficiency of the procedures is solely the responsibility of the specified parties and a disclaimer of responsibility for the sufficiency of those procedures
- i. A list of the procedures performed (or reference thereto) and related findings
- j. Where applicable, a description of any agreed-upon materiality limits (Refer to the materiality discussion in paragraph .27.)
- k. A statement that the practitioner was not engaged to examine and did not conduct an examination of the subject matter (or the written assertion related thereto), the objective of which would be the expression of an opinion, a disclaimer of opinion on the subject matter (or the written assertion related thereto), and a statement that if the practitioner had performed additional procedures, other matters might have come to his or her attention that would have been reported
- l. A statement restricting the use of the report to the specified parties and that the report is intended solely for the use of the specified parties
- m. Where applicable, reservations or restrictions concerning procedures or findings
- n. Where applicable, a description of the nature of the assistance provided by a specialist
- o. The manual or printed signature of the practitioner's firm
- p. The date of the report

An illustrative report is presented in appendix E of this SOP.

.29 The date of completion of the agreed-upon procedures should be used as the date of the practitioner's report.

Explanatory Language in the Practitioner's Agreed-Upon Procedures Report

.30 The practitioner may include explanatory language in his or her agreed-upon procedures report related to matters such as the following:

- Disclosure of stipulated facts, assumptions, or interpretations (including the source thereof) used in the application of agreed-upon procedures.
- Description of the condition of records, controls, or data to which the procedures were applied.
- Explanation that the practitioner has no responsibility to update his or her report.
- Explanation of sampling risk.
- Explanation that the procedures performed do not address all of the SEC's requirements for XBRL submissions.
- Explanation that the XBRL files and source information may be updated prior to filing with the SEC. Accordingly, the findings in the report may not correspond to the final XBRL files submitted.

Adding Specified Parties (Nonparticipant Parties)

.31 Subsequent to the completion of the agreed-upon procedures engagement, a practitioner may be requested to consider the addition of another party as a specified party (a nonparticipant party). The practitioner may agree to add a nonparticipant party as a specified party, based on consideration of such factors as the identity of the nonparticipant party and the intended use of the report. If the practitioner does agree to add the nonparticipant party, he or she should obtain affirmative acknowledgment, normally in writing, from the nonparticipant party agreeing to the procedures performed and taking responsibility for the sufficiency of the procedures. If the nonparticipant party is added after the practitioner has issued his or her report, the report may be reissued or the practitioner may provide other written acknowledgment that the nonparticipant party has been added as a specified party. If the report is reissued, the report date should not be changed. If the practitioner provides written acknowledgment that the nonparticipant party has been added as a specified party, such written acknowledgment ordinarily should state that no procedures have been performed subsequent to the date of the report.

.32 Many companies hire a third party entity to create the XBRL files or assist them with the tagging process. When a third party does not agree to the procedures and, therefore, does not become a specified party, use of the report by the third party is inappropriate. Such a party, typically, is not considered a specified party to the engagement because it performs this work under the direction of management and is not intending to evaluate the XBRL files based on the agreed-upon procedures and related findings. As a result, the practitioner's findings should be communicated directly to management (and the audit committee) for its evaluation and consideration, which may result in management providing direction to the third party service provider to make changes to the XBRL files.

Written Representations

.33 During an attest engagement, the responsible party (for example, management) makes many representations to the practitioner, both oral and written, in response to specific inquiries or through the presentation of the subject matter or an assertion. A practitioner may find a representation letter to be a useful and practical means of obtaining representations from the responsible party. An illustrative representation letter is presented in appendix C of this SOP.

.34 If management refuses to furnish all written representations that the practitioner deems necessary, the practitioner should consider whether to disclose in his or her report the inability to obtain representations from the responsible party, withdraw from the engagement, or change the engagement to another form of engagement.

Knowledge of Matters Outside Agreed-Upon Procedures

.35 The practitioner need not perform procedures beyond the agreed-upon procedures. However, in connection with the application of agreed-upon procedures, if matters come to the practitioner's attention by other means that significantly contradict the subject matter (or written assertions related thereto) referred to in the practitioner's report, the practitioner should include this matter in his or her report (for example, if during the course of performing agreed-upon procedures that address XBRL-formatted financial statements and the related notes and required schedules submitted as an exhibit to the SEC, the practitioner becomes aware by means other than performing the agreed upon procedures that a calculation linkbase has been omitted, the practitioner should include this matter in his or her report).

Effective Date

.36 This SOP is effective for any XBRL agreed-upon procedures engagements accepted subsequent to the issuance of this SOP.

Appendix A — Illustrative Management Assertions

This appendix presents illustrative management assertions for the agreed-upon procedures engagement described in this SOP (agreed-upon procedures that address XBRL-formatted financial statements and the related notes and required schedules submitted as an exhibit to the SEC). These assertions are illustrative only and are not intended to apply to, or be sufficient for, any particular engagement. Management should tailor its assertions to the specific facts and circumstances of the particular engagement.

Management should develop assertions and agreed-upon procedures that meet its objectives. Management's assertions may align with the principles identified in the exhibit of *Principles and Criteria for XBRL-Formatted Information* or may be broader or more detailed as outlined here.

The XBRL files related to the [identify source information and period (for example, the Company's [Quarterly or Annual] Report) on Form [10-K or 10-Q] for the period ended [identify date] to be submitted to the Securities Exchange Commission (SEC)] are in compliance with the SEC's requirements including, but not limited to, the following:

1. **Completeness of the XBRL files.** All required information is formatted at the required levels of detail, as defined by the SEC's requirements. Only permitted information is included in the XBRL files.
2. **Mapping of the source information.** The elements selected are consistent with the meaning of the corresponding business reporting concepts in the source information in accordance with the SEC's requirements.
3. **Consistency of the XBRL files with the source information.** All formatted information in the XBRL files is consistent with the source information and formatted in accordance with the SEC's requirements.
4. **Structure of the XBRL files.** XBRL files are structured in accordance with the SEC's requirements.

Appendix B — Illustrative Engagement Letter

This appendix presents an illustrative engagement letter⁹ for the agreed-upon procedures engagement described in this SOP (engagement described in this SOP addresses the completeness, mapping, consistency, or structure of an entity's XBRL-formatted financial statements and the related notes and required schedules submitted as an exhibit to the SEC). It is intended to be illustrative only.

In this illustrative engagement letter, management and the audit committee of XYZ Company are the specified parties.

[CPA Firm Letterhead]

[Client's Name and Address]

To Management and the Audit Committee of XYZ Company:

This will confirm our understanding of the arrangements for our performance of certain agreed-upon procedures to assist management and the audit committee of XYZ Company in evaluating [identify subject matter and criteria (for example, the completeness of the XBRL files, mapping of the source information to the XBRL files, consistency of the XBRL files)] with the source information and the structure of the XBRL files related to the [identify source information and period (for example, the Company's [Quarterly or Annual] Report on Form [10-K or 10-Q] for the period ended [identify date] to be submitted to the Securities Exchange Commission [SEC])] in accordance with the *Principles and Criteria for XBRL-Formatted Information* [AICPA, *Technical Practice Aids*].

The procedures enumerated in the attachment to this letter, which were specified by management and the audit committee of XYZ Company, are the procedures to be performed. Our responsibility is to carry out these procedures and report our findings. We will conduct our engagement in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of management and the audit committee of XYZ Company. Consequently, it is understood that we make no representation regarding the sufficiency of the procedures described in the attachment for the purpose for which this report has been requested or for any other purpose.

Management is responsible for both the completeness and accuracy of the source information and compliance with the SEC's requirements including those related to the completeness of the XBRL files, mapping of the source information to the XBRL files, consistency of the XBRL files with the source information, structure of the XBRL files, and for the information provided to us. Management also is responsible for the design, implementation, effectiveness, and monitoring of controls over the preparation and submission of XYZ Company's XBRL files. It is understood that we make no representation regarding the completeness or accuracy of the source information provided to us during this engagement.

⁹ It should be noted that although paragraph .10 of AT section 201 requires the practitioner to establish an understanding with the client regarding the services to be performed, that understanding is not required to be in writing. It may be preferable that the understanding be in writing to avoid any misunderstandings regarding the services to be performed. paragraph .20 of this SOP describes additional matters that may be appropriate to include in the engagement letter.

Our engagement to perform agreed-upon procedures is substantially less in scope than an examination, the objective of which is the expression of an opinion on management's assertion regarding the XBRL files. Accordingly, the report will not express an opinion or any other form of assurance thereon and if additional procedures were to be performed, other matters might have come to our attention.

At the completion of the agreed-upon procedures, we expect to issue a report that will state the procedures performed and the findings from those procedures. If, however, we are not able to complete all of the specified procedures, we will so advise you.

Distribution and use of our agreed-upon procedures report is restricted to the audit committee and management of the Company.

[Discuss other practitioner-specific matters, such as billing arrangements.]

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

Sincerely,

[Firm Name or Firm Representative's Signature]

Accepted and agreed to by XYZ Company

[Client Representative's Signature (such as Name of Chief Financial Officer)]

[Title]

[Date]

Appendix C — Illustrative Representation Letter

Paragraph .33 of this SOP indicates that a practitioner may find a representation letter to be a useful and practical means of obtaining representations from management. This appendix includes an illustrative representation letter for the agreed-upon procedures engagement described in this SOP (agreed-upon procedures that address the completeness, mapping, consistency, or structure of an entity's XBRL-formatted financial statements and the related notes and required schedules submitted as an exhibit to the SEC). This representation letter is illustrative only and is not intended to be applicable to all engagements. In addition, it may not include items that are relevant to a specific engagement.

[Date]

To [CPA Firm]:

We are providing this letter in connection with the performance of certain agreed-upon procedures to assist management and the audit committee of XYZ Company in evaluating [identify subject matter and criteria (for example, the completeness of the XBRL files, mapping of the source information to the XBRL files, consistency of the XBRL files)] with the source information and structure of the XBRL files related to the [identify source document and period (for example, the Company's [Quarterly or Annual] Report on Form [10-K or 10-Q] for the period ended [identify date] to be submitted to the Securities Exchange Commission [SEC])]. We confirm that we are responsible for the XBRL files relating to our financial statements and the related notes and required schedules, the related assertions (attached hereto)¹⁰ and for compliance with the SEC's requirements including those related to the completeness, mapping, consistency, and structure of XYZ Company's XBRL files and its assertions thereon, and for the completeness and accuracy of information provided to you, including the source information. We also confirm that we are responsible for selecting the criteria specified in the procedures and for determining that such criteria and procedures are sufficient for our purposes.

We confirm, to the best of our knowledge and belief, as of [identify date of agreed-upon procedures report], the following representations made to you during your agreed-upon procedures engagement.

1. All known matters with respect to the XBRL-formatted information relating to our financial statements or the assertions have been disclosed to you.
2. We have made available to you all—
 - a. Financial records and related data requested by you.
 - b. Documents used in the preparation of the XBRL files, such as information provided to a third party and tagging worksheets.
 - c. Output of all validation reports.
3. All of the data in the [identify the source information; for example, financial statements and the related notes and required schedules] that is required to be formatted in XBRL has been accurately and completely formatted and included in the XBRL files using [identify the taxonomy used; for example, U.S. GAAP Financial Reporting Taxonomy,

¹⁰ Management assertions may be incorporated in the representation letter or may be provided separately.

Version X] in accordance with the SEC rules, and except as communicated to you, the tags have been consistently applied from the prior submission as applicable.

4. There have been no communications from regulatory agencies affecting the XBRL-formatted information relating to our financial statements or previously submitted XBRL exhibits.¹¹
5. We have no knowledge of any fraud or suspected fraud affecting the entity's XBRL-formatted information.
6. We have no knowledge of any matters contrary to your findings.
7. *[Add other matters as the practitioner deems appropriate, such as:* We have limited the use of extension elements to cases where an appropriate element does not exist in the standard taxonomy.]

[Name of Chief Executive Officer and Title]

[Name of Chief Financial Officer and Title]

¹¹ If this representation letter is obtained subsequent to the issuance of the underlying financial statements, a representation such as the following may be appropriate: "We are not aware of any communication from any regulatory agencies regarding the financial statements or previously submitted XBRL exhibits, and no material modifications exist that need to be made to the financial statements."

Appendix D — Illustrative Procedures and Findings

This appendix presents a table that includes illustrative procedures that a practitioner might perform and findings that a practitioner might report as part of the agreed-upon procedures engagement described in this SOP (agreed-upon procedures that address the completeness, mapping, consistency, or structure of XBRL-formatted financial statements (including notes) and required schedules submitted as an exhibit to the SEC). These procedures are illustrative only and do not represent a complete set of procedures that might be performed in any specific engagement. In addition, they do not necessarily address every attribute associated with a particular management assertion.

The following items provide additional information about the procedures, the reporting of findings, and sources of information about SEC requirements regarding XBRL-formatted information.

1. Certain agreed-upon procedures may appear in the following table under one assertion, but may be relevant to more than one assertion; however, each procedure would only need to be performed once.
2. As indicated in paragraph .27 of this SOP, the practitioner should report and describe all differences, exceptions, and other findings noted during the application of the agreed-upon procedures as part of his or her findings, unless they are below any agreed-upon materiality limits described in the practitioner's report.
3. In planning for the execution of such an agreed-upon procedures engagement, the practitioner may find it useful to perform additional activities to assist in gaining an understanding of the entity's formatting approach. Examples of such activities may include
 - inquiring of management to gain an understanding of its overall formatting and validation process,¹² including software applications or third-party providers used, and relevant experience and knowledge of those involved with the XBRL reporting process.
 - requesting management to provide a list of known differences between its XBRL files and the SEC requirements.
4. Certain of these procedures may be performed using XBRL software (for example, analysis, querying, validation). Accordingly, as part of tailoring the procedures to a specific agreed-upon procedures engagement, management might agree to or specify the use of a particular XBRL software product and version for performing such procedures.
5. The SEC provides requirements for the proper formatting of the XBRL files and maintains electronic systems to receive, validate, and process the XBRL files. Filers are responsible for compliance with these requirements and are encouraged to make a test submission of the XBRL files prior to submission to the SEC to reduce the likelihood of the exhibit not being accepted by the SEC systems.¹³

¹² Various software applications or third party providers used may produce different reports or present information in a different manner, which may affect the timing, nature, and performance of procedures.

¹³ The SEC's validation system checks only a subset of the requirements and should not be considered a method to measure compliance with all of the requirements.

6. This table provides some references to relevant guidance in the SEC's EDGAR Filer Manual (EFM) Version 23.¹⁴ The most current document is available on the SEC's website at <http://xbrl.sec.gov> and is updated frequently.

Illustrative Procedures and Findings for an Agreed-Upon Procedures Engagement that Addresses the Completeness, Mapping, Consistency, or Structure of XBRL-Formatted Information

	Principles and Criteria ¹⁵		Procedure		Finding
Completeness of the XBRL Files—All required information is formatted at the required levels of detail as defined by the SEC's requirements. Only permitted information¹⁶ is included in the XBRL files.					
A	All information that is required to be formatted as defined by the SEC's requirements is formatted at the appropriate levels of detail in the XBRL files	C1	Inspect the XBRL files ¹⁷ to ascertain whether each of the following items in the source information is included in the XBRL files and is formatted at the level of detail noted in the following list:	C1	All such items in the [<i>identify source information</i>] that were required to be formatted as defined by the SEC's requirements were included in the XBRL files and formatted at the level of detail indicated [except as follows: <i>list facts</i>].
A (1)	All information (including parenthetical information) on the face of the financial statements in the		<ul style="list-style-type: none"> Each amount on the face of the financial statements (including "0" and amounts represented by 		

¹⁴ Future updates to the EFM could result in changes to the requirements, which could affect the procedures that the client might request be performed.

¹⁵ Principles and criteria listed herein are the same as those listed in the application guidance of the principles and criteria in the exhibit of the *Principles and Criteria for XBRL-Formatted Information*. In some cases, footnotes to these principles and criteria have been modified for improved readability or to provide practitioners with more information.

¹⁶ In a case in which an entity elects to format permitted information in addition to the required information, preparers should consider the level of detail to format such information so that it is not misleading to the user of the XBRL files.

¹⁷ Inspection of the XBRL files may take different forms (for example, different XBRL analysis software may be used to view, manipulate or export the data into various forms for analysis). Alternatively, a mapping worksheet that is prepared by the entity prior to finalizing the XBRL files for submission may be used; in this case additional procedures would be necessary to ascertain whether the selected elements in the mapping worksheet are the same as those included in the final XBRL files.

	Principles and Criteria ¹⁵		Procedure		Finding
	source information ¹⁸ is formatted in the XBRL files, including facts that represent zero or do not have amounts.		numbers or words and including amounts in parentheses and amounts in superscript ¹⁹ footnotes) <ul style="list-style-type: none"> • Each line item on the face of the financial statements that represents no value (for example, commitments and contingencies²⁰ for which there is only disclosure and no value) • Each heading in the financial statements is formatted as an abstract element 		
A (2)	All required document and entity information (DEI) is formatted in the XBRL files.		<ul style="list-style-type: none"> • Each required document and entity information concept is formatted 		
A (3)	Each complete note and required schedule under Regulation S-X are formatted separately using a text block element.		<ul style="list-style-type: none"> • Each note to the financial statements is formatted using a text block element • Each schedule required by Regulation S-X 		

(continued)

¹⁸ Source information for purposes of submission to the SEC is the electronic or paper-based financial statements, including the notes; required schedules under Regulation S-X; and document and entity information (DEI) (which includes document type, document period end date, registrant name, central index key [CIK], fiscal year end date, public float, fiscal year, fiscal period, filer category, and reporting status as well as an indication of whether an amendment flag exists [if so, include a description of the reason for the amendment], whether the filer is not required to file reports, and whether the filer is a well-known seasoned issuer).

¹⁹ Text that is included at the bottom of the page or table that is preceded by a superscript number or symbol which represents a footnote.

²⁰ Business reporting concepts that have no value for all periods, such as commitments and contingencies, must have the nil attribute set to "true."

	Principles and Criteria¹⁵		Procedure		Finding
			is formatted using a text block element		
A (4)	Each significant accounting policy (whether included in the accounting policies note or elsewhere within the notes to the financial statements) is formatted separately using a text block ²¹ element.		<ul style="list-style-type: none"> Each significant accounting policy, identified by management (whether included in the accounting policies note or other notes to the financial statements), is formatted using a text block element 		
A (5)	Each table within each note is formatted separately using a text block element.		<ul style="list-style-type: none"> Each table within each note is formatted using a text block element 		
A (6)	Each amount ²² disclosed in the notes and required schedules under Regulation S-X (including amounts written as words) is formatted separately.		<ul style="list-style-type: none"> Each amount²³ in the notes that is represented in numbers or words (including "0" and amounts in parentheses and amounts in superscript footnotes) Each amount in the schedules (including "0" and amounts in parentheses and amounts in superscript footnotes) that is represented in numbers or words 		

²¹ The U.S. GAAP Taxonomy has adopted a convention for distinguishing among text block elements intended for use in tagging accounting policies, tables, and disclosures.

²² Not all amounts are required to be formatted (for example, there is no need to format the "2" in "2 percent milk") (See SEC Compliance and Disclosure Interpretation 146.16 located on the SEC's website for additional examples).

²³ Optional information may be formatted to provide more context to individual amounts.

	Principles and Criteria¹⁵		Procedure		Finding
A (7)	Each amount included in the superscript footnotes is formatted separately.		<i>Preceding bullets address this criterion.</i>		
A (8)	Text that is shown on the face of the financial statements at the bottom of the page or bottom of a table preceded by a superscript is formatted using XBRL footnote links. ²⁴		<ul style="list-style-type: none"> Text immediately following each superscript footnote number on the face of the financial statements or in tables is formatted using a footnote link 		
B	The XBRL files contain only facts or presentation or calculation relationships that are included in the source information and other required or permitted information (such as DEI ²⁵ required by the SEC) and contain only unused elements and linkbase information that are used intermittently unless otherwise prohibited. ²⁶	C2	Compare the tagged facts in the XBRL files to the source information and identify any tagged facts that are not included in the source information other than other required (for example, DEI) or permitted information (for example, definitions for extension elements).	C2	All tagged facts that were included in the XBRL files were in the source information or otherwise permitted [except as follows: <i>describe elements and relationships</i>].

(continued)

²⁴ The EFM requires this only for the face of the financial statements.

²⁵ DEI includes information that may be outside of the financial statements such as the number of outstanding shares of a company's stock that is in the hands of public investors, as opposed to company officers, directors, or controlling-interest investors (public float) and CIK.

²⁶ The entity may carry forward unused elements or presentation, definition, or calculation relationships in the taxonomy that are used intermittently in the instance document (for example, taxonomies may reflect elements or relationships used in instance documents for annual financial statements [Form 10-K] but not used in the instance documents for quarterly financial statements [Form 10-Q]). Used elements or relationships refer to those used in the instance document.

	Principles and Criteria ¹⁵		Procedure		Finding
Mapping of the source information—The elements²⁷ selected are consistent with the meaning of the corresponding business reporting concepts in the source information in accordance with the SEC’s requirements.					
C	Elements used in the XBRL files, considering their attributes; ²⁸ definitions (for example, documentation labels in the label linkbase); and references are consistent with the corresponding business reporting concepts in the underlying source information.	M1	For each element used in the XBRL files, compare the following aspects of the element to the nature of the business reporting concept in the source information: <ul style="list-style-type: none"> • Abstract (that is, true, false) • Data type (for example, block text, monetary value, or other numeric value) • Period type (that is, instant, duration) • Other definitional aspects (that is, documentation labels and standard labels in the label linkbase, and references) 	M1	All such aspects of the elements used in the XBRL files reflect the nature of the business reporting concepts in the [<i>identify: source information</i>] [except for the following: <i>list elements and describe differences</i>].
C (1)	Headings in the source information are represented as abstract elements.		<i>Procedures C1 and M1, listed previously, address this criterion.</i>		<i>See findings under C1 and M1, listed previously.</i>

²⁷ Elements include line items and combinations of line items, domain members, and axes.

²⁸ The “basic element attributes” include (a) abstract, (b) data type (that is, whether the content is expected to conform to a certain type of content, such as block text, a monetary value, or other numeric value), (c) period type (that is, whether it is a point in time or a period of time), and (d) balance type (that is, whether it is normally a debit or a credit). The balance attribute is currently not a primary consideration in selecting elements in the SEC program.

	Principles and Criteria ¹⁵		Procedure		Finding
D	The most specific elements or dimensional combination of elements across the entire taxonomy whose attributes; definitions (for example, documentation labels in the label linkbase); and references are consistent with the corresponding business reporting concepts have been used.	M2	Search the taxonomy for any elements and any combination of elements for which element aspects (that is, documentation labels and standard labels in the label linkbase, and references) that reflect more specifically ²⁹ the corresponding business reporting concept without violating the criteria for element selection (aspects of elements as listed previously in procedure M1).	M2	No elements from the [<i>specify taxonomy</i>] ³⁰ for which definitions and standard labels in the label linkbase, and references may more specifically reflect the corresponding business reporting concepts in the [<i>identify: source information</i>] were noted. Or The following elements from the [<i>specify taxonomy</i>] for which definitions and standard labels in the label linkbase, and references more specifically reflect the corresponding business reporting concepts in the [<i>identify: source information and list the elements and the business reporting concepts</i>].

(continued)

²⁹ This may include identifying more detailed elements. For example, in the case of a concept on the financial statements for short-term investments available for sale, the entity used the short-term investments element in the XBRL files; however, the practitioner may identify short-term investments available for sale as a more specific element. There may be some situations that require the exercise of a level of judgment that may not be appropriate for an agreed-upon procedure engagement. In such cases, the practitioner should not make the judgment but should lay out the facts for the specified parties.

³⁰ This procedure may be performed against the standard taxonomy (for example, U.S. GAAP Taxonomy as documented in the EFM) or against the extension taxonomy of the instance document (incorporating extension elements).

	Principles and Criteria¹⁵		Procedure		Finding
D (1)	Certain elements required for use by the SEC (for example, DEI elements or elements for reporting consolidating entities) have been used if applicable.	M3	From the list of required elements per the SEC's EFM (sections 6.5.20, 6.5.21, and 6.6.3 through 6.6.10) pertaining to <ul style="list-style-type: none"> • consolidations and legal entities, • stock classes, and • document and entity-related information trace the required elements for business reporting concepts included in the source information to inclusion in the XBRL files.	M3	Required elements for business reporting concepts pertaining to consolidations and legal entities, stock classes, and document and entity-related information included in the source information were included in the XBRL files [except for the following elements: <i>list elements not included</i>].
E	Use of selected elements is permitted (for example, the selected element is not deprecated)	M4	Search the XBRL files to identify the elements ³¹ in the XBRL files that have a deprecated label in the standard taxonomy.	M4	The XBRL files do not contain any elements that have deprecated labels in the standard taxonomy [except the following elements used in the XBRL files: <i>list elements</i>].
F	The same business reporting concepts appearing multiple times in the source information are formatted once using the same elements or combination of elements throughout the	M5	For business reporting concepts appearing more than once in the source information (including those concepts with values reported for more than one period), search the XBRL files for use	M5	No items were noted in which a different element was used for the same business reporting concept appearing more than once or for different periods [except as follows: <i>describe, for</i>

³¹ The procedure to be performed addresses the situation of deprecated elements; however, there may be other conditions where elements are not permitted. Procedures to address other examples are not included in this SOP because they may be automatically tested with software.

	Principles and Criteria¹⁵		Procedure		Finding
	XBRL files, when appropriate ³²		of more than one element for the same business reporting concept except when alternative line item and domain member combinations are prescribed by related guidance.		<i>example, cash appearing on the balance sheet was tagged with a different element (or combination of elements) than cash appearing on the cash flow statement].</i>
G	The same elements are used consistently to report the same business reporting concepts, including for each period for which such concepts appear in the underlying source information. ³³		<i>Procedure M5, listed previously, addresses this criterion.</i>		<i>See findings in M5, listed previously.</i>
H	Extension elements are created only when both of the following conditions are met: no suitable elements exist in the selected taxonomy, and extensions are permitted in accordance with the SEC's rules.		<i>Procedures M1, M2, and M3, listed previously, address this criterion.</i>		<i>See findings from M1, M2, and M3, listed previously.</i>

(continued)

³² Exceptions exist when business reporting concepts will be formatted using different line item and domain member combinations, or when the related guidance requires different elements to be used based on the level of granularity of the source data being formatted (for example, in situations where concepts must use both dimensional and nondimensional approaches, such as Treasury stock presented on the balance sheet without dimensions and then presented on the statement of stockholders' equity with dimensions). The appropriate use of duplicate elements should be considered, and redundantly formatted facts should be eliminated.

³³ Although the source information may contain different values (for example, positive, negative, or zero) in one period as compared with another (for example, net income [loss]) or represent an ending balance in one period and the beginning balance in the next, the same element should be used in all periods presented. Notwithstanding, there may be certain situations in which the taxonomy may include different elements to reflect positive and negative values (for example, certain elements relating to tax assets and tax liabilities in the U.S. GAAP Taxonomy).

	Principles and Criteria¹⁵		Procedure		Finding
I	Definitions, if provided (for example, documentation labels in the label linkbase) for extension elements used in the instance document, are consistent with the source information.		<i>Procedure M1, listed previously, addresses this criterion.</i>		<i>See findings from M1, listed previously.</i>
Consistency of the XBRL Files With the Source Information—All formatted information³⁴ in the XBRL files is consistent with the source information and formatted in accordance with the SEC's requirements.					
J	Formatted amounts in the XBRL files reflect the entire numbers of the corresponding business reporting concepts (that is, the XBRL amounts are not scaled ³⁵).	CO1	For each amount tagged in the XBRL files, compare such information with the amount of the corresponding business reporting concept in the source information to identify any amount that does not reflect the entire number.	CO1	All amounts in the XBRL files reflect the entire number of the corresponding business reporting concept [except for the following elements: <i>list elements and describe differences</i>].
K	Formatted amounts have the appropriate signs based on the nature of the values in the source information, balance attributes, and definitions (documentation labels in the label	CO2	For negative amounts in the instance document, that have been tagged with elements whose definitions or standard labels do not include terminology identified in the table in the SEC's	CO2	The signs for negative amounts for elements with definitions or standard labels that do not include terminology from the SEC table are consistent with the nature of the value of the

³⁴ Formatted information includes data (for example, amounts, text, dates); contextual information (for example, monetary units); and relationships (for example, presentation order and calculations).

³⁵ Amounts in financial statements are often presented in various formats (for example, rounded to millions) and may represent a different scale. However, amounts formatted in XBRL must be entered without such presentational formatting. For example, 23.5 million would be entered as 23500000, 14.3 percent would be entered as .143.

	Principles and Criteria ¹⁵		Procedure		Finding
	linkbase) of the elements.		Staff Observations (SEC table) ³⁶ (for example, increase/decrease, gain/loss, provided by/used in) within the definition (documentation label in the label linkbase) or standard label, compare the sign ³⁷ to the nature of the value of the corresponding business reporting concepts in the source information.		corresponding business reporting concepts in the [identify: source information] [except for the following: list elements].
		CO3	For elements for which the definition (documentation label in the label linkbase) or standard label includes terminology identified in the SEC table, compare the sign for each amount in the XBRL files to the nature of the value of the corresponding business reporting concept in the source information.	CO3	The signs for the formatted amounts in the XBRL files of elements for which the definitions or standard labels includes terminology in the SEC table are consistent with the nature of the value of the corresponding business reporting concepts in the [identify: source information] [except for the following: list elements and describe differences in signs].

(continued)

³⁶ Under the heading “Negative Values” in the SEC’s *Staff Observations from the Review of Interactive Data Financial Statements (from December 13, 2011)* is a table in which the SEC staff provides examples of language included in definitions or standard labels of elements that can be negative. This is not necessarily a complete list, therefore, the practitioner and preparer may agree to extend this procedure beyond the elements that have definitions or labels that contain specified language included in the table.

³⁷ Identified negative amounts may not be an error; however, they likely require further assessment by management.

	Principles and Criteria¹⁵		Procedure		Finding
L	All text, dates, and uniform resource identifiers in the XBRL files are consistent with the underlying source information.	CO4	For text, dates, and uniform resource identifiers (URIs) tagged in the XBRL files, compare such information with the corresponding concepts in the source information.	CO4	No differences for text, dates, and URIs in the XBRL files as compared with [<i>identify source information</i>] were noted [except for the following elements: <i>list elements and describe differences</i>].
L (1)	Nil attribute ³⁸ is used only to convey business reporting concepts reported that have no amounts associated but are not zero (for example, commitments and contingencies).	CO5	For each business reporting concept in the source information that represents no value (associated with it) inspect whether the nil attribute for the corresponding element is set to true in the XBRL files.	CO5	Nil attributes were set to true in the XBRL files for each concept in the [<i>identify source information</i>] for which no value is associated [except for the following elements: <i>list elements</i>].
		CO6	For each element in the instance document for which the nil attribute is set to true, identify those elements that represent business reporting concepts other than commitments and contingencies and preferred stock. ³⁹	CO6	For none of the elements in the instance document other than commitments and contingencies and preferred stock was the nil attribute set to true. Or Elements in the instance document other than commitments and contingencies and preferred stock for which the nil

³⁸ A nil attribute is used only for elements in the instance document and presentation to convey business reporting concepts that have no amounts, text, dates, or uniform resource identifiers in the source information.

³⁹ Management may specify other appropriate concepts for which the nil attribute would be set to true and modify this procedure to include such other appropriate concepts.

	Principles and Criteria ¹⁵		Procedure		Finding
					attribute is set to true include <i>[list elements]</i> .
M	Extension elements included in the instance document of the XBRL files for monetary amounts include debit or credit balance attributes or documentation labels with an indication of the meaning of positive or negative values, when applicable, that are consistent with the nature of the business reporting concepts in the underlying source information.	CO7	<p>For each line item in the instance document that has an extension element with a monetary type</p> <ul style="list-style-type: none"> • and a balance (debit / credit) attribute, compare the balance attribute to the nature of the business reporting concept in the source information. • and not a balance (debit / credit) attribute, inspect the elements for a definition (that is, documentation label) that includes an indication of the meaning of a positive or negative value (for example, “A positive adjustment value indicates a net increase in accounts receivable”) and compare such definition to the nature of the business reporting concept in the source information. 	CO7	No monetary type line item extension elements were noted that contain a balance attribute (or definition, as applicable) that is inconsistent with the nature of the business reporting concepts in the <i>[identify source information]</i> [except for the following elements: <i>list elements and describe differences from the source information</i>].

(continued)

	Principles and Criteria¹⁵		Procedure		Finding
M (1)	Extension elements included in the XBRL files for monetary amounts of balance sheet or income statement concepts include balance attributes (debit or credit) that are consistent with the nature of the underlying source information.	CO8	Identify the monetary type extension elements included in the XBRL files for monetary amounts presented in the balance sheet or income statement that do not include balance attributes. <i>[Procedure CO7 (first bullet), in combination with this procedure addresses this criterion.]</i>	CO8	No such items were noted for monetary amounts presented on the balance sheet and income statement that do not include balance attributes [except the following elements: <i>list extension elements and describe differences</i>]. <i>Also see findings for CO7.</i>
N	The context periods ⁴⁰ are consistent with the source information (for example, second calendar quarter 2012 is expressed as “2012-04-01 to 2012-06-30”).	CO9	For each business reporting concept that appears on the face of the financial statements or in tables in the source information, compare the reporting period (implied and explicitly stated) to the corresponding context period in the XBRL files.	CO9	No differences were noted in the XBRL files relating to context periods for concepts appearing on the face of the financial statements or in tables in the <i>[identify source information]</i> [except for the following elements: <i>list elements and describe differences</i>].
		CO10	For business reporting concepts within narrative text (for example, in the notes), compare the “as of” or period dates in the source information to the dates ⁴¹ in the	CO10	No differences were noted in the XBRL files relating to context periods for business reporting concepts included with narrative text in the

⁴⁰ Context periods for a roll-forward format use the same “instant” context for the beginning balance as for the ending balance of the previous period.

⁴¹ Procedures may be tailored, as appropriate, for application to periods included in the source information in addition to those listed.

	Principles and Criteria ¹⁵	Procedure	Finding
		<p>context period of the corresponding elements in the XBRL files.</p> <ul style="list-style-type: none"> • For amounts with a period type of instant <ul style="list-style-type: none"> — if a date is specified in the notes (for example, “as of” or “on”), ascertain whether the date for the context period in the XBRL files is the date specified in the source information. — if the month is specified (for example, March), ascertain whether the date for the context period in the XBRL files is the last day of that month. — if the quarter is specified (for example, in the second quarter), ascertain whether the date for the context period in the XBRL files is the end date for that quarter. 	<p><i>[identify source information]</i> <i>[except the following context periods: list elements and describe differences]</i></p>

(continued)

	Principles and Criteria ¹⁵		Procedure		Finding
			<ul style="list-style-type: none"> • For amounts that have a period type of duration <ul style="list-style-type: none"> — if the month is specified (for example, March), ascertain whether the date for the context period in the XBRL files is first and last day of the month. — if the quarter is specified (for example, in the second quarter), ascertain whether the date for the context period in the XBRL files is the first and last day of the quarter. 		
N (1)	The required DEI elements use the Required Context. ⁴²	CO11	Compare the contexts used in the XBRL files for DEI to those required by the SEC's EFM (sections 6.5.20 and 6.5.21) pertaining to DEI.	CO11	The context in the XBRL files used for DEI elements agreed with the context required by sections 6.5.20 and 6.5.21 of the SEC's EFM [except the following elements for which the context did not use the Required Context: <i>list elements</i>].

⁴² The *Required Context* is defined in the EFM as the context when the dates cover the current reporting period and no segment or scenario information (that is, dimensional information) is included.

	Principles and Criteria¹⁵		Procedure		Finding
O	The decimal attribute values are consistent with the degree of accuracy of the amounts as represented in source information (for example, 23.5 million is rounded to the hundred thousandths).	CO12	For each amount in the XBRL files compare the value of the decimal attribute (for example, “-6”) to the corresponding degree of accuracy represented in the source information.	CO12	No differences were noted between the decimal attribute values in the XBRL files and the degree of accuracy represented in the [identify source information] [except for the following decimal attributes in the XBRL files: list elements and describe differences].
P	The units defined in the instance document are consistent with the measurements represented in the source information (for example, U.S. dollars are defined as “iso4217:USD”, as properly defined in XBRL Specification 2.1).	CO13	For each amount included in the instance document, compare the units (including custom units) to the standard list of units specified by the SEC (for example, in the International Organization for Standardization (ISO) currency codes, or the XBRL International Unit Registry).	CO13	No differences were noted in the units used in the instance document as compared to the standard list of units specified by the SEC [except for the following units in the XBRL files: list elements and describe any differences].
		CO14	For each amount included in the instance document of the XBRL files, compare the units (including custom units) to the nature of the corresponding unit in the source information.	CO14	No differences were noted in the units used in the instance document of the XBRL files as compared to the source information [except for the following units in the instance document of the XBRL files: list elements and describe any differences].

(continued)

	Principles and Criteria¹⁵		Procedure		Finding
Q	The entity identifier in the instance document properly represents the reporting entity [for example, central index key (CIK)] in accordance with the SEC requirements.	CO15	Compare the identifier(s) used in the instance document to the registrant's unique CIK code.	CO15	The CIK code used in the XBRL files agrees with the registrant's CIK code. Or The following [identify CIK code(s)] were used in the XBRL files that did not agree with the registrant's CIK code.
Q (1)	Only one CIK code is used throughout the XBRL files.	CO16	Search the contexts for the use of more than one CIK code in the XBRL files.	CO16	Only one CIK code was used in the XBRL files. Or The following [identify CIK codes] were used in the XBRL files.
R	The format and layout of the text block information are consistent ⁴³ with the format and layout of the content in the source information.	CO17	Compare the format and layout of the text block information in the XBRL files to the form and layout in the source information (for example, content, indentations, italics, bold, color, order).	CO17	No differences were noted in the format and layout of text block information in the XBRL files as compared to the [identify source information] [except for the following elements: <i>list elements and describe differences</i>].
S	The order and hierarchy (that is, arrangement of appropriate abstracts and line items) reflected in the presentation linkbase are	CO18	Compare the order and hierarchy of the elements in the presentation linkbase with the source information.	CO18	No differences were noted in the order and hierarchy of the elements in the presentation linkbase as compared to the

⁴³ The EFM requires the same format and layout in text blocks as in the source information.

	Principles and Criteria¹⁵		Procedure		Finding
	consistent ⁴⁴ with the SEC's requirements.				[<i>identify source information</i>] [except for the following: <i>list elements and describe differences</i>].
T	Labels ⁴⁵ are consistent ⁴⁶ with the captions or meanings in the source information, as applicable.	CO19	Compare labels for line item elements (with no dimensions) reflecting business reporting concepts on the face of the financial statements or in tables in the source information to the captions in the source information Compare labels for all other tagged facts with the corresponding business reporting concept in the source information.	CO19	No differences other than those permitted ⁴⁷ were noted with the label information of elements appearing in the rendering as compared to the [<i>identify source information</i>] [except for the following: <i>list elements and describe differences</i>].
		CO20	Compare standard "en-US" labels used for each extension element in the XBRL files to the labels of other elements in the XBRL files and the standard taxonomy to ascertain whether duplicate standard English labels "en-US" are used.	CO20	No duplicate standard "en-US" labels were noted [except for the following extension elements: <i>list elements with duplicate standard en-US labels</i>].

(continued)

⁴⁴ When using dimensions to format information, it may not be possible to present this information in the same order and hierarchy (for example, transposed or intermingled axes for line items and domain members may occur).

⁴⁵ Labels in the label linkbase under the SEC rules must be the same as the captions in the source information, including parenthetical information.

⁴⁶ *Consistent* means the same as the printed captions in the source information, when required, or within the scope of variances otherwise permitted.

⁴⁷ EFM 6.11.3 requires additional information be included in the label for certain elements within a presentation group to distinguish the units in those elements where the majority of the elements within the group use a different unit.

	Principles and Criteria¹⁵		Procedure		Finding
T (1)	The appropriate label roles (in the label linkbase) are specified in presentation groupings and are consistent with the source information, as applicable. (For example, negated labels are used to reverse the sign of numeric values for presentation purposes.)	CO21	<p>Compare the preferred label roles in the XBRL files with the presentation of the corresponding business reporting concept in the source information and the following requirements:</p> <ul style="list-style-type: none"> • For period type of “instant”: <ul style="list-style-type: none"> — A Period Start label role was used when concepts were presented as a beginning of a roll forward (for example, cash balances) — A Period End label role was used when concepts were presented as an ending of a roll forward (for example, cash balances) • Total label role must be used when representing concepts presented as a summation of other line items • Negated label roles were used when necessary to reverse the sign of the numeric value for presentation purposes to correspond to the business reporting concept 	CO21	No differences were noted for the preferred label roles as compared to the presentation of the corresponding business reporting concept in the source information and the label requirements [except for the following: <i>list elements and labels and describe differences</i>].

	Principles and Criteria ¹⁵		Procedure		Finding
			as presented in the source information.		
U	Calculations reflected in the source information are included in the calculation linkbase in accordance with the SEC's requirements to the extent possible within the technical limitations ⁴⁸ of XBRL.	CO22	For those subtotals/totals that have two or more line items in the source information with amounts in the same context and within the dates represented by the period of the Required Context ⁴⁹ (no dimensional information), compare such relationships with the corresponding calculation relationship in the XBRL files.	CO22	No differences in the calculation relationships were noted in the XBRL files as compared to the source information [except for the following business reporting concepts: <i>list business reporting concepts and describe differences</i>].
Structure of the XBRL files—XBRL files are structured⁵⁰ in accordance with the following listed criteria.					
V	Taxonomies, including versions, referenced in the XBRL files are permitted by the SEC's requirements.	S1	Compare the standard taxonomy used in the XBRL files to the list of permitted taxonomies at www.sec.gov/info/edgar/edgartaxonomies.shtml .	S1	We noted that the standard taxonomy(ies) [<i>identify taxonomy(ies)</i>] used in the XBRL files is (are) permitted according to the SEC website. Or We noted that the standard taxonomy(ies) [<i>identify taxonomy(ies)</i>]

(continued)

⁴⁸ Due to current limitations of XBRL, calculations cannot be performed across different contexts; accordingly, it is currently not possible to include such calculations in the XBRL files.

⁴⁹ See definition of Required Context in footnote 42. Although not required, additional calculations outside of the required context are permitted.

⁵⁰ It is beyond the scope of these principles and criteria to include all applicable rules, regulations and technical requirements related to the intended purpose of the XBRL submissions. Notwithstanding, preparers are responsible for identification of and compliance with all of the SEC's requirements and a preparer may choose to request that a practitioner perform procedures with respect to such requirements.

	Principles and Criteria¹⁵		Procedure		Finding
					used in the XBRL files is (are) not permitted according to the SEC website.
W	Presentation groupings are consistent with the titles and order of the components of the underlying source information and in accordance with the SEC's requirements.		<i>Procedures S2 and S3, listed subsequently, address this criterion</i>		<i>See findings under S2 and S3.</i>
W (1)	Separate note presentations groupings (base sets) are created for each required level (I, II, III, and IV) and ordered in accordance with the SEC's requirements	S2	Compare the existence and order of the base sets in the presentation linkbase to the financial statement and note whether they appear in order of the source information and the ordering requirements as described in the SEC's EFM (section 6.7.12) as follows: <ol style="list-style-type: none"> 1. Each financial statement followed by a base set for the parentheticals within the statement [<i>in order of statements</i>] 2. Notes (text block) [order of notes] 3. Schedules (text block) 4. Significant accounting policies (policies) 	S2	The order of the presentation base sets in the presentation linkbase agreed to the [<i>identify source information</i>] and the EFM requirements [except for the following base sets: <i>list base sets and describe differences</i>].

	Principles and Criteria ¹⁵		Procedure		Finding
			5. Notes (tables) 6. Notes (detail) 7. Schedules (detail)		
W (2)	Titles of presentation groupings are in accordance with the SEC's formatting requirements.	S3	Compare base set titles (role type definition link) in the presentation linkbase to the SEC formatting requirements ⁵¹ for the following: 1. Formatting pattern: {Sort-Code} - {Type} - {Title} (for example: 01 - Statement - Statement of Income) 2. Titles of statements and notes in the source information	S3	No differences were noted with respect to the base set titles [except the following: <i>list base sets and describe how they did not conform to or agree with the SEC formatting requirements</i>].
X	The entity scheme (for example, www.sec.gov/CIK) for each context throughout the instance document is in accordance with the SEC's requirements.	S4	For each context, compare the entity scheme to http://www.sec.gov/CIK .	S4	We noted that the entity scheme http://www.sec.gov/CIK was used in all contexts [except for the following: <i>list contexts and describe differences</i>].
Y	New table structures are only created when no suitable table structure exists in the applicable standard	S5	Compare the table structures in the definition linkbase (that is, table, axis, domain member, line item) to the predefined table	S5	No new table structures were created when a suitable table structure existed [except for the following: <i>list</i>

(continued)

⁵¹ This is not a complete list of all SEC formatting requirements. Refer to EFM for requirements.

	Principles and Criteria¹⁵		Procedure		Finding
	taxonomy's definition linkbase.		structures ⁵² in the standard taxonomy's definition linkbase.	S5	<i>contexts and describe differences</i>]. No differences were noted in table structures as compared to the predefined table structures in the <i>[specify taxonomies]</i> [except for the following tables: <i>list tables and describe differences</i>].
Z	The names of extension elements contain no prohibited information.		<i>Procedure S6, in the following row, addresses this criterion.</i>		<i>See findings under S6.</i>
Z (1)	The names of extension elements (excluding domain members) do not include company- or period-specific information.	S6	Search the element name of each extension element (excluding domain members) for company or period specific information within the element name.	S6	No such elements were noted that have company or period specific information within the element name [except for the following elements: <i>list elements and describe differences</i>].
AA	The XBRL files include all files required by the SEC (for example, an instance, schemas and linkbases).	S7	Inspect the XBRL files to ascertain whether there is only one of each of the following files ⁵³ included: <ul style="list-style-type: none"> • Instance document • Presentation linkbase 	S7	Only one of each of the required files was included. Or The following files were missing: <i>[list files]</i> Or

⁵² Dimensional structures in the definition linkbase of the standard taxonomy contain ordered combinations of tables, axes, line items, and domain members. Definition linkbases for extension taxonomies should include dimensional structures from the standard taxonomy's definition linkbase when they exist.

⁵³ Although the EFM permits multiple linkbases and schema files, in most cases there will only be one included with the submission.

	Principles and Criteria ¹⁵		Procedure		Finding
			<ul style="list-style-type: none"> • Label linkbase • Calculation linkbase • Schema • Definition linkbase 		Multiple schema files were included.
BB	The language of the information in the XBRL files uses a permitted (or required) language (for example, English).		<i>Procedures S8 and S9, in the following rows, address this criterion.</i>		<i>See findings under S8 and S9.</i>
BB (1)	Elements must include fact values and labels expressed in U.S. English.	S8	For each fact in the source information in a language other than U.S. English, ascertain whether the corresponding formatted information in the XBRL files has values and labels expressed in U.S. English.	S8	No items were noted in which business reporting concepts in the source information in a language other than U.S. English were not formatted in the XBRL files with values and labels expressed in U.S. English [except for the following concepts: <i>list concepts and describe differences</i>].
		S9	Search extension elements in the XBRL files for any that do not have a standard English “en-US” label.	S9	No elements were noted in the XBRL files that did not have a standard “en-US” label [except for the following elements: <i>list elements and describe differences</i>].

Appendix E — Illustrative Agreed-Upon Procedures Report

The following is an illustrative practitioner's report for an agreed-upon procedures engagement described in this SOP (agreed-upon procedures that address the completeness, mapping, consistency, or structure of an entity's XBRL-formatted financial statements [and related notes] and required schedules submitted as an exhibit to the SEC). It is illustrative only and is not intended to be applicable to, or comprehensive for, all engagements. A practitioner should tailor the report to the specific facts and circumstances of each engagement.

Independent Accountant's Report on Applying Agreed-Upon Procedures

To Management and the Audit Committee of XYZ Company:

We have performed the procedures enumerated in Attachment A, which were agreed to by the audit committee and management of XYZ Company, solely to assist you in evaluating the completeness of the XBRL files, mapping of the source information to the XBRL files, consistency of the XBRL files with the source information, and structure of XYZ Company's XBRL files related to the [identify source information and period]⁵⁴ (for example, the Company's [Quarterly or Annual] Report on Form [10-K or 10-Q] for the period ended [identify date] to be submitted to the U.S. Securities Exchange Commission [SEC]). XYZ Company's management is responsible for its XBRL files.

This agreed-upon procedures engagement was performed in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of those parties specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures described in Attachment A either for the purpose for which this report has been requested or for any other purpose.

[Additional explanatory language may be added, such as the following].⁵⁵

The procedures performed do not address all of the SEC's requirements for XBRL submissions.

The XBRL files and source information may be updated prior to submitting to the SEC, therefore, the findings in this report may not correspond to the final XBRL files submitted.]

The findings relating to the procedures are included in Attachment A.

We were not engaged to and did not conduct an examination, the objective of which would be the expression of an opinion on the XBRL files. 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 audit committee and management of XYZ Company and is not intended to be and should not be used by anyone other than these specified parties.

[Signature]

[Date]

[Include as an attachment an enumeration of the procedures and findings.]

⁵⁴ It is common that these engagements are performed on DRAFT XBRL files and source information (prior to the submission to the SEC). The agreed-upon procedures report should indicate the specific version of the source information and files used.

⁵⁵ Refer to paragraph .30 of this SOP for additional examples.

Appendix F – Glossary

abstract. An attribute of an element to primarily indicate that the element is used only in a hierarchy to group related elements together or to provide headings in a rendering. An abstract element cannot be used to tag data in an instance document.

attribute. A property of an element that indicates the kind of data that can be tagged to the concept, such as its data type, period type, and whether the element is abstract.

axis (pl. axes). An instance document contains facts; an axis (and domain member) differentiates facts, and each axis represents a way the facts may be classified. For example, revenue for a period might be reported along a business unit axis, country axis, product axis, and so forth.

balance type. An attribute of a monetary item type designated as debit or credit; a designation, should be the natural or most expected balance of the element—credit or debit—and, thus, indicates how calculation relationships involving the element may be assigned a weight attribute (–1 or 1), as well as how numbers should be entered into the instance document.

calculation linkbase. A taxonomy file that defines weighted summation, aggregating relationships between numeric items expressed as parent-child hierarchies.

caption. Explanatory text provided to describe facts presented in a report.

context. Entity- and report-specific information (reporting period, segment information, and so forth) required by eXtensible Business Reporting Language (XBRL) that allows tagged data to be understood in relation to other information.

decimal. Fact attribute used to express the number of decimal places to which numbers have been rounded.

deprecated element. An element within a taxonomy that has been declared not to be used in instance documents for various reasons (for example, superseded, redundant, or incorrect).

domain. An element that represents an entire set of other elements that are used to further describe line items; the domain and its members are used to classify facts along the axis of a table. For example, “Arkansas” could be a domain member in the domain “States” and would be used to classify elements, such as revenues and assets, in Arkansas as distinct from other states. When a fact does not have any domain member specified, that means it applies to the entire domain.

domain member. An element representing one of the classifications within a domain. A domain member categorizes the information to which it is applied.

element. An XBRL component, such as a line item, domain member, and dimension (a dimension is called an axis in the U.S. GAAP Taxonomy). The representation of a business reporting concept, including line items in the face of the financial statements, important narrative disclosures, and rows and columns in tables are all examples of elements in a taxonomy. The terms *concept*, *element*, and *tag* (noun) are often used interchangeably in XBRL.

- element definition.** A description of a reporting concept, most commonly a documentation label in the label linkbase.
- extension element.** An element that is created in an extension taxonomy to define business reporting concepts that have not previously been defined in a standard taxonomy.
- extension taxonomy.** A taxonomy in which users can add additional entity-specific elements and indicate additional relationships to a standard taxonomy in order to define business reporting concepts or element relationships and aspects (presentation, calculation, labels, and so forth) to reflect their own unique reporting characteristics.
- fact.** The occurrence of an amount or other information tagged in an instance document by a taxonomy element or combination of elements.
- formatted information.** Information represented using XBRL and included in one or more electronic files. Commonly referred to as tagged data or structured data.
- hierarchy.** An organizational treelike structure to present relationships between elements (such as order and indentation of elements in linkbases).
- instance or instance document.** A file that contains business reporting information and represents a collection of business facts and report-specific information using elements from one or more XBRL taxonomies.
- label.** Name or description for an element for presentation purposes; under the SEC mandate, for example, each element has, at a minimum, a standard label in U.S. English (such as, cash and cash equivalents) and is unique across the taxonomy.
- label type.** A distinguishing name for each distinct label indicating the circumstances in which it should be used; each is given a separate defining role to use in different presentation situations (for example, beginning, ending, and so forth).
- line item.** Elements that conventionally appear on the vertical axis (rows) of a table or columnar presentation. Line items represent the primary business reporting concepts of tagged data in the instance document.
- linkbase.** A taxonomy file that contains additional defining information and relationships for taxonomy elements. The primary taxonomy linkbases in XBRL are calculation, definition, label, presentation, and reference.
- mapping.** Process of identifying the elements that correspond to lines, columns, and tables in the source information to elements in the taxonomy.
- name.** An attribute that uniquely identifies an element in a schema.
- namespace.** Every element is associated with a universal resource identifier that may identify the organization that maintains the taxonomy. In the 2012 US GAAP Financial Reporting Taxonomy, namespaces start with <http://xbrl.fasb.org/us-gaap/2012>.
- negated label.** A negated label is a special label type that can be referenced in the presentation linkbase. A negated label role is a convention used to indicate that the sign for a tagged amount should be reversed when presented in a rendering.
- nil.** An attribute of an element that, when marked as “true” in an instance document, reflects a concept tagged without a value.
- period type.** An attribute of an element that reflects whether it is reported as a point in time (an instant) or period of time (duration).

- presentation linkbase.** A taxonomy file that defines presentation order of elements in the taxonomy. The presentation linkbase also suggests which label type should be used at each point of presentation.
- render or rendering.** To process an instance document into a layout that facilitates readability and understanding of its contents.
- scaling.** A process that automatically adjusts numeric data to present a specific format, thus saving time of entering zeros during the entry or creation process. The XBRL specification does not support the scaling of numeric values (all values must be reported in their entirety); however, it is a feature commonly found in instance document creation software.
- segment.** Tag that allows additional information to be included in the context of an instance document; this information captures segment information, such as an entity's business units, type of debt, and type of other income.
- sign value.** Denotes whether a numeric fact in an instance has an implied positive (no sign) or a negative (–) value.
- source information.** The information (which may be in electronic format) that is to be formatted in XBRL files (for example, financial statements, including the notes, and required schedules; sustainability reports; or the “Risk/Return Summary” section of the mutual fund prospectuses).
- table.** Generally, a presentation of rows and columns also known as a hypercube. In the presentation linkbase, an element that organizes a set of axes and set of line items to indicate that each fact of one of the line items could be further characterized along one or more of its axes. For example, if a line item is “Sales,” and an axis is “Scenario,” this means that an instance document could have facts that are either for an unspecified scenario or a specific scenario, such as “forecast.”
- tag (noun).** The terms *element* and *tag* are often used interchangeably in XBRL. The tag is the structure that brings together the content being tagged with the associated element from the taxonomy and additional attributes to related contexts, units, and other information.
- tag (verb).** To apply tags to business reporting concepts.
- taxonomy(ies).** Electronic “dictionary” of elements used to report business data, their definitions, and interrelationships.
- type or data type.** Attribute that defines type (for example, monetary, string, share, decimal) of data that an element represents.
- unit of measure.** The units in which numeric items have been measured, such as U.S. dollars (iso4217:USD); shares (xbri:shares); euros (iso4217:EUR); or compound units, such as U.S. dollars per share.
- validation.** Process of checking that instance documents and taxonomies correctly meet the rules of the XBRL specification and certain requirements of the entity's reporting environment.
- XBRL files.** Electronic files that may include the instance document, taxonomy extension schema, label linkbase, calculation linkbase, presentation linkbase, and definition linkbase documents (or other linkbases)
- XBRL footnote link.** Additional information that is attached to an element used to tag information in superscript footnotes.

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