

1989

# Special reports; Statement on auditing standards, 062

American Institute of Certified Public Accountants. Auditing Standards Board

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## Special Reports

(Supersedes Statement on Auditing Standards No. 14, AICPA, Professional Standards, vol. 1, AU sec. 621.)

### SUMMARY

This Statement on Auditing Standards (SAS) changes generally accepted auditing standards by —

- Prescribing a new special report form that parallels the form of the auditor's standard report in SAS No. 58, *Reports on Audited Financial Statements*.
- Requiring the auditor's special report to state that the financial statements were prepared in conformity with a comprehensive basis of accounting other than generally accepted accounting principles (GAAP).
- Clarifying that there is no requirement to describe in the auditor's special report how the presentation differs from a presentation in conformity with generally accepted accounting principles.
- Clarifying requirements for issuing a special-purpose report on special or incomplete presentations
- Restricting the distribution of (a) reports on financial presentations prepared to comply with a basis of accounting prescribed in a contract or regulatory provision that result in (1) presentations that are not in conformity with GAAP or an other comprehensive basis of accounting (OCBOA) or (2) incomplete GAAP or OCBOA presentations (except when the auditor's report and related financial presentation are to be filed with a regulatory agency and included in a

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document that is distributed to the general public) and (b) reports on compliance with aspects of contractual agreements or regulatory requirements related to audited financial statements.

This SAS supersedes previous guidance in SAS No. 14, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 621). This statement also supersedes guidance contained in the following interpretations of SAS No. 14:

- *Reports on Elements, Accounts, or Items of a Financial Statement That Are Presented in Conformity With GAAP*
- *Financial Statements Prepared in Accordance with Accounting Practices Specified in an Agreement*
- *Reporting on Special-Purpose Financial Presentations*
- *Adequacy of Disclosure in Financial Statements Prepared on a Comprehensive Basis of Accounting Other Than GAAP*

This statement is effective for special reports dated on or after July 1, 1989. Earlier application of the provisions of this statement is permissible.

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## Introduction

1. This statement applies to auditors' reports issued in connection with the following:

- a. Financial statements that are prepared in conformity with a comprehensive basis of accounting other than generally accepted accounting principles (paragraphs 2 through 10)
- b. Specified elements, accounts, or items of a financial statement (paragraphs 11 through 18)
- c. Compliance with aspects of contractual agreements or regulatory requirements related to audited financial statements (paragraphs 19 through 21)
- d. Financial presentations to comply with contractual agreements or regulatory provisions (paragraphs 22 through 30)
- e. Financial information presented in prescribed forms or schedules that require a prescribed form of auditor's report (paragraphs 32 and 33)

## Financial Statements Prepared in Conformity With a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles

2. Generally accepted auditing standards are applicable when an auditor conducts an audit of and reports on any financial statement. A financial statement may be, for example, that of a corporation, a consolidated group of corporations, a combined group of affiliated entities, a not-for-profit organization, a governmental unit, an estate or trust, a partnership, a proprietorship, a segment of any of these, or an individual. The term *financial statement* refers to a presentation of financial data, including accompanying notes, derived from accounting records and intended to communicate an entity's economic resources or obligations at a point in time or the changes therein for a period of time in conformity with a comprehensive basis of accounting. For reporting purposes, the independent auditor should consider each of the following types of financial presentations to be a financial statement:

- a. Balance sheet
- b. Statement of income or statement of operations

- c. Statement of retained earnings
- d. Statement of cash flows
- e. Statement of changes in owners' equity
- f. Statement of assets and liabilities that does not include owners' equity accounts
- g. Statement of revenue and expenses
- h. Summary of operations
- i. Statement of operations by product lines
- j. Statement of cash receipts and disbursements

3. An independent auditor's judgment concerning the overall presentation of financial statements should be applied within an identifiable framework (see SAS No. 5, *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report* [AICPA, *Professional Standards*, vol. 1, AU sec. 411] as amended April 1988, by Omnibus Statement on Auditing Standards No. 52). Normally, the framework is provided by generally accepted accounting principles, and the auditor's judgment in forming an opinion is applied accordingly (see paragraph 4 of SAS No. 5). In some circumstances, however, a comprehensive basis of accounting other than generally accepted accounting principles may be used.

4. For purposes of this statement, a comprehensive basis of accounting other than generally accepted accounting principles is one of the following:

- a. A basis of accounting that the reporting entity uses to comply with the requirements or financial reporting provisions of a governmental regulatory agency to whose jurisdiction the entity is subject (for example, insurance companies use a basis of accounting pursuant to the rules of a state insurance commission)
- b. A basis of accounting that the reporting entity uses or expects to use to file its income tax return for the period covered by the financial statements
- c. The cash receipts and disbursements basis of accounting, and modifications of the cash basis having substantial support, such as recording depreciation on fixed assets or accruing income taxes
- d. A definite set of criteria having substantial support that is applied to all material items appearing in financial statements, such as the price-level basis of accounting

Unless one of the foregoing descriptions applies, reporting under the provisions of paragraph 5 is not permitted.

## **Reporting on Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting (OCBOA)**

5. When reporting on financial statements prepared in conformity with a comprehensive basis of accounting other than generally accepted accounting principles, as defined in paragraph 4, an independent auditor should include in the report —

- a. A title that includes the word *independent*.<sup>1</sup>
- b. A paragraph that —
  - (1) States that the financial statements identified in the report were audited.
  - (2) States that the financial statements are the responsibility of the company's management<sup>2</sup> and that the auditor is responsible for expressing an opinion on the financial statements based on the audit.
- c. A paragraph that —
  - (1) States that the audit was conducted in accordance with generally accepted auditing standards.
  - (2) States that generally accepted auditing standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.
  - (3) States that an audit includes —
    - (a) Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements,

<sup>1</sup> This statement does not require a title for an auditor's report if the auditor is not independent. See SAS No. 26, *Association With Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 504), for guidance on reporting when the auditor is not independent.

<sup>2</sup> In some instances, a document containing the auditor's report may include a statement by management regarding its responsibility for the presentation of the financial statements. Nevertheless, the auditor's report should state that the financial statements are management's responsibility. However, the statement about management's responsibility should not be further elaborated upon in the auditor's standard report or referenced to management's report.

- (b) Assessing the accounting principles used and significant estimates made by management, and
  - (c) Evaluating the overall financial statement presentation (see paragraph 9).
- (4) States that the auditor believes that his or her audit provides a reasonable basis for the opinion.
- d. A paragraph that —
  - (1) States the basis of presentation and refers to the note to the financial statements that describes the basis (see paragraphs 9 and 10).
  - (2) States that the basis of presentation is a comprehensive basis of accounting other than generally accepted accounting principles.
- e. A paragraph that expresses the auditor's opinion (or disclaims an opinion) on whether the financial statements are presented fairly, in all material respects, in conformity with the basis of accounting described. If the auditor concludes that the financial statements are not presented fairly on the basis of accounting described or if there has been a limitation on the scope of the audit, he or she should disclose all the substantive reasons for that conclusion in an explanatory paragraph(s) (preceding the opinion paragraph) of the report and should include in the opinion paragraph the appropriate modifying language and a reference to such explanatory paragraph(s).<sup>3</sup>
- f. If the financial statements are prepared in conformity with the requirements or financial reporting provisions of a governmental regulatory agency (see paragraph 4a), a paragraph that restricts the distribution of the report solely to those within the entity and for filing with the regulatory agency. Such a restrictive paragraph is appropriate, even though by law or regulation the auditor's report may be made a matter of public record. The auditor may also use this form of report if additional distribution of the financial state-

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<sup>3</sup> Paragraph 31 of this statement discusses other circumstances that may require that the auditor add additional explanatory language to the special report.



ments and report is recognized as appropriate by an AICPA audit or accounting guide or auditing interpretation.<sup>4</sup>

- g. The manual or printed signature of the auditor's firm.
- h. The date.<sup>5</sup>

6. Unless the financial statements meet the conditions for presentation in conformity with a "comprehensive basis of accounting other than generally accepted accounting principles" as defined in paragraph 4, the auditor should use the standard form of report (see paragraph 8 of SAS No. 58, *Reports on Audited Financial Statements* [AICPA, *Professional Standards*, vol. 1, AU sec. 508]), modified as appropriate because of the departures from generally accepted accounting principles.

7. 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 conformity with generally accepted accounting principles. Consequently, the auditor should consider whether the financial statements that he or she is reporting on are suitably titled. For example, cash basis financial statements might be titled *statement of assets and liabilities arising from cash transactions*, or *statement of revenue collected and expenses paid*, and a financial statement prepared on a statutory or regulatory basis might be titled *statement of income — statutory basis*. If the auditor believes that the financial statements are not suitably titled, the auditor should disclose his or her reservations in an explanatory paragraph of the report and qualify the opinion.

8. Following are illustrations of reports on financial statements prepared in conformity with a comprehensive basis of accounting other than generally accepted accounting principles.

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<sup>4</sup> If the financial statements and report are intended for distribution other than for filing with the regulatory agency to whose jurisdiction the entity is subject or if such additional distribution is not recognized as appropriate by an AICPA audit or accounting guide or auditing interpretation, the auditor should consider the guidance in SAS No. 1, "Lack of Conformity with Generally Accepted Accounting Principles" (AICPA, *Professional Standards*, vol. 1, AU sec. 544).

<sup>5</sup> For guidance on dating the auditor's report, see SAS No. 1, "Dating of the Independent Auditor's Report" (AICPA, *Professional Standards*, vol. 1, AU sec. 530).

## **Financial Statements Prepared on a Basis Prescribed by a Regulatory Agency Solely for Filing With That Agency**

### Independent Auditor's Report

We have audited the accompanying statements of admitted assets, liabilities, and surplus-statutory basis of XYZ Insurance Company as of December 31, 19X2 and 19X1, and the related statements of income and cash flows-statutory basis and changes in surplus-statutory basis for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note X, these financial statements were prepared in conformity with the accounting practices prescribed or permitted by the Insurance Department of [State], which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of XYZ Insurance Company as of (at) December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in Note X.

This report is intended solely for the information and use of the board of directors and management of XYZ Insurance Company and for filing with the [name of regulatory agency] and should not be used for any other purpose.

## **Financial Statements Prepared on the Entity's Income Tax Basis**

### Independent Auditor's Report

We have audited the accompanying statements of assets, liabilities, and capital-income tax basis of ABC Partnership as of December 31, 19X2 and 19X1, and the related statements of revenue and expenses-income tax basis and of changes in partners' capital accounts-income tax basis for the years then ended. These financial statements are the responsibility of the Partnership's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note X, these financial statements were prepared on the basis of accounting the Partnership uses for income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets, liabilities, and capital of ABC Partnership as of December 31, 19X2 and 19X1, and its revenue and expenses and changes in partners' capital accounts for the years then ended, on the basis of accounting described in Note X.

## **Financial Statements Prepared on the Cash Basis**

### Independent Auditor's Report

We have audited the accompanying statements of assets and liabilities arising from cash transactions of XYZ Company as of December 31, 19X2 and 19X1, and the related statements of revenue collected and expenses paid for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note X, these financial statements were prepared on the basis of cash receipts and disbursements, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets and liabilities arising from cash transactions of XYZ Company as of December 31, 19X2 and 19X1, and

its revenue collected and expenses paid during the years then ended, on the basis of accounting described in Note X.

## **Evaluating the Adequacy of Disclosure in Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting**

9. When reporting on financial statements prepared on a comprehensive basis of accounting other than generally accepted accounting principles, 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. The auditor should apply essentially the same criteria to financial statements prepared on an other comprehensive basis of accounting as he or she does to financial statements prepared in conformity with generally accepted accounting principles. Therefore, the auditor's opinion should be based on his or her judgment regarding whether the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation as discussed in paragraph 4 of SAS No. 5, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles" in the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 411).

10. Financial statements prepared on an other comprehensive basis of accounting should include, in the accompanying notes, a summary of significant accounting policies that discusses the basis of presentation and describes how that basis differs from generally accepted accounting principles. However, the effects of the differences between generally accepted accounting principles and the basis of presentation of the financial statements that the auditor is reporting on need not be quantified. In addition, when the financial statements contain items that are the same as, or similar to, those in financial statements prepared in conformity with generally accepted accounting principles, similar informative disclosures are appropriate. For example, financial statements prepared on an income tax basis or a modified cash basis of accounting usually reflect depreciation, long-term debt, and owners' equity. Thus, the informative disclosures for depreciation, long-term

debt, and owners' equity in such financial statements should be comparable to those in financial statements prepared in conformity with generally accepted accounting principles. When evaluating the adequacy of disclosures, the auditor should also consider disclosures related to matters that are not specifically identified on the face of the financial statements, such as (a) related party transactions, (b) restrictions on assets and owners' equity, (c) subsequent events, and (d) uncertainties.

## **Specified Elements, Accounts, or Items of a Financial Statement**

11. An independent auditor may be requested to express an opinion on one or more specified elements, accounts, or items of a financial statement. In such an engagement, the specified element(s), account(s), or item(s) may be presented in the report or in a document accompanying the report. Examples of one or more specified elements, accounts, or items of a financial statement that an auditor may report on based on an audit made in accordance with generally accepted auditing standards include rentals, royalties, a profit participation, or a provision for income taxes.<sup>6</sup>

12. When expressing an opinion on one or more specified elements, accounts, or items of a financial statement, the auditor should plan and perform the audit and prepare his or her report with a view to the purpose of the engagement. With the exception of the first standard of reporting, the ten generally accepted auditing standards are applicable to any engagement to express an opinion on one or more specified elements, accounts, or items of a financial statement. The

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<sup>6</sup> See SAS No. 35, *Special Reports—Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AICPA, *Professional Standards*, vol. 1, AU sec. 622), for guidance when reporting on the results of applying agreed-upon procedures to one or more specified elements, accounts, or items of a financial statement and *Statements on Standards for Attestation Engagements, Attestation Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 2010), for guidance when reporting on a review of one or more specified elements, accounts or items of a financial statement.

first standard of reporting, which requires that the auditor's report state whether the financial statements are presented in conformity with generally accepted accounting principles, is applicable only when the specified elements, accounts, or items of a financial statement are intended to be presented in conformity with generally accepted accounting principles.

13. An engagement to express an opinion on one or more specified elements, accounts, or items of a financial statement may be undertaken as a separate engagement or in conjunction with an audit of financial statements. In either case, an auditor expresses an opinion on each of the specified elements, accounts, or items encompassed by the auditor's report; therefore, the measurement of materiality must be related to each individual element, account, or item reported on rather than to the aggregate thereof or to the financial statements taken as a whole. Consequently, an audit of a specified element, account, or item for purposes of reporting thereon is usually more extensive than if the same information were being considered in conjunction with an audit of financial statements taken as a whole. Also, many financial statement elements are interrelated, for example, sales and receivables; inventory and payables; and buildings and equipment and depreciation. The auditor should be satisfied that elements, accounts, or items that are interrelated with those on which he or she has been engaged to express an opinion have been considered in expressing an opinion.

14. The auditor should not express an opinion on specified elements, accounts, or items included in financial statements on which he or she has expressed an adverse opinion or disclaimed an opinion based on an audit, if such reporting would be tantamount to expressing a piecemeal opinion on the financial statements (see paragraph 73 of SAS No. 58). 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 the 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 accounts receivable balance 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 report on the financial statements of the entity.

## Reports on One or More Specified Elements, Accounts, or Items of a Financial Statement

15. When an independent auditor is engaged to express an opinion on one or more specified elements, accounts, or items of a financial statement, the report should include —

- a. A title that includes the word *independent*.<sup>7</sup>
- b. A paragraph that —
  - (1) States that the specified elements, accounts, or items identified in the report were audited. If the audit was made in conjunction with an audit of the company's financial statements, the paragraph should so state and indicate the date of the auditor's report on those financial statements. Furthermore, any departure from the standard report on those statements should also be disclosed if considered relevant to the presentation of the specified element, account, or item.
  - (2) States that the specified elements, accounts, or items are the responsibility of the company's management and that the auditor is responsible for expressing an opinion on the specified elements, accounts, or items based on the audit.
- c. A paragraph that —
  - (1) States that the audit was conducted in accordance with generally accepted auditing standards.
  - (2) States that generally accepted auditing standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the specified elements, accounts, or items are free of material misstatement.
  - (3) States that an audit includes —
    - (a) Examining, on a test basis, evidence supporting the amounts and disclosures in the presentation of the specified elements, accounts, or items,
    - (b) Assessing the accounting principles used and significant estimates made by management, and
    - (c) Evaluating the overall presentation of the specified elements, accounts, or items.

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<sup>7</sup> See note 1.

- (4) States that the auditor believes that his or her audit provides a reasonable basis for the auditor's opinion.
- d. A paragraph<sup>8</sup> that —
- (1) Describes the basis on which the specified elements, accounts, or items are presented (see paragraphs 9 and 10) and, when applicable, any agreements specifying such basis if the presentation is not prepared in conformity with generally accepted accounting principles.<sup>9</sup>
  - (2) If considered necessary, includes a description and the source of significant interpretations, if any, made by the company's management, relating to the provisions of a relevant agreement.
- e. A paragraph that expresses the auditor's opinion (or disclaims an opinion) on whether the specified elements, accounts, or items are fairly presented, in all material respects, in conformity with the basis of accounting described. If the auditor concludes that the specified elements, accounts, or items are not presented fairly on the basis of accounting described or if there has been a limitation on the scope of the audit, the auditor should disclose all the substantive reasons for that conclusion in an explanatory paragraph(s) (preceding the opinion paragraph) of the report and should include in the opinion paragraph appropriate modifying language and a reference to such explanatory paragraph(s).<sup>10</sup>
- f. If the specified element, account, or item is prepared to comply with the requirements or financial reporting provisions of a contract or agreement that results in a presentation that is not in conformity with either generally accepted accounting principles or an other comprehensive basis of accounting, a paragraph that restricts the distribution of the report to those within the entity and the parties to the contract or agreement.<sup>11</sup> Such a restriction is necessary

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<sup>8</sup> Alternatively, this requirement can be met by incorporating the description in the introductory paragraph discussed in 15*b* above.

<sup>9</sup> When the specified element, account, or item is presented in conformity with an other comprehensive basis of accounting, see paragraph 5*d*(2).

<sup>10</sup> Paragraph 31 of this statement discusses other circumstances that may require that the auditor add additional explanatory language to the special report.

<sup>11</sup> If the presentation is prepared on a basis prescribed by a governmental regulatory agency (which is also OCBOA), the auditor should restrict the distribution of the report on such presentation. See paragraph 5*f* for further reporting guidance in this situation.



because the basis of presentation is determined by reference to a document that would not generally be available to other third parties.

- g. The manual or printed signature of the auditor's firm.
- h. The date.<sup>12</sup>

When expressing an opinion on one or more specified elements, accounts, or items of a financial statement, the auditor, to provide more information as to the scope of the audit, may wish to describe in a separate paragraph certain other auditing procedures applied. However, no modification in the content of paragraph 15*c* above should be made.

16. If a specified element, account, or item is, or is based upon, an entity's net income or stockholders' equity or the equivalent thereof, the auditor should have audited the complete financial statements to express an opinion on the specified element, account, or item.

17. The auditor should consider the effect that any departure, including additional explanatory language because of the circumstances discussed in paragraph 11 of SAS No. 58, from the standard report on the audited financial statements might have on the report on a specified element, account, or item thereof.

18. Following are illustrations of reports expressing an opinion on one or more specified elements, accounts, or items of a financial statement.

## **Report Relating to Accounts Receivable**

### Independent Auditor's Report

We have audited the accompanying schedule of accounts receivable of ABC Company as of December 31, 19X2. This schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on this schedule based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule of accounts receivable is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule of accounts receivable. An audit also

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<sup>12</sup> See note 5.

includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the schedule of accounts receivable referred to above presents fairly, in all material respects, the accounts receivable of ABC Company as of December 31, 19X2, in conformity with generally accepted accounting principles.<sup>13</sup>

## **Report Relating to Amount of Sales for the Purpose of Computing Rental**

### Independent Auditor's Report

We have audited the accompanying schedule of gross sales (as defined in the lease agreement dated March 4, 19XX, between ABC Company, as lessor, and XYZ Stores Corporation, as lessee) of XYZ Stores Corporation at its Main Street store, [City], [State], for the year ended December 31, 19X2. This schedule is the responsibility of XYZ Stores Corporation's management. Our responsibility is to express an opinion on this schedule based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule of gross sales is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule of gross sales. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the schedule of gross sales referred to above presents fairly, in all material respects, the gross sales of XYZ Stores Corporation at its Main Street store, [City], [State], for the year ended December 31, 19X2, as defined in the lease agreement referred to in the first paragraph.

This report is intended solely for the information and use of the boards of directors and managements of XYZ Stores Corporation and ABC Company and should not be used for any other purpose.

## **Report Relating to Royalties**

### Independent Auditor's Report

We have audited the accompanying schedule of royalties applicable to

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<sup>13</sup> Since this presentation was prepared in conformity with generally accepted accounting principles, the report need not be restricted.

engine production of the Q Division of XYZ Corporation for the year ended December 31, 19X2, under the terms of a license agreement dated May 14, 19XX, between ABC Company and XYZ Corporation. This schedule is the responsibility of XYZ Corporation's management. Our responsibility is to express an opinion on this schedule based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule of royalties is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

We have been informed that, under XYZ Corporation's interpretation of the agreement referred to in the first paragraph, royalties were based on the number of engines produced after giving effect to a reduction for production retirements that were scrapped, but without a reduction for field returns that were scrapped, even though the field returns were replaced with new engines without charge to customers.

In our opinion, the schedule of royalties referred to above presents fairly, in all material respects, the number of engines produced by the Q Division of XYZ Corporation during the year ended December 31, 19X2, and the amount of royalties applicable thereto, under the license agreement referred to above.

This report is intended solely for the information and use of the boards of directors and managements of XYZ Corporation and ABC Company and should not be used for any other purpose.

## **Report on a Profit Participation<sup>14</sup>**

### Independent Auditor's Report

We have audited, in accordance with generally accepted auditing standards, the financial statements of XYZ Company for the year ended December 31, 19X1, and have issued our report thereon dated March 10, 19X2. We have also audited XYZ Company's schedule of John Smith's profit participation for the year ended December 31, 19X1. This schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on this schedule based on our audit.

We conducted our audit of the schedule in accordance with generally

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<sup>14</sup> See paragraph 16.

accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule of profit participation is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

We have been informed that the documents that govern the determination of John Smith's profit participation are (a) the employment agreement between John Smith and XYZ Company dated February 1, 19X0, (b) the production and distribution agreement between XYZ Company and Television Network Incorporated dated March 1, 19X0, and (c) the studio facilities agreement between XYZ Company and QRX Studios dated April 1, 19X0, as amended November 1, 19X0.

In our opinion, the schedule of profit participation referred to above presents fairly, in all material respects, John Smith's participation in the profits of XYZ Company for the year ended December 31, 19X1, in accordance with the provisions of the agreements referred to above.

This report is intended solely for the information and use of the board of directors and management of XYZ Company and John Smith and should not be used for any other purpose.

## **Report on Federal and State Income Taxes Included in Financial Statements<sup>15</sup>**

### Independent Auditor's Report

We have audited, in accordance with generally accepted auditing standards, the financial statements of XYZ Company, Inc., for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX. We have also audited the current and deferred provision for the Company's federal and state income taxes for the year ended June 30, 19XX, included in those financial statements, and the related asset and liability tax accounts as of June 30, 19XX. This income tax information is the responsibility of the Company's management. Our responsibility is to express an opinion on it based on our audit.

We conducted our audit of the income tax information in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the federal and state income tax accounts are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures related to the federal and state

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<sup>15</sup> See paragraph 16.

income tax accounts. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the federal and state income tax accounts. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the Company has paid or, in all material respects, made adequate provision in the financial statements referred to above for the payment of all federal and state income taxes and for related deferred income taxes that could be reasonably estimated at the time of our audit of the financial statements of XYZ Company, Inc., for the year ended June 30, 19XX.

## **Compliance With Aspects of Contractual Agreements or Regulatory Requirements Related to Audited Financial Statements**

19. Entities may be required by contractual agreements, such as certain bond indentures and loan agreements, or by regulatory agencies to furnish compliance reports by independent auditors.<sup>16</sup> For example, loan agreements often impose on borrowers a variety of obligations involving matters such as payments into sinking funds, payments of interest, maintenance of current ratios, and restrictions of dividend payments. They usually also require the borrower to furnish annual financial statements that have been audited by an independent auditor. In some instances, the lenders or their trustees may request assurance from the independent auditor that the borrower has complied with certain covenants of the agreement relating to accounting matters. The independent auditor may satisfy this request by giving negative assurance relative to the applicable covenants based on the audit of the financial statements. This assurance may be given in a separate report or in one or more paragraphs of the auditor's report accompanying the financial statements. Such assurance, however, should not be given unless the auditor has audited the financial statements to

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<sup>16</sup> When the auditor is engaged to test compliance with laws and regulations in accordance with *Government Auditing Standards* (Yellow Book) issued by the Comptroller General of the United States, he or she should follow guidance contained in SAS No. 63, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance*.

which the contractual agreements or regulatory requirements relate and should not extend to covenants that relate to matters that have not been subjected to the audit procedures applied in the audit of the financial statements.<sup>17</sup> In addition, such assurance should not be given if the auditor has expressed an adverse opinion or disclaimed an opinion on the financial statements to which these covenants relate.

20. When an auditor's report on compliance with contractual agreements or regulatory provisions is being given in a separate report, the report should include —

- a. A title that includes the word *independent*.<sup>18</sup>
- b. A paragraph that states the financial statements were audited in accordance with generally accepted auditing standards and that includes the date of the auditor's report on those financial statements. Furthermore, any departure from the standard report on those statements should also be disclosed.
- c. A paragraph that includes a reference to the specific covenants or paragraphs of the agreement, provides negative assurance relative to compliance with the applicable covenants of the agreement insofar as they relate to accounting matters, and specifies that the negative assurance is being given in connection with the audit of the financial statements. The auditor should ordinarily state that the audit was not directed primarily toward obtaining knowledge regarding compliance.
- d. A paragraph that includes a description and the source of significant interpretations, if any, made by the company's management relating to the provisions of a relevant agreement.
- e. A paragraph that restricts the distribution of the report to those within the entity and the parties to the contract or agreement or for filing with the regulatory agency, since the matters on which the auditor is reporting are set forth in a document that would not generally be available to other third parties.

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<sup>17</sup> When the auditor is engaged to provide assurance on compliance with contractual agreements or regulatory provisions that relate to matters that have not been subjected to the audit procedures applied in the audit of the financial statements, the auditor should refer to the guidance in the Statements on Standards for Attestation Engagements, *Attestation Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 2010).

<sup>18</sup> See note 1.

- f. The manual or printed signature of the auditor's firm.
- g. The date.<sup>19</sup>

21. When an auditor's report on compliance with contractual agreements or regulatory provisions is included in the report that expresses the auditor's opinion on the financial statements, the auditor should include a paragraph, after the opinion paragraph, that provides negative assurance relative to compliance with the applicable covenants of the agreement, insofar as they relate to accounting matters, and that specifies the negative assurance is being given in connection with the audit of the financial statements. The auditor should also ordinarily state that the audit was not directed primarily toward obtaining knowledge regarding compliance. In addition, the report should include a paragraph that includes a description and source of any significant interpretations made by the entity's management as discussed in paragraph 20(d) as well as a paragraph that restricts its distribution as discussed in paragraph 20(e). Following are examples of reports that might be issued:

**Report on Compliance With Contractual Provisions Given in a Separate Report<sup>20</sup>**  
Independent Auditor's Report

We have audited, in accordance with generally accepted auditing standards, the balance sheet of XYZ Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended, and have issued our report thereon dated February 16, 19X3.

In connection with our audit, nothing came to our attention that caused us to believe that the Company failed to comply with the terms, covenants, provisions, or conditions of sections XX to XX, inclusive, of the Indenture dated July 21, 19X0, with ABC Bank insofar as they relate to accounting matters. However, our audit was not directed primarily toward obtaining knowledge of such noncompliance.

This report is intended solely for the information and use of the boards of directors and managements of XYZ Company and ABC Bank and should not be used for any other purpose.

<sup>19</sup> See note 5.

<sup>20</sup> When the auditor's report on compliance with contractual agreements or regulatory provisions is included in the report that expresses the auditor's opinion on the financial statements, the last two paragraphs of this report are examples of the paragraphs that should follow the opinion paragraph of the auditor's report on the financial statements.

## **Report on Compliance With Regulatory Requirements Given in a Separate Report When the Auditor's Report on the Financial Statements Included an Explanatory Paragraph Because of an Uncertainty**

### Independent Auditor's Report

We have audited, in accordance with generally accepted auditing standards, the balance sheet of XYZ Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended, and have issued our report thereon dated March 5, 19X3, which included an explanatory paragraph that described the litigation discussed in Note X of those statements.

In connection with our audit, nothing came to our attention that caused us to believe that the Company failed to comply with the accounting provisions in sections (1), (2), and (3) of the [*name of state regulatory agency*]. However, our audit was not directed primarily toward obtaining knowledge of such noncompliance.

This report is intended solely for the information and use of the board of directors and management of XYZ Company and the [*name of state regulatory agency*] and should not be used for any other purpose.

## **Special-Purpose Financial Presentations to Comply With Contractual Agreements or Regulatory Provisions**

22. An auditor is sometimes asked to report on special-purpose financial statements prepared to comply with a contractual agreement<sup>21</sup> or regulatory provisions. In most circumstances, these types of presentations are intended solely for the use of the parties to the agreement, regulatory bodies, or other specified parties. This section discusses reporting on these types of presentations, which include —

- a. A special-purpose financial presentation prepared in compliance with a contractual agreement or regulatory provision that does not constitute a complete presentation of the entity's assets, liabilities, revenues and expenses, but is otherwise prepared in conformity with generally accepted accounting principles or another comprehensive basis of accounting (paragraphs 23 through 26).
- b. A special-purpose financial presentation (may be a complete set of financial statements or a single financial statement) prepared on a

<sup>21</sup> A contractual agreement as discussed in this section is an agreement between the client and one or more third parties other than the auditor.



basis of accounting prescribed in an agreement that does not result in a presentation in conformity with generally accepted accounting principles or an other comprehensive basis of accounting (paragraphs 27 through 30).

### **Financial Statements Prepared on a Basis of Accounting Prescribed in a Contractual Agreement or Regulatory Provision That Results in an Incomplete Presentation but Is Otherwise in Conformity With Generally Accepted Accounting Principles or an Other Comprehensive Basis of Accounting**

23. A governmental agency may require a schedule of gross income and certain expenses of an entity's real estate operation in which income and expenses are measured in conformity with generally accepted accounting principles, but expenses are defined to exclude certain items such as interest, depreciation, and income taxes. Such a schedule may also present the excess of gross income over defined expenses. Also, a buy-sell agreement may specify a schedule of gross assets and liabilities of the entity measured in conformity with generally accepted accounting principles, but limited to the assets to be sold and liabilities to be transferred pursuant to the agreement.

24. Paragraph 2 of this statement defines the term *financial statement* and includes a list of financial presentations that an auditor should consider to be financial statements for reporting purposes. The concept of specified elements, accounts, or items of a financial statement discussed in paragraphs 11 through 18, on the other hand, refers to accounting information that is part of, but significantly less than, a financial statement. The financial presentations described above and similar presentations should generally be regarded as financial statements, even though, as indicated above, certain items may be excluded. Thus, when the auditor is asked to report on these types of presentations, the measurement of materiality for purposes of expressing an opinion should be related to the presentations taken as a whole (see SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* [AICPA, *Professional Standards*, vol. 1, AU sec. 312]). Further, the presentations should differ from complete financial statements only to the extent necessary to meet the special purposes for which they were prepared. In addition, when these financial presentations contain items that are the same as, or similar to, those contained in a full set of

financial statements prepared in conformity with generally accepted accounting principles, similar informative disclosures are appropriate (see paragraphs 9 and 10). The auditor should also be satisfied that the financial statements presented are suitably titled to avoid any implication that the special-purpose financial statements on which he or she is reporting are intended to present financial position, results of operations, or cash flows.

25. When the auditor is asked to report on financial statements prepared on a basis of accounting prescribed in a contractual agreement or regulatory provision that results in an incomplete presentation but one that is otherwise in conformity with generally accepted accounting principles or an other comprehensive basis of accounting, the auditor's report should include —

- a. A title that includes the word *independent*.<sup>22</sup>
- b. A paragraph that —
  - (1) States that the financial statements identified in the report were audited.
  - (2) States that the financial statements are the responsibility of the company's management<sup>23,24</sup> and that the auditor is responsible for expressing an opinion on the financial statements based on the audit.
- c. A paragraph that —
  - (1) States that the audit was conducted in accordance with generally accepted auditing standards.
  - (2) States that generally accepted auditing standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.
  - (3) States that an audit includes —
    - (a) Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements,

<sup>22</sup> See note 1.

<sup>23</sup> Sometimes the auditor's client may not be the person responsible for the financial statements on which the auditor is reporting. For example, when the auditor is engaged by the buyer to report on the seller's financial statements prepared in conformity with a buy-sell agreement, the person responsible for the financial statements may be the seller's management. In this case, the wording of this statement should be changed to clearly identify the party that is responsible for the financial statements reported on.

<sup>24</sup> See note 2.

- (b) Assessing the accounting principles used and significant estimates made by management, and
  - (c) Evaluating the overall financial statement presentation.
  - (4) States that the auditor believes that the audit provides a reasonable basis for his or her opinion.
- d. A paragraph that —
- (1) Explains what the presentation is intended to present and refers to the note to the special-purpose financial statements that describes the basis of presentation (see paragraphs 9 and 10).
  - (2) If the basis of presentation is in conformity with generally accepted accounting principles, states that the presentation is not intended to be a complete presentation of the entity's assets, liabilities, revenues and expenses.<sup>25</sup>
- e. A paragraph that expresses the auditor's opinion related to the fair presentation, in all material respects, of the information the presentation is intended to present in conformity with generally accepted accounting principles or an other comprehensive basis of accounting. If the auditor concludes that the information the presentation is intended to present is not presented fairly on the basis of accounting described or if there has been a limitation on the scope of the audit, the auditor should disclose all the substantive reasons for that conclusion in an explanatory paragraph(s) (preceding the opinion paragraph) of the report and should include in the opinion paragraph appropriate modifying language and a reference to such explanatory paragraph(s).<sup>26</sup>
- f. A paragraph that restricts the distribution of the report to those within the entity, to the parties to the contract or agreement, for filing with a regulatory agency or to those with whom the entity is negotiating directly. However, a restrictive paragraph is not appropriate when the report and related financial presentation are

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<sup>25</sup> If the basis of presentation is an other comprehensive basis of accounting, the paragraph should state that the basis of presentation is a comprehensive basis of accounting other than generally accepted accounting principles and that it is not intended to be a complete presentation of the entity's assets, liabilities, revenues, and expenses on the basis described.

<sup>26</sup> Paragraph 31 of this statement discusses other circumstances that may require that the auditor add additional explanatory language to the special report.

to be filed with a regulatory agency, such as the Securities and Exchange Commission, and are to be included in a document (such as a prospectus) that is distributed to the general public.

- g. The manual or printed signature of the auditor's firm.
- h. The date.<sup>27</sup>

26. The following examples illustrate reports expressing an opinion on such special-purpose financial statements:

**Report on a Schedule of Gross Income and Certain Expenses to Meet a Regulatory Requirement and to Be Included in a Document Distributed to the General Public**

Independent Auditor's Report

We have audited the accompanying Historical Summaries of Gross Income and Direct Operating Expenses of ABC Apartments, City, State (Historical Summaries), for each of the three years in the period ended December 31, 19XX. These Historical Summaries are the responsibility of the Apartments' management. Our responsibility is to express an opinion on the Historical Summaries based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Historical Summaries are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the Historical Summaries. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the Historical Summaries. We believe that our audits provide a reasonable basis for our opinion.

The accompanying Historical Summaries were prepared for the purpose of complying with the rules and regulations of the Securities and Exchange Commission (for inclusion in the registration statement on Form S-11 of DEF Corporation) as described in Note X and are not intended to be a complete presentation of the Apartments' revenues and expenses.

In our opinion, the Historical Summaries referred to above present fairly, in all material respects, the gross income and direct operating expenses described in Note X of ABC Apartments for each of the three years in the period ended December 31, 19XX, in conformity with generally accepted accounting principles.

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<sup>27</sup> See note 5.

## **Report on a Statement of Assets Sold and Liabilities Transferred to Comply With a Contractual Agreement**

### Independent Auditor's Report

We have audited the accompanying statement of net assets sold of ABC Company as of June 8, 19XX. This statement of net assets sold is the responsibility of ABC Company's management. Our responsibility is to express an opinion on the statement of net assets sold based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the statement of net assets sold is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the statement. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the statement of net assets sold. We believe that our audit provides a reasonable basis for our opinion.

The accompanying statement was prepared to present the net assets of ABC Company sold to XYZ Corporation pursuant to the purchase agreement described in Note X, and is not intended to be a complete presentation of ABC Company's assets and liabilities.

In our opinion, the accompanying statement of net assets sold presents fairly, in all material respects, the net assets of ABC Company as of June 8, 19XX sold pursuant to the purchase agreement referred to in Note X, in conformity with generally accepted accounting principles.

This report is intended solely for the information and use of the boards of directors and managements of ABC Company and XYZ Corporation and should not be used for any other purpose.

## **Financial Statements Prepared on a Basis of Accounting Prescribed in an Agreement That Results in a Presentation That Is Not in Conformity With Generally Accepted Accounting Principles or an Other Comprehensive Basis of Accounting**

27. The auditor may be asked to report on special-purpose financial statements prepared in conformity with a basis of accounting that departs from generally accepted accounting principles or an other comprehensive basis of accounting. A loan agreement, for example, may require the borrower to prepare consolidated financial statements in which assets, such as inventory, are presented on a basis that is not in conformity with generally accepted accounting principles or an other comprehensive basis of accounting. An acquisition agreement may

require the financial statements of the entity being acquired (or a segment of it) to be prepared in conformity with generally accepted accounting principles except for certain assets, such as receivables, inventories, and properties for which a valuation basis is specified in the agreement.

28. Financial statements prepared under a basis of accounting as discussed above are not considered to be prepared in conformity with a “comprehensive basis of accounting” as contemplated by paragraph 4 of this statement because the criteria used to prepare such financial statements do not meet the requirement of being “criteria having substantial support,” even though the criteria are definite.

29. When an auditor is asked to report on these types of financial presentations, the report should include —

- a. A title that includes the word *independent*.<sup>28</sup>
- b. A paragraph that —
  - (1) States that the special-purpose financial statements identified in the report were audited.
  - (2) States that the financial statements are the responsibility of the company’s management<sup>29,30</sup> and that the auditor is responsible for expressing an opinion on the financial statements based on the audit.
- c. A paragraph that —
  - (1) States that the audit was conducted in accordance with generally accepted auditing standards.
  - (2) States that generally accepted auditing standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.
  - (3) States that an audit includes —
    - (a) Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements,

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<sup>28</sup> See note 1.

<sup>29</sup> See note 23.

<sup>30</sup> See note 2.

- (b) Assessing the accounting principles used and significant estimates made by management, and
  - (c) Evaluating the overall financial statement presentation.
  - (4) States that the auditor believes that the audit provides a reasonable basis for the auditor's opinion.
  - d. A paragraph that —
    - (1) Explains what the presentation is intended to present and refers to the note to the special-purpose financial statements that describes the basis of presentation (see paragraphs 9 and 10).
    - (2) States that the presentation is not intended to be a presentation in conformity with generally accepted accounting principles.
  - e. A paragraph that includes a description and the source of significant interpretations, if any, made by the company's management relating to the provisions of a relevant agreement.
  - f. A paragraph that expresses the auditor's opinion related to the fair presentation, in all material respects, of the information the presentation is intended to present on the basis of accounting specified. If the auditor concludes that the information the presentation is intended to present is not presented fairly on the basis of accounting described or if there has been a limitation on the scope of the audit, the auditor should disclose all the substantive reasons for that conclusion in an explanatory paragraph(s) (preceding the opinion paragraph) of the report and should include in the opinion paragraph appropriate modifying language and a reference to such explanatory paragraph(s).<sup>31</sup>
  - g. A paragraph that restricts the distribution of the report to those within the entity, to the parties to the contract or agreement, for filing with a regulatory agency, or to those with whom the entity is negotiating directly.
  - h. The manual or printed signature of the auditor's firm.
  - i. The date.<sup>32</sup>
30. The following example illustrates reporting on special-purpose

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<sup>31</sup> Paragraph 31 of this statement discusses other circumstances that may require that the auditor add additional explanatory language to the special report.

<sup>32</sup> See note 5.

financial statements that have been prepared pursuant to a loan agreement:

**Report on Financial Statements Prepared Pursuant to a Loan Agreement That Results in a Presentation Not in Conformity With Generally Accepted Accounting Principles or an Other Comprehensive Basis of Accounting**

Independent Auditor's Report

We have audited the special-purpose statement of assets and liabilities of ABC Company as of December 31, 19X2 and 19X1, and the related special-purpose statements of revenues and expenses and of cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The accompanying special-purpose financial statements were prepared for the purpose of complying with Section 4 of a loan agreement between DEF Bank and the Company as discussed in Note X, and are not intended to be a presentation in conformity with generally accepted accounting principles.

In our opinion, the special-purpose financial statements referred to above present fairly, in all material respects, the assets and liabilities of ABC Company as of December 31, 19X2 and 19X1, and the revenues, expenses and cash flows for the years then ended, on the basis of accounting described in Note X.

This report is intended solely for the information and use of the boards of directors and managements of ABC Company and DEF Bank and should not be used for any other purpose.

## **Circumstances Requiring Explanatory Language in an Auditor's Special Report**

31. Certain circumstances, while not affecting the auditor's unqualified opinion, may require that the auditor add additional explanatory



language to the special report. These circumstances include the following:

- a. *Lack of Consistency in Accounting Principles.* If there has been a change in accounting principles or in the method of their application,<sup>33</sup> the auditor should add an explanatory paragraph to the report (following the opinion paragraph) that describes the change and refers to the note to the financial presentation (or specified elements, accounts, or items thereof) that discusses the change and its effect thereon,<sup>34</sup> if the accounting change is considered relevant to the presentation. Guidance on reporting in this situation is contained in paragraphs 34 through 36 of SAS No. 58.
- b. *Uncertainties.* If the financial presentations (or specified elements, accounts, or items thereof) are affected by uncertainties concerning future events, the outcome of which is not susceptible of reasonable estimation at the date of the auditor's report, the auditor should add an explanatory paragraph after the opinion paragraph<sup>35</sup> if the uncertainties are considered relevant to the presentation.<sup>36</sup> For example, if the auditor is reporting on compliance with specific provisions of a loan agreement or on the fair presen-

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<sup>33</sup> When financial statements (or specified elements, accounts, or items thereof) have been prepared in conformity with generally accepted accounting principles in prior years, and the entity changes its method of presentation in the current year by preparing its financial statements in conformity with an other comprehensive basis of accounting, the auditor need not follow the reporting guidance in this subparagraph. However, the auditor may wish to add an explanatory paragraph to the report to highlight (1) a difference in the basis of presentation from that used in prior years or (2) that another report has been issued on the entity's financial statements prepared in conformity with another basis of presentation (for example, when cash basis financial statements are issued in addition to GAAP financial statements).

<sup>34</sup> A change in the tax law is not considered to be a change in accounting principle for which the auditor would need to add an explanatory paragraph, although disclosure may be necessary.

<sup>35</sup> The addition of an explanatory paragraph to the auditor's report to identify an uncertainty, as contemplated by this section, serves adequately to inform users of the financial statements (or specified elements, accounts, or items thereof). Nothing in this section, however, is intended to preclude an auditor from declining to express an opinion in cases involving uncertainties. If the auditor disclaims an opinion, the uncertainties and the possible effects on the financial statements (or specified elements, accounts, or items thereof) should be disclosed in an appropriate manner, and the auditor's report should give all the substantive reasons for his or her disclaimer of opinion.

<sup>36</sup> The auditor should consider the guidance in paragraphs 16 through 33 of SAS No. 58 on addressing and evaluating material uncertainties.

tation, in conformity with a specified basis of accounting, of a schedule related to a specific aspect of an entity's operations (such as a schedule of product royalties), an explanatory paragraph highlighting the material uncertainty arising from a lawsuit may not be necessary if the uncertainty is not relevant to the presentation. In contrast, such an explanatory paragraph would be necessary in a report on an entity's financial statements prepared on the cash basis because the uncertainty would be relevant.

- c. *Going Concern Uncertainties.* If the auditor has substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time not to exceed one year beyond the date of the financial statements, the auditor should add an explanatory paragraph after the opinion paragraph of the report only if the auditor's substantial doubt is relevant to the presentation.<sup>37</sup>
- d. *Other Auditors.* When the auditor decides to make reference to the report of another auditor as a basis, in part, for his or her opinion, the auditor should disclose that fact in the introductory paragraph of the report and should refer to the report of the other auditors in expressing his or her opinion. Guidance on reporting in this situation is contained in paragraphs 12 and 13 in SAS No. 58.
- e. *Comparative Financial Statements (or Specified Elements, Accounts, or Items Thereof).* If the auditor expresses an opinion on prior-period financial statements (or specified elements, accounts, or items thereof) that is different from the opinion he or she previously expressed on that same information, the auditor should disclose all of the substantive reasons for the different opinion in a separate explanatory paragraph preceding the opinion paragraph of the report. Guidance on reporting in this situation is contained in paragraphs 77 and 78 in SAS No. 58.

As in reports on financial statements prepared in conformity with generally accepted accounting principles, the auditor may add an explanatory paragraph to emphasize a matter regarding the financial statements (or specified elements, accounts, or items thereof).

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<sup>37</sup> See SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341), for a report example when the auditor has substantial doubt about the entity's ability to continue as a going concern. (Also, see note 35.)

## **Financial Information Presented in Prescribed Forms or Schedules**

32. Printed forms or schedules designed or adopted by the bodies with which they are to be filed often prescribe the wording of an auditor's report. Many of these forms are not acceptable to independent auditors because the prescribed form of auditor's report does not conform to the applicable professional reporting standards. For example, the prescribed language of the report may call for statements by the auditor that are not consistent with the auditor's function or responsibility.

33. Some report forms can be made acceptable by inserting additional wording; others can be made acceptable only by complete revision. When a printed report form calls upon an independent auditor to make a statement that he or she is not justified in making, the auditor should reword the form or attach a separate report. In those situations, the reporting provisions of paragraph 5 may be appropriate.

## **Effective Date**

34. This statement is effective for reports dated on or after July 1, 1989. Early application of the provisions of this statement is permissible.

*The statement entitled Special Reports was adopted by the assenting votes of twenty-one members of the board, of whom two, Messrs. Bintinger and Brown, assented with qualification.*

Mr. Bintinger qualifies his assent to the statement because he disagrees with the requirement in paragraph 5f and footnote 11 to paragraph 15f to restrict, in all circumstances, an auditor's report on financial statements prepared in conformity with regulatory accounting principles. When the entity does not prepare financial statements in conformity with generally accepted accounting principles, he believes the auditor should be able to report in a similar manner as for the other comprehensive bases of accounting described in paragraph 4.

Mr. Brown qualifies his assent to the statement because he believes that the requirement in paragraph 5d(2) and footnote 25 fails to clearly inform users about the lack of conformity with generally accepted accounting principles. It is intended that the term "a comprehensive basis of accounting other than generally accepted accounting principles" satisfy the first standard of reporting, but that term may be unclear to some users. If the financial statements are not presented in conformity with generally accepted accounting principles, he would prefer a clearer and more forceful statement to that effect.

Mr. Brown also qualifies his assent to the last sentence of paragraph 12 because he believes the first standard of reporting applies in all cases.

### **Auditing Standards Board (1988)**

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**Note:** *Statements on Auditing Standards are issued by the Auditing Standards Board, the senior technical body of the Institute designated to issue pronouncements on auditing matters. Rule 202 of the Institute's Code of Professional Conduct requires compliance with these standards.*